

PENN SQUARE BANK FAILURE

HEARINGS BEFORE THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

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FAILURE OF PENN SQUARE BANK

WEDNESDAY, SEPTEMBER 29, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The committee met, pursuant to call, at 9:30 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman) presiding.

Present: Representatives St Germain, Minish, Annunzio, LaFalce, Oakar, Vento, Barnard, Lowry, Schumer, Patman, William J. Coyne, Wylie, McKinney, Leach, Paul, Weber, McCollum, Carman, Wortley, Roukema, Lowery, and James K. Coyne.

The CHAIRMAN. The committee will come to order.

This morning we will resume hearings into the failure of the Penn Square Bank of Oklahoma City.

The shock waves from what was once a relatively obscure shopping center bank have rolled across financial institutions in at least 35 States and have stirred new doubts about the effectiveness of the Federal financial supervisory system.

Today's testimony will center on Penn Square's amazing ability to churn out and market energy loans to other commercial banks from coast to coast—loans that once held the glitter of fast-buck profits from the oil and gas fields of the Southwest.

With energy loans flowing out of Penn Square faster than Oklahoma was pumping oil, one can only speculate why no one in the Comptroller's Office had the curiosity to start tracing the streams across the financial community.

In fact, that parking lot at the little Penn Square shopping center became a veritable traffic jam of money brokers and bankers grabbing onto the financial merry-go-round, trying to get the brass ring, while the OCC continued to search its manual for the chapter on "go-go" banking.

The questions about why so many knew so little intensified after this committee discovered during the August 16 hearings in Oklahoma that Penn Square had secretly made millions of dollars of interest and principal payments to upstream banks on nonperforming loans—a fact that examiners should have uncovered quickly and sounded the alarm to the banks holding the delinquent paper, or at a minimum, raised yellow caution flags for their fellow regulators in the various regions.

I have expressed my disappointment in the Comptroller's Office, but it is all too easy to lay the total blame on the doorstep of the regulators. Banking judgments are made by bankers, not by the Comptroller.

For an industry that has made eloquent and frequent pleas for less regulation and less government interference, it is not particularly convincing to hear the argument that "Uncle Sam should have protected us."

Throughout this 2½-month investigation, we have constantly returned to the question of how sophisticated banking institutions, equipped with big staffs and big budgets, could slip so deeply into the Penn Square morass. What super sales pitch rolled off the tongues of the Bill Jennings and the Bill Pattersons?

I know that recounting mistakes and listening to Monday morning quarterbacking of banking judgments is not a happy task for any banker. We know that most, if not all, our witnesses today wish they had never heard of Penn Square. We have received excellent cooperation from the banks appearing here today and the committee is appreciative of this fact.

Two of the witnesses, John R. Lytle and John Boyd, have lost their positions at their respective banks—Continental Illinois and Seattle First National—in the wake of the Penn Square failure.

Clearly Penn Square is exacting a heavy toll on these two gentlemen. Despite this, both have been forthright and very cooperative as the committee has prepared for this hearing. We appreciate their willingness to help the committee unravel the story.

This testimony is essential to the legislative and oversight responsibilities assigned this committee by the House of Representatives. To understand what happened at Penn Square, it is very important that we have full knowledge of how these correspondent relationships began, how they grew, and how all the relationships developed between the various banking institutions and when and how much the regulators knew and what they did with the knowledge.

At this time the Chair would note that in compliance with House and committee rules, copies of these rules are available to the witnesses at the witness table.

In addition, each witness has been furnished in advance with a copy of the rules by mail.

Since some of the witnesses today will be accompanied by counsel, I should clarify now what the role of counsel will be.

Under the House and committee rules, witnesses at investigatory hearings may be accompanied by counsel to advise them of their rights. Counsel will not be allowed to address the committee unless the Chair grants permission to do so.

Any inquiries about the treatment of a witness before the committee should be addressed to the Chair by the witness, not by counsel. The Chair will do all within its power to protect the rights of witnesses under the rules and the Constitution.

The Chair will note for the record that there are seven members along with the Chair, a quorum for the taking of testimony.

Our first witness this morning will be Mr. John R. Lytle. Mr. Lytle, would you be good enough to approach the witness table with your counsel?

[Witness sworn.]

The CHAIRMAN. I understand you have a prepared statement, Mr. Lytle.

Mr. LYTLE. Yes, I do. Thank you.

The CHAIRMAN. We would be happy to hear from you at this time.

**TESTIMONY OF JOHN R. LYTLE, FORMER VICE PRESIDENT,
CONTINENTAL BANK'S MID-CONTINENT OIL & GAS DIVISION**

Mr. LYTLE. Mr. Chairman, members of the committee, my name is John Lytle. Until July of this year, I was manager of the Continental Bank's Mid-Continent Oil & Gas Division.

My division was responsible for the oil and gas participation loans with the Penn Square Bank. At the time the Comptroller of the Currency closed the Penn Square Bank on July 5, 1982, the Mid-Continent Division had approximately \$2.2 billion of oil and gas loans. \$1.056 billion were with the Penn Square Bank.

I graduated from the University of Illinois in 1957, with a bachelor of science degree in economics and finance. After serving 2 years as an officer in the U.S. Navy, 1957-59, I joined Continental Illinois National Bank in 1959, 23 years ago.

In 1977, I was made section manager, oil and gas division, with account responsibility for independent oil companies.

In August 1980, the oil and gas group was restructured. I was named manager of the newly formed Mid-Continent Division which had responsibility for independent oil companies in the geographic area east of Denver, except for Texas. The Oklahoma section was part of the Mid-Continent Division.

I have been published, on occasion, on articles relating to independent gas.

Continental Bank first started doing business with Penn Square Bank in 1978. I was introduced to Bill Patterson of Penn Square by Dennis Winget, head of the Continental's Oklahoma section.

A majority of the loans with Penn Square were overline participations. These were loans where Penn Square would make the loan and then sell a portion to the participating bank.

For example, if the total loan or credit were for \$10 million, Penn Square would take \$1 million and the participating bank \$9 million.

Even in the case of smaller loans, Penn Square often would sell 90 percent or more to the participating bank rather than take its legal limit share.

Significantly, in the case of participation loans, the loan documentation was initiated and held by Penn Square Bank.

The dollar amount of Continental participations and other loans with Penn Square customers increased each year in 1979 and 1980, increased dramatically in 1981 and continued to grow in the first quarter of 1982.

The following are approximate numbers:

As of December 31, 1980, Continental's loans with Penn Square customers were \$250 million; as of September 31, 1981, \$550 million; as of December 31, 1981, \$800 million; and as of June 30, 1982, \$1.056 billion.

This growth, in part, reflected the boom in the Oklahoma oil and gas economy and drilling activity which continued to expand at a rapid rate until approximately May of this year. The growth also

reflected the Continental Bank's aggressive pursuit of this business.

What is significant is that three-quarters of a billion dollars of new loans were booked subsequent to the Comptroller of the Currency's findings in April 1980, of banking violations by Penn Square Bank.

We at the Continental Bank were not privy to these findings. Nor were we told that Penn Square Bank was on the Comptroller's "watch list" of problem banks or that it was operating under an August 1980 letter agreement with the Comptroller's Office.

Almost \$500 million of Penn Square loans were added after July 1981, when, as we now know, the Comptroller's Office warned the Penn Square board of directors that the bank was flirting with disaster and considered issuing a cease and desist order.

Again, we at Continental were not informed of the Comptroller's assessment and the contemplated action regarding Penn Square.

Had we been timely informed of the Comptroller's adverse findings, we would not have increased our loan participations with Penn Square and would have taken protective steps in regard to existing loans.

Parentetically, we were not told that Mr. Eldon Beller was just a figurehead president with no loan authority for oil and gas loans, or 80 percent of Penn Square's total loan portfolio, as I understand, he testified in substance before this committee.

Bill Patterson told me on a number of occasions that loan approvals were held up because they were on Mr. Beller's desk awaiting approval.

As a result of the explosive growth in oil and gas loans in 1981, documentation and reporting problems developed. These, which I will call operating problems, were perceived as early as the fall of 1981 by Continental and corrective action was instigated.

For example, review of Continental's loan files disclosed certain of the loan documents were missing. These were participation loans where the loan documentation had been initiated by Penn Square and they had failed to supply Continental with copies of all the loan documents.

A list of missing documents was prepared and sent to Penn Square and they began furnishing copies from their loan files.

The CHAIRMAN. Are you saying the documents had never been provided prior to this event where you found out some were missing or they had been provided and disappeared?

Mr. LYTLE. I can't say with any certainty that there was never a case where documents were provided and disappeared. I might point out that these are not loan documents per se; they are photostatic copies of the documentation which was kept on record in Penn Square Bank. I can say with certainty that the vast majority of the exceptions we discovered at that time were documents that had not yet been provided to Continental Bank.

There was also a problem reconciling the principal and interest balances reported by Penn Square and Continental. As a consequence, certain loans were shown as past due when in fact principal and interest were current.

A Continental team was sent to Penn Square to reconcile the numbers. This was an ongoing project and not completed until

April 1982. The result of the investigation was to confirm that the past due problem was primarily a reporting and documentary problem and not a credit problem because the borrowers could not pay on time.

We were never told Penn Square had advanced interest payments on behalf of certain of its borrowers until late in the days of Penn Square's existence.

It was not until June 1982 that we had any reason to believe the Penn Square Bank was in trouble financially.

Before recounting the June events, I would like to refer to some statistics which reflect the dramatic and sudden turn down in the Oklahoma oil and gas economy.

Probably the best indicator of oil and gas activity is the Hughes count of active drilling rigs. As can be seen from the chart I have provided; the rig count in Oklahoma continued to increase during all of 1981 and in the first quarter of 1982.

As late as May 1982, the rig count in Oklahoma stood at 800 active drilling rigs, the highest in history, up 150 rigs, or 23 percent, from May 1981.

At the same time, drilling activity in Texas and nationally was down 18 and 13 percent respectively.

However, by June 1982—and the date I used was the day after Penn Square was closed, July 6—the Oklahoma rig count is down by 155 rigs from May and 45 rigs, 7 percent, from the preceding year.

By September of this year, the Oklahoma rig count was 479, down 321 rigs from May and 276 rigs, or 36 percent from the preceding year.

Thus the Oklahoma turn down had caught up with the statistics that were prevalent throughout the country by September.

The rapid deterioration in gas prices was equally dramatic. As late as May 1982, purchasers of gas in the Oklahoma deep, unregulated Anadarko Deep Basin were still aggressively seeking contracts.

El Paso Gas, a large buyer of natural gas supplying California, dropped its offering price in May from 110 percent of oil to 100 percent of oil, or to approximately \$6.60 per thousand cubic feet, but was still looking for customers.

At about the same time, Michigan-Wisconsin Pipeline reduced its price to \$6 per thousand cubic feet. The relatively low acceptance rate of the \$6 price indicated continuing optimism by sellers of gas. However, by July and August 1982, no one was offering contracts for deep gas in the Anadarko basin at any price.

Currently, Arkla Pipeline is offering \$3.50 per thousand cubic feet for deep gas on a 1- to 3-year contract.

As can be seen from the rapid decline in drilling activity and collapse in gas prices, the bottom fell out of the Oklahoma oil and gas economy in June of this year.

It was the week of June 14, 1982, that Bill Patterson told me that the Federal examiners were going to require Penn Square Bank to charge off approximately \$10 million to loss loans.

The CHAIRMAN. Excuse me. Was that when he visited you in Chicago?

Mr. LYTLE. I don't recollect.

The CHAIRMAN. Did he tell you this in person or telephone?

Mr. LYTLE. I don't recollect.

The CHAIRMAN. Was he alone when he told you this or was he accompanied by anyone?

Mr. LYTLE. I was about to say I guess he told me by telephone since about 80 percent of our communication was by telephone, but I cannot specifically recollect the date except the general week and the means by which he conveyed the \$10 million figure to me.

I immediately asked him if any losses were Continental participations; he said none. He further added he had arranged investors that would cover the \$10 million writeoff by additional purchases of Penn Square stock.

By the week of June 21, the estimated loan loss amount had grown to \$20 million. By the weekend of June 26 and 27, Patterson reported the Comptroller's Office was insisting that Penn Square raise \$30 million of new equity by June 30, or they were going to shut the bank down.

On June 29, the Comptroller's Office notified Continental's chairman, Mr. Roger Anderson, of the Penn Square crisis and the fact that an examiner from his office would meet the next day to review Penn Square problem loans in which the Continental Bank had participations.

On June 30 and July 1, we met with the examiners reviewing a list of problem loans compiled by them. It was in connection with this review that we learned for the first time of apparent missing collateral and collateral substitutions.

For example, according to our records and earlier representations by Patterson, a certain loan was secured by the unlimited guarantee of a wealthy individual affiliated with the drilling venture.

When the examiner suggested that the loan be charged off as a loss loan, I pointed out it was secured or supported by the unlimited guarantee of the individual.

The examiner said, "No, all you have is smaller—than the amount of the loan—limited guarantees."

Similarly, we were told by the examiner that another loan, instead of being secured by oil leases as shown on our copy of the note, was collateralized by a Florida marina.

This also came from the bank examiner on the 30th or 1st of July.

At some point during this review of loans, I called Patterson who had been suspended and was at home. Patterson's office files had been locked by either the Comptroller's Office or perhaps the FDIC. I told Patterson to go to his office, or have someone go to the office and have the examiners unseal his files and get the unlimited guarantee.

Patterson replied, "I'm sorry, John, I never got it."

On July 5, 1982, the Federal banking authorities pronounced Penn Square Bank insolvent and closed the bank. That same day, I was placed on special assignment.

On August 30, 1982, I was terminated.

In a press release, I charged that I was being made a scapegoat and I still feel that way. I wasn't responsible for the Penn Square collapse. And I wasn't responsible for Continental Bank's being in

the oil and gas business, and for their stated strategy of growing with the oil and gas business.

In a 1981 article entitled "In the Highflying Field of Energy Finance, Continental Illinois Bank Is Striking It Rich," the Wall Street Journal reported, and I quote in part:

Twenty-five years ago it wasn't easy for an independent oil man with a big dream to get the funding he needed. Most banks considered making loans like that too speculative.

But Continental Illinois National Bank & Trust Co., was willing to finance some of the projects that others refused.

Now, in an industry where memories are long, the bank is being rewarded for its years of attention. It has become a leader in the highflying field of energy finance.

And it's still building business by making deals other banks won't.

The article continues:

Continental's strategy could turn out to have an Achilles heel. If the price of oil continues to drop, energy companies will find it harder to repay bank loans.

If the price of oil [continues to] go up, everybody will be heroes again. If not, some banks may be hurt.

But Continental says energy financing is dangerous only for newcomers. Bank officials are also confident that the current drop in oil prices will be brief. "This is just a little blip," says John A. Redding, [my boss] senior vice president in charge of the bank's oil and gas group. He believes that Saudi Arabia's ability to manipulate oil prices will prevail over the softening effects of a decline in demand. "When the Saudis get the price where they want it," he says, "they will adjust supply to equal demand."

The article concludes:

While it has many admirers, Continental's aggressive lending style has also been criticized as unnecessarily risky. In response, Continental officials cite the bank's record. Cushioned in part by rising oil prices, chargeoffs and net loan losses in the energy area have averaged less than half of those in regular lending over the past five years, says Gerald Bergman [Redding's boss], executive vice president in charge of lending to special industries.

What happened to John Lytle is not important to this committee in its investigation. What is important is that corrective legislation be enacted which will prevent a recurrence of a Penn Square debacle to the extent possible.

Had the Comptroller's Office notified the participating banks of its knowledge of Penn Square's deteriorating financial and operating conditions, we would have taken steps to minimize or altogether avoid loan losses.

The CHAIRMAN. Thank you, Mr. Lytle.

[Mr. Lytle's prepared statement follows:]

STATEMENT OF JOHN R. LYTLE

Mr. Chairman and Members of the Committee:

My name is John Lytle. Until July of this year, I was manager of the Continental Bank's Mid Continent Oil & Gas Division. My division was responsible for the oil & gas participation loans with the Penn Square Bank. At the time the Comptroller of the Currency closed the Penn Square Bank on July 5, 1982, the Mid Continent Division had approximately \$2.2 billion of oil & gas loans. \$1.056 billion were with the Penn Square Bank.

I graduated from the University of Illinois in 1957, with a Bachelor of Science degree in economics and finance. After serving two years as an officer in the United States Navy (1957-59), I joined Continental Illinois National Bank in 1959.

In 1977, I was made Section Manager, Oil & Gas Division, with account responsibility for independent oil companies. In August, 1980, the Oil & Gas Group was restructured. I was named manager of the newly-formed Mid Continent Division which had responsibility for independent oil companies in the geographic area east of Denver, except for Texas. The Oklahoma section was part of the Mid Continent Division.

Continental Bank first started doing business with Penn Square Bank in 1978. I was introduced to Bill Patterson of Penn Square by Dennis Winget, head of the Continental's Oklahoma section.

A majority of the loans with Penn Square were overline participations. These were loans where Penn Square would make the loan and then sell a portion to the participating bank. For example, if the total loan or credit were for \$10 million, Penn Square would take \$1 million and the participating bank \$9 million. However, even in the case of smaller loans, Penn Square often would sell 90% or more to the participating bank, rather than take its legal limit share. Significantly, in the case of participation loans, the loan documentation was initiated by Penn Square Bank.

The dollar amount of Continental participation and other loans with Penn Square customers increased each year in 1979 and 1980, increased dramatically in 1981 and continued to grow in the first quarter of 1982. These are approximate numbers. As of 12/31/80, Continental's loans with Penn Square customers were \$250 million; as of 9/31/81, \$550 million; as of 12/31/81, \$800 million; and as of 6/30/82, \$1.056 billion. This growth, in part, reflected the boom in the Oklahoma oil and gas economy and drilling activity which continued to expand at a rapid rate until

approximately May of this year. The growth also reflected the Continental Bank's aggressive pursuit of this business.

What is significant is that three-quarters of a billion dollars of new loans were booked subsequent to the Comptroller of the Currency's findings in April, 1980, of banking violations by Penn Square Bank. We at the Continental Bank were not privy to these findings. Nor were we told that Penn Square Bank was on the Comptroller's "watch list" of problem banks or that it was operating under an August, 1980 letter agreement with the Comptroller's office.

Almost \$500 million of Penn Square loans were added after July, 1981, when, as we now know, the Comptroller's office warned the Penn Square Board of Directors that the bank was "flirting with disaster" and considered issuing a cease and desist order. Again, we at Continental were not informed of the Comptroller's assessment and contemplated action regarding Penn Square.

Had we been timely informed of the Comptroller's adverse findings, we would not have increased our loan participations with Penn Square and would have taken protective steps in regard to existing loans.

Parenthetically, we were not told that Mr. Eldon Beller was just a figurehead President with no loan authority for oil & gas loans, or 80% of Penn Square's total

loan portfolio, as I understand he testified in substance before this Committee. Bill Patterson told me on a number of occasions that loan approvals were held up because they were on Beller's desk awaiting approval.

As a result of the explosive growth in oil & gas loans in 1981, documentation and reporting problems developed. These - what I will call operating problems - were perceived as early as the fall of 1981 and corrective action was instigated. For example, review of Continental's loan files disclosed certain of the loan documents were missing. These were participation loans where the loan documentation had been initiated by Penn Square and they had failed to supply Continental with copies of all the loan documents. A list of missing documents was prepared and sent to Penn Square and they began furnishing copies from their loan files. There was also a problem reconciling the principal and interest balances reported by Penn Square and Continental. As a consequence, certain loans were shown as "past due" when in fact principal and interest were current. A Continental team was sent to Penn Square to reconcile the numbers. This was an ongoing project and not completed until April of 1982. The result of the investigation was to confirm that the "past due" problem was primarily a reporting problem and not a credit problem

because the borrowers could not pay on time. We were never told Penn Square had advanced interest payments on behalf of certain of its borrowers.

It was not until June of 1982, that we had any reason to believe the Penn Square Bank was in trouble financially.

Before recounting the June events, I would like to refer to some statistics which reflect the dramatic and sudden turn down in the Oklahoma Oil & Gas economy.

[<u>RIG COUNT</u>		Chg. fr. yr prev	O/O
	<u>May 3, 1982</u>	<u>May 4, 1981</u>		
Oklahoma	800	650	+150	+23
Texas	1,030	1,264	-234	-18
US	3,312	3,801	-500	-13
	<u>July 6, 1982</u>	<u>July 6, 1981</u>		
Oklahoma	645	690	-45	-7
Texas	817	1,350	-533	-39
US	2,816	3,984	-1,168	-29
	<u>Sept 7, 1982</u>	<u>Sept 8, 1981</u>		
Oklahoma	479	755	-276	-36
Texas	785	1,415	-630	-44
Total US	2,526	4,184	-1,658	-39]

Probably the best indicator of oil and gas activity is the count of active drilling rigs. As can be seen from the chart, the rig count in Oklahoma continued to increase during all of 1981 and the first quarter of 1982. As late as May, 1982, the rig count in Oklahoma stood at 800 active drilling rigs, up 150 rigs or 23% from May, 1981. At the same time, drilling activity in Texas and nationally was down 18% and 13% respectively.

In July, 1982, the Oklahoma rig count is down by 155 rigs from May and 45 rigs and 7% from the preceding year.

By September of this year, the Oklahoma rig count was 479, down 321 rigs from May and 276 rigs or 36% from the preceding year.

The rapid deterioration in gas prices was equally dramatic. As late as May, 1982, purchasers of gas in the Oklahoma deep, unregulated Anadarko Basin were still aggressively seeking contracts. El Paso Gas, a large buyer of natural gas supplying California, dropped its offering price in May from 110% of oil to 100% of oil, or to approximately \$6.60 per thousand cubic feet (MCF), but continued to actively buy. At about the same time, Michigan-Wisconsin Pipeline reduced its price to \$6.00 MCF. The relatively low acceptance rate of the \$6.00 price indicated continuing optimism by sellers of gas. However, by July and August of 1982, no one was offering contracts for deep gas in the Anadarko Basin at any price! Currently, Arkla Pipeline is offering \$3.50 MCF for deep gas on a one to three year contract.

As can be seen from the rapid decline in drilling activity and collapse in gas prices, the bottom fell out of the Oklahoma oil and gas economy in June of this year.

It was the week of June 14, 1982, that Bill Patterson told me that the Federal examiners were going to require Penn Square Bank to charge off approximately \$10 million of "loss loans." He said Penn Square had investors who would cover the \$10 million write-off by purchase of Penn Square Bank stock. I asked if any of the losses were Continental participations. He said none were.

By the week of June 21, the loan loss amount had grown to \$20 million. And by the weekend of June 26-27, Patterson reported the Comptroller's office was insisting that Penn Square raise \$30 million of new equity by June 30, or they were going to shut the bank down.

On June 29, the Comptroller's office notified Continental's Chairman, Mr. Roger Anderson, of the Penn Square crisis and the fact that an examiner from his office would meet the next day to review Penn Square problem loans in which the Continental Bank had participations.

On June 30 and June 31, we met with the examiners reviewing a list of problem loans compiled by them. It was in connection with this review that we learned for the first time of apparent missing collateral and collateral substitutions.

For example, according to our records and earlier representations by Bill Patterson, a certain loan was secured by the unlimited guarantee of a wealthy individual

affiliated with the drilling venture. When the examiner suggested that this loan should be charged off as a loss loan, I pointed out it was secured by the unlimited guarantee of the individual. The examiner said, "no, all you have is smaller (than the amount of the loan) limited guarantees." Similarly, we were told by the examiner that another loan, instead of being secured by oil reserves as shown on our copy of the note, was collateralized by a Florida marina.

At some point during this review of loans, I called Patterson who had been suspended by Penn Square and was at home. Patterson's office files had been locked by either the Comptroller's office or the FDIC. I told Patterson to go to his office and have the examiners unseal his files and get the unlimited guarantee. Patterson replied, "I'm sorry, John, I never got it."

On July 5, 1982, the Federal banking authorities pronounced Penn Square Bank insolvent and closed the bank. That same day, I was placed on "special assignment." On August 30, 1982, I was terminated. In a press release, I charged that I was being made a scapegoat. I still feel that way. I wasn't responsible for the Penn Square collapse. And I wasn't responsible for the Continental Bank being in the oil and gas lending business. In a 1981 article entitled "In the Highflying Field of Energy Finance,

Continental Illinois Bank Is Striking It Rich," the Wall Street Journal reported:

Twenty-five years ago, it wasn't easy for an independent oil man with a big dream to get the funding he needed. Most banks considered making loans like that too speculative.

But Continental Illinois National Bank & Trust Co. was willing to finance some of the projects that others refused.

Now, in an industry where memories are long, the bank is being rewarded for its years of attention. It has become a leader in the highflying field of energy finance.

And it's still building business by making deals other banks won't.

* * *

The article continues:

Continental's strategy could turn out to have an Achilles heel. If the price of oil continues to drop, energy companies will find it harder to repay bank loans.

* * *

If the price of oil (continues to) go up, everybody will be heroes again. If not, some banks may be hurt.

But Continental says energy financing is dangerous only for newcomers. Bank officials are also confident that the current drop in oil prices will be brief. "This is just a little blip, says John A. Redding, [my boss] senior vice president in charge of the bank's oil and gas group. He believes that Saudi Arabia's ability to manipulate oil prices will prevail over the softening effects of a decline in demand. When the Saudis get the price where they want it, he says, they will adjust supply to equal demand.

* * *

The article concludes:

While it has many admirers, Continental's aggressive lending style has also been criticized as unnecessarily risky. In response, Continental officials cite the bank's record. Cushioned in part by rising oil prices, charge-offs and net loan losses in the energy area have averaged less than half of those in regular lending over the past five years, says Gerald Bergman [Redding's boss], executive vice president in charge of lending to special industries.

What happened to John Lytle is really unimportant to this Committee in its investigation. What is important is that corrective legislation be enacted which will, to the extent possible, prevent a recurrence of a Penn Square debacle. Had the Comptroller's office notified the participating banks of its knowledge of Penn Square's deteriorating financial and operating conditions, we would have taken steps to minimize or altogether avoid loan losses.

DATED: September 29, 1982

The CHAIRMAN. As far as the legislation you suggested is concerned, don't you think it is just as important—on the one hand you want someone to notify the participating banks—that is important, but how about all the individuals that didn't have the sophistication of Continental and some of the other participating banks and yet invested in Penn Square, put deposits in over and beyond the \$100,000 limit hours before it shut down, members of the board of directors of Penn Square who 2 days before the demise of Penn Square put enormous sums of money over and beyond the \$100,000?

Don't you think we should look a little bit at their situation as well?

Mr. LYTLE. I agree, Mr. Chairman. We do not live in a perfect world. I don't think legislation is possible that can cure all problems.

The CHAIRMAN. I think what you are referring to, at least what the Chair is interested in, is that we come to our senses and realize that this requirement over the years, or this religious fervor over the years for secrecy be done away with and that we treat banks like we treat any other corporation in this country that is publicly held and that they have to issue reports to their stockholders that are accurate about nonperforming loans, and so forth.

Mr. LYTLE. Speaking as a public citizen, I believe I agree with you. My specific feelings about improvements in the legislation relate only to a very careful look at a specific problem.

If the bank examiner knows that there is no guarantee or that there is a discrepancy in the documentation of a note which has been sold to an upstream bank, it is my opinion that that upstream bank has the privilege of that secrecy and should not be excluded from the information.

That is the point I am trying to make.

The CHAIRMAN. By the same token, it appears as though the Comptroller's Office in one region didn't talk to the Comptroller's Office in another.

Otherwise the Comptroller's Office in the Chicago region would have looked more closely at these loans on your books, the participations.

Mr. LYTLE. Very definitely. We had the bank examiners in Continental in May. They were still there in June doing a routine examination of my division as well as the other oil and gas divisions.

We had problems developing we were discussing. We had one loan that was in serious condition. On the other hand, 12 months earlier the bank examiners had cited no loans for special consideration, any kind of rating, that were Penn Square overlies from Continental Bank, zero.

I have forgotten the statistic about our outstandings, but I would guess it was \$250 to \$500 million at that time.

Certainly some of the problems that existed when the FDIC and our special team went down in July 1982 had to have existed in May 1981.

The CHAIRMAN. I would say to the members of the committee, we are talking about computerized examinations in the future. You may have read some of the releases from the regulatory agencies. I think we want to look at that very carefully in view of what we are hearing from Mr. Lytle at this moment.

Mr. Lytle, in your testimony you mentioned a BGP Marina in Florida. Do you know any more other than what you just told us about that, that it is being used as a guarantee?

Mr. LYTLE. I heard the words BGP from Fortune Magazine or some other publication.

The CHAIRMAN. You didn't hear them from Mr. Patterson?

Mr. LYTLE. No; that is one of the cases I referred to.

The photostat of the note document we received said in the typed-in space that refers to the collateral, oil and gas leases and made no reference to real estate or a marina or whatever it was.

The CHAIRMAN. You are not aware of the fact this is a rather cause celebre down in the Clearwater-Tampa area of Florida?

Mr. LYTLE. I am not aware of the marina.

The CHAIRMAN. FBI raids, tapes on Patterson conversations, et cetera?

Mr. LYTLE. The first I learned of it was that information given to me by the Federal bank examiner who had examined Penn Square and who came up to visit us on the 30th and 1st.

He told me we did not have oil and gas leases, but rather, had some Florida real estate. After that——

The CHAIRMAN. A lot of it was under water?

Mr. LYTLE. That is right. Remember, I left the bank for practical purposes in terms of information gathering 3 days later.

After that all of my knowledge of the BGP and the switch of collateral I have learned in the newspapers and other publications.

The CHAIRMAN. I would like to insert in the record at this point a copy of an FBI affidavit for a search warrant of a residence in Clearwater, Fla., dated September 9, 1982.

[The material follows:]

United States District Court FOR THE MIDDLE DISTRICT OF FLORIDA

82-164M-W

Docket No.-----

Case No.-----

UNITED STATES OF AMERICA

A three-story residence at 700 Spottis Woode Lane, Clearwater, Fla., described as a red brick structure with attached garage (carport) consisting of approximately 40 rooms and located within a walled/fenced compound and bordering on an inter-coastal waterway.

AFFIDAVIT FOR SEARCH WARRANT

BEFORE U. S. Magistrate Thomas G. Wilson, Tampa, Fla. Name of Judge or Federal Magistrate Address of Judge or Federal Magistrate

The undersigned being duly sworn deposes and says:

That he has reason to believe that (on the premises known as) 700 Spottis Woode Lane, Clearwater, Fla., a three-story residence described as a red brick structure with attached garage/carport consisting of a-proximately 40 rooms and locate within a walled/fenced compound and bordering on an inter-coastal waterway.

in the Middle District of Florida

there is now being concealed certain property, namely telephonic voice recordings and/or tapes of conversations or transcripts of such recordings between Allen M. Se and Bill G. Patterson, which constitute evidence of the commission of a criminal offense in violation of Title 18, U. S. Code, Sections 1014, 656 and 371, or which are contraband, fruits of a crime, or things otherwise criminally possessed, or property designed or intended for use or which is or have been, used as the means of committing a criminal offense which are

here give alleged grounds for search and seizure

And that the facts tending to establish the foregoing grounds for issuance of a Search Warrant are as follows:*

(See Affidavit for Search Warrant)

ALFRED W. SCUDIERI Signature of Affiant Special Agent, Federal Bureau of Investigation Official Title, if any.

Sworn to before me, and subscribed in my presence, September 9, 19 82

THOMAS G. WILSON Judge or Federal Magistrate United States Magistrate

*United States Judge or Judge of a State Court of Record. If a search is to be authorized "at any time in the day or night" pursuant to Rule 41(c), show reasonable cause therefor. If the warrant is to authorize execution pursuant to 21 U.S.C. § 876 without prior notice of authority or purpose, indicate the circumstances creating the need for such a warrant.

AFFIDAVIT

82 - 164M.W

I. SUMMARY OF ALLEGATIONS

The following affidavit alleges that there is probable cause to believe violations of Title 18 USC Sections 1014, 371 and 656 have occurred relative to the purchase of real estate property belonging to Allen M. Senall and that these violations were carried out by certain officers of the Penn Square Bank of Oklahoma City, Oklahoma, and by other individuals, some of whom are known and others who are unknown, and that evidence of this crime is presently being concealed at the residence of A. M. Senall, 700 Spottiss Woodde Lane, Clearwater, Florida, in the form of voice recordings.

Affiant, Special Agent Alfred W. Scudieri, being duly sworn, depose and say:

II. BUSINESS ASSOCIATES OF ALLEN SENALL

On April 15, 1982, August 26, 1982, and September 7, 1982, Allen M. Senall, President, A. M. Senall Company, 714 Grand Central Avenue, Clearwater, Florida, was interviewed by Special Agents of the FBI and identified the following business entities and individuals with whom he has conducted business between the period 1980 to the present time:

The Metropolitan Bank and Trust Company (MBTC) of Tampa - a banking institution that was declared insolvent by the Federal Deposit Insurance Corporation (FDIC) on February 12, 1982; Donald Regar - the former president of MBTC; Paul Mansfield - a former MBTC loan officer; Allen Z. Wolfson - a Tampa based real estate developer currently incarcerated for bank fraud violations; John Eloian, a Tampa based osteopath and business associate of Allen Z. Wolfson; Arlis Roberts - a Tampa based businessman and associate of Allen Z. Wolfson; The Port Tarpon Marina - a condominium conversion project located at Tarpon Springs, Florida..

Thomas D. Chilcott, former operator of a fraudulent commodities investment pool in Colorado;

Samantha Petroleum Corporation, a Utah corporation, whose board of directors as of December 15, 1981, were: Allen M. Senall, Roger A. Larson, Clark Long, Brook Grant, and John Gaskill;

Brook Grant, former president of Samantha and former brother-in-law of Dick Penny, a vice president, Correspondent Banking Division, of Chase Manhattan Bank (CMB), New York, which participated in numerous loans to

loans to Senall's enterprises through Penn Square Bank (PSB), of Oklahoma City, Oklahoma;

Margaret C. (Meg) Sipperly, a loan officer of CMB;

Chase Manhattan Bank, a New York bank which was an "upstream" bank for PSB loan participations involving Allen Senall and others;

Maximo Moorings, Inc., (MMI), a Florida corporation, formerly owned by Allen M. Senall; Mitchell Joseph; Melvin Wank; Doug Robertson, and Clark Long;

Penn Square Bank, N. A., (PSB), a bank located in Oklahoma City, which was closed by the Controller of the Currency on July 5, 1982, currently known as Deposit Insurance National Bank of Oklahoma City, whose board chairman was Bill P. Jennings; whose president was Eldon L. Beller; and whose former president was Frank L. Murphy; whose senior executive vice president (Oil and Gas Division) was Bill G. Patterson; loan officers Tom Orr and Pat McCoy; senior vice president of Oil and Gas Division who was Tom Swineford; and whose director and executive vice president of Loan Administration was Rick Dunn;

BGP Marina, Inc., (BGP), a Florida corporation formed by Bill G. Patterson for the purpose of purchasing MMI from Allen Senall;

Clark Long, a former loan officer of PSB who subsequently was employed by Allen Senall of Samantha Petroleum;

Glen Terry, President of Samantha Petroleum;

Alan R. Miller, Attorney for Saket Petroleum;

Ken Tureaud, President of Saket Petroleum;

Walter Heller, a mortgage brokerage firm;

Herb Gruber, the Miami agent for Walter Heller.

III. FACTS OF INSTANT CASE

On April 15, 1982, Allen M. Senall told Special Agents Alfred W. Scudieri and Ronald H. Jordan of the FBI that he is in the business of purchasing boating marinas in Florida and elsewhere, and converting rental boat slips for sale under a condominium concept. He entered into a business arrangement with the Metropolitan Bank and Trust of Tampa to finance such a conversion at The Port Tarpon Marina, Tarpon Springs, Florida. According to Senall, a proposed financing package at MBTC was arranged by Allen Wolfson with Donald Regar and Paul Mansfield. This conversion was ultimately

financed with funds collected from individual investors including Wolfson and Arlis Roberts.

On August 26, 1982, Allen Senall advised Special Agents Alfred W. Scudieri and Gary Pilawski that he regularly dealt with Bill G. Patterson and Thomas Orr, officers of the Penn Square Bank of Oklahoma City, Oklahoma, as an individual and as a principal of Samantha Petroleum. He also acknowledged he knew PSB officers William Jennings, Frank Murphy and Eldon Beller. He identified Kenneth Tureaud, Alan Miller, Saket Petroleum, Thomas Chilcott and Melvin Wank as business associates of his who also borrowed at PSB.

Senall described his purchase of Maximo Moorings, Inc. for 6.5 million dollars. He borrowed 4.1 million of this amount from PSB. The Chase Manhattan Bank of New York participated in this loan. Meg Sipperly of Chase was his contact at that bank.

Senall said that in January, 1982, he was about to lose Maximo for non-payment of debts. He had conversations with Herb Gruber of the Walter Heller Corporation regarding his sale of the marina, but the transaction could not be finalized. In January, 1982, he was telephonically contacted by Bill G. Patterson who told Senall he wanted to "front" for the purchase of Maximo under the corporate name of BGP Marina, Inc. The sale of the marina to BGP occurred in March, 1982, and was financed at the PSB.

Senall advised he tape records all telephonic business conversations that are made to or from his residence. He advised he is in possession of several recordings with Patterson including the one described above which he maintains at his residence; however, he declined to furnish these tapes to the FBI.

On September 7, 1982, Special Agent James A. Montee, a C.P.A., examined records of the PSB relating to three PSB loans totaling 7.5 million dated March 10, 1982. The stated purpose of each loan was for use in acquisition of oil and gas leases. These loans were authorized by Bill G. Patterson and presented to PSB's loan committee by Patterson as being loans related to oil and gas investment ventures. Special Agent Montee's analysis of these loans determined that the proceeds of these loans, in fact, were used to purchase Maximo Marina, Inc., by BGP Marina, Inc., and not for use in the acquisition of oil and gas leases.

On September 7, 1982, Allen Senall was interviewed by Special Agents Scudieri and Montee, and at that time he advised that Thomas Swineford, Pat McCoy, Rick Dunn and Clark Long are employees of PSB with whom he has dealt regarding loans at PSB. He further identified Dick Penny as an officer of OMB with whom he dealt regarding loans. He identified Brook Grant, Mitchell Joseph, Doug Robertson and Glen Terry as individuals who, by virtue of their business association with Senall, had knowledge of Senall's loans with PSB.

Senall reiterated that he tape recorded business conversations at his residence and, as of September 7, 1982, maintained at least a portion of these recordings at his residence at 700 Spottis Woode Lane, Clearwater. He stated that in his opinion at least one such recording of a conversation between him and Bill G. Patterson contained evidence of a criminal act, specifically the misapplication of \$335,000 of bank funds by Bill G. Patterson. This is one of five recordings with Patterson he maintains at his residence. Senall again declined to furnish such recordings to the FBI and stated that he would not feel obligated to comply with a subpoena requiring their production.

Senall further stated that in his extensive experience in dealing with bank officers, it was not unusual for conflicts of interest to arise. In his opinion, "that's the way all bankers do business."

From my experience as a Special Agent of the FBI, I have learned that voice recordings are fragile in nature and are easily altered or erased.

All information contained herein received by Agents of the FBI other than the affiant, was directly conveyed to the affiant by these individuals.

ALFRED W. SCUDIERY, Special Agent
Federal Bureau of Investigation

Sworn to before me, and subscribed in my presence, September 9, 1982.

THOMAS G. WILSON, U. S. Magistrate

The CHAIRMAN. I would say this to you: You are no longer with Continental. If you wrote that statement yourself, you are a pretty good writer. You probably could write a tremendous novel based on Penn Square and probably make more money than you were making at Continental.

Mr. LYTLE. I have thought of that.

The CHAIRMAN. Mr. Lytle, in public accounts as you have stated, you have taken a great deal of blame and abuse for the problems that Continental has had as a result of their relationship with Penn Square. You were a vice president in the Mid Continent Oil & Gas Division of the bank. You had \$1 billion involved in these loans. Do you do this all by your onesy, solely, or were there any communications with anybody above you in this financial institution?

Mr. LYTLE. Yes, sir, daily.

The CHAIRMAN. Daily? So there were others who were reviewing the relationship between Penn Square or the purchase of participations from Penn Square you described to us earlier in the testimony?

Mr. LYTLE. Yes, sir.

The CHAIRMAN. Could you tell us who was your superior, monitor, adviser at Continental in this area?

Mr. LYTLE. From a chain of command point of view, I reported to John Redding, the senior vice president in charge of the oil and gas group. He had four divisions reporting to him. These divisions comprised all of the oil and gas lending done by Continental worldwide.

Mr. Redding reported to Gerald Bergman, head of special industries, and had a dozen divisions headed by three group managers, Jack Redding being one of them, reporting to him.

From a direct credit approval point of view with certain exceptions, that was the chain of command for credit approval.

The CHAIRMAN. Let me ask you this: You referred to the article that seems to be complimentary to Continental about how they were expanding and flying high and doing tremendously well in energy loans and that they were the experts and there was a payoff, their involvement over many years.

As a result of that article, certainly someone at the bank had to pay tribute to you for your work in this area.

Did you ever get a pat on the back from up in the ivory tower saying, gee, you are doing a great job. You are getting these wonderful participations?

Mr. LYTLE. It was sufficient for me to get a pat on my back from my boss. I got that frequently. His boss would occasionally compliment me. The bank was very fair to me in terms of compensation as well as the two promotions I recounted.

I might add I excluded from the quote in the Journal specific mention to three or four different customers that were mentioned as new customers and indicative of the type of new business, good work we had done.

I had been involved in bringing in two of them and indirectly involved with the other two, so I was getting credit and recognition for it and certainly feel that I was fairly treated in terms of my contribution.

The CHAIRMAN. Mr. Lytle, as you are aware, while we were down in Oklahoma City, the news hit the wires about some of your personal loans; and very frankly there was a little confusion as to the exact amount of your personal loans. Did you indeed borrow money?

Mr. Eldon Beller told us you had borrowed money for a home mortgage, but he was very, very vague at the time. Are you prepared at this point in time to tell us about this—these personal loans?

Mr. LYTLE. I would be happy to.

In June or July 1980, I mentioned to Bill Patterson that my then extensive home addition was going to require some additional funds. Bill said to me, why don't you borrow it from Penn Square?

At that time I had a \$170,000 loan with Continental Bank in their real estate department, and I said, well, Bill, that would be fine. You are a close correspondent bank and a good friend and I would be happy to do it; what would be the terms and conditions?

He said you would borrow on a mortgage type loan at prices charged similar borrowers.

I began a relationship by borrowing \$20,000, but from the moment that I started it, I had a tacit agreement with Patterson that if he wanted to take out Continental's \$170,000—well, it was an assignment of beneficial interest, but the effect of it was it is a first mortgage loan—he could take that out and would have a secured mortgage loan.

I continued to borrow from July 1980 through January 1982. The peak of the loan occurred in December 1981, was there for 30 days, and was fully paid—

The CHAIRMAN. What was the amount of the peak?

Mr. LYTLE. \$565,000. The loan was fully paid on January 25—

The CHAIRMAN. Was that secured, by the way?

Mr. LYTLE. No, sir.

The CHAIRMAN. That was unsecured?

Mr. LYTLE. Yes, sir.

The CHAIRMAN. How does the amount of that loan relate to your net worth? What is the ratio of the loan amount to your net worth?

Mr. LYTLE. Let me make that point.

From a credit point of view, whether to take collateral certainly is influenced by an individual's net worth, but it is equally influenced by his other debts because in the event of a crisis, or an inability to pay, the real competition is the other creditors, not the individual who is borrowing the money.

As my statement will show—and that is available to the committee if they are willing to look at it, I had virtually no other debts other than the \$170,000 that I earlier mentioned. Specifically, I had—

The CHAIRMAN. By the way, that you say was for an addition to your home?

Mr. LYTLE. Yes.

The CHAIRMAN. You know poor Mr. Beller down there in Oklahoma City thought that that was to buy a home. He didn't realize what the prices of homes are up there in the Chicago Continental area.

Mr. LYTLE. I paid considerably less for my home than I did for the addition.

I will say the addition was about 50 or 60 percent. I bought the house with a wife and put the addition on with four kids and two dogs.

Mr. ANNUNZIO. Mr. Chairman, would you yield on that point?

The CHAIRMAN. Sure, Mr. Annunzio.

Mr. ANNUNZIO. Mr. Lytle, did you ever report these loans to your superiors at the bank?

Mr. LYTLE. No, I did not.

Mr. ANNUNZIO. Why not?

Mr. LYTLE. I didn't feel and still don't, that there was any reporting responsibility. I borrowed from First of Winnetka 15 years ago to buy some real estate; I had a loan in the Continental Bank real estate department.

Mr. ANNUNZIO. But the Winnetka is next door to Continental. You are at Penn Square 1,000 miles away.

The CHAIRMAN. If I might reclaim my time, we can get to that point later, but I think Mr. Lytle is right. He wasn't borrowing from Continental, and I don't know of any responsibility.

Would you please continue?

Mr. ANNUNZIO. Mr. Chairman, did he have any deposits at Penn Square? Why was Penn Square so nice to him?

The CHAIRMAN. That is what I am trying to find out.

Mr. ANNUNZIO. He is a nice looking man, I know that.

Mr. LYTLE. I think we are talking about the quality of my loan.

The CHAIRMAN. I asked you what your collateral was.

Mr. LYTLE. There was no collateral.

The CHAIRMAN. Therefore, we would have to look at your net worth.

Mr. LYTLE. Net worth, and overall assets. I have done a careful computation of my personal financial statement as of the day before each of the notes that I took down at Penn Square, as I gradually built this facility up.

At no time in the course of my borrowing at Penn Square did I ever have less than 2 to 1 available collateral to cover the dollar amount of the loan, using as values, (a) appraised real estate, and (b) the subsequent price of oil and gas properties that I sold them for, so that I think both numbers prove to be at least conservative.

So the balance sheets showed no other debt, 2 to 1 asset coverage on the takedowns, and the handshake agreement with Bill Patterson—and I must point out at this time all during this time Bill Patterson and I had a relationship of extreme trust.

When I told Bill Patterson I would do something, he believed me. I told him that he could have collateral any time he wanted it.

The CHAIRMAN. By the same token, when he told you something, you believed him?

Mr. LYTLE. I did, sir.

The CHAIRMAN. The beliefs were well founded on both sides, or do you think maybe you got taken a little bit?

Mr. LYTLE. I wish I had never heard of Penn Square Bank, to quote the chairman.

The CHAIRMAN. How about Bill Patterson?

Mr. LYTLE. Same thing.

The CHAIRMAN. If you think he was a hero, tell us.

Mr. LYTLE. However, that condition did not prevail until June or July 1982. In carefully examining my relationship, in talking to my conferees in the bank, we had no reason to believe Bill Patterson was dishonest prior to that point.

Eclectic, colorful, certainly one of the best go-getters the oil patch has ever seen, but not dishonest.

The CHAIRMAN. You told us what the peak of your loans were. You told us you have a financial statement that is available to the committee?

That being the case, I will ask unanimous consent to have it inserted in the record at this point.

[The financial statement of Mr. Lytle follows:]

JOHN R. LYTLE PERSONAL NET WORTH STATEMENT

	<u>7/14/80</u>	<u>9/30/80</u>	<u>12/15/80</u>	<u>1/13/81</u>	<u>4/20/81</u>	<u>7/5/81</u>	<u>8/24/81</u>	<u>9/27/81</u>	<u>12/10/81</u>	<u>3/11/82</u>	<u>3/30/82</u>
Cash	1	2	1	3	1	18	13	43	4	31	36
Securities	1	1	1	1	1	1	1	1	50	40	40
Personal Property	60	60	70	75	79	79	104	104	125	125	125
Trust	150	150	150	150	150	150	150	150	150	150	150
House and Lot	500	525	550	575	575	600	600	625	650	675	675
Cash Value Life Ins.	2	2	2	2	3	3	3	3	3	5	5
Profit Sharing Net	35	35	35	35	35	30	30	30	30	30	30
Oil Properties Cost	0	0	0	0	0	63	63	68	68	182	5
Total Assets	250	775	809	841	844	947	964	1,024	1,080	1,238	1,030
Bank Debt-Continental	170	170	170	170	170	170	0	0	0	0	0
Penn Square	0	20	50	75	100	180	370	420	490	0	0
State Nat'l	17	17	17	17	17	18	18	18	18	18	17
1st Winnetka	20	20	20	20	20	20	20	15	15	15	15
Community Bk	0	0	0	0	0	0	0	0	0	565	264
Healdton	0	0	0	0	0	0	0	0	0	146	0
Total Bank Debt	207	227	257	282	307	388	408	453	523	744	296
Other Payables	5	5	5	5	5	5	5	5	5	5	5
Total Liabilities	212	232	262	287	312	393	413	458	528	749	301
Net Worth	538	548	547	554	532	554	551	566	552	489	729
Adjust Net Worth for market value of oil properties						52	52	112	112	+295	-4
						606	603	678	664	784	725

The CHAIRMAN. Mr. Wylie.

Mr. WYLIE. Mr. Lytle, in your opinion, who is the ultimate villain in the Penn Square episode?

Mr. LYTLE. I haven't had time to sit back and come to a conclusion that definite, Mr. Wylie.

I just don't know. Certainly there has been a lot of problems that have come up. I also might point out that I left Continental Bank effective as of July 5 and have not had the benefit of discovery since then as to the problems that occur in Continental.

Mr. WYLIE. Chairman St Germain made the observation that maybe it is a cast of thousands. I don't know. Would that be a proper characterization?

Mr. LYTLE. I think it would be closer than trying to identify one person, yes, sir.

Mr. WYLIE. Did Continental buy loans from Penn Square which were, in fact, made to Penn Square's own directors or to companies which those directors owned or represented?

Mr. LYTLE. Yes, sir.

Mr. WYLIE. Can you tell us how much money was involved in those loan participations?

Mr. LYTLE. No, not with any definite figure, but it would be safe to say where there was a direct or indirect involvement by a director, well over \$100 million of our portfolio.

Mr. WYLIE. Would it be fair to say that this amount is abnormally high relative to Continental's participation with other banks?

Mr. LYTLE. Which amount, sir?

Mr. WYLIE. The \$100 million you just mentioned.

Mr. LYTLE. I don't know that. It was relatively high compared to my division's participation with other banks, but I am not privy to the other dozens of divisions that Continental and their involvement with the correspondent banks.

Mr. WYLIE. How are the loans collateralized?

Mr. LYTLE. Our primary source of collateral was—and I presume continues to be—oil and gas reserves. Oil and gas reserves are unproduced oil properties where an appraisal has been made by an outside engineering firm and a loan value attributed to it.

Probably the second largest category would be refining assets and inventory. I answer this question with regard to my overall portfolio, not the specific guaranteed loans that you referred to.

Mr. WYLIE. Can you describe your relationship with Bill Jennings while you were at Continental?

Mr. LYTLE. My contacts with Jennings were cordial, infrequent, and I was respectful of him.

Mr. WYLIE. Did you personally extend personal loans to him at any time?

Mr. LYTLE. Did John Lytle or his Mid-Continent Division do so?

Mr. WYLIE. Yes, sir.

Mr. LYTLE. No.

Mr. WYLIE. Can you describe your relationship with Bill Patterson when you were with Continental?

Mr. LYTLE. Much more intimate, a close personal friend, a business relationship of deep trust, and one of constant contact; telephone primarily.

Mr. WYLIE. The chairman asked me to yield. I would be glad to.

The CHAIRMAN. Mr. Lytle, you got very close to Bill Patterson, handshakes, he lent you money, right?

In retrospect, would you not agree that he was lending you money so that he was taking you and Chicago—rather Continental Illinois—for a sleigh ride and that indeed he wasn't being your friend, but he was buying you?

Mr. LYTLE. I thought about that before I borrowed; probably not much during the borrowing, and then constantly since the collapse; so my answer is very sincere.

I think it takes a moment to recount the environment in which I was operating. Continental Bank wanted to build loans. We discovered in 1978 and later developed in 1980, and early in 1981, a very prolific producer of what we thought were excellent loans.

We were discovered by the Northern, SeaFirst, Chase, Michigan National, and others, as having had a tremendously close relationship with Penn Square.

As manager—and you remember I am not a lender, I am managing a group of lenders and approving their credits; I took it upon myself to build a very strong relationship on behalf of Continental Bank with Bill Patterson and with Bill Jennings, but primarily with Patterson.

Patterson is a loan obtainer; Lytle is a loan obtainer.

We go out on the street and find new customers. If I bring in a loan of \$30 million to Continental Bank, it is a proper loan, unsecured or secured, a good individual; I get a pat on the back.

When I gave what became a \$565,000 loan to Penn Square Bank, I was doing my best correspondent bank a favor in hopes of building a relationship.

The reason I used \$30 million at Continental is because that is roughly as important to us as the \$565,000 was to Penn Square.

This was a significant income earning asset for Penn Square, and I felt that I was doing Penn Square a favor and would obtain the opposite of the implication, Mr. Wylie, that you suggested.

Certainly the newspapers didn't report it that way, but that was the thinking that went through my going to that bank instead of the bank where I presently borrow in Oklahoma City or where I could have borrowed in Chicago.

It felt to me that it was something that was beneficial both to me and to the Continental Bank.

Mr. WYLIE. The answer to this question may require some thought on your part. I do think your opinion is important.

To what extent would you say Bill Jennings is responsible for Penn Square's failure?

Mr. LYTLE. That is a very difficult question, because it involves the responsibility of a chief executive for his people. If you said to me are my loan officers responsible for the bad loans that were made at Penn Square, I would say in part, but so am I.

I was their manager. I could have stopped them.

I could have discouraged this loan or that and did, of course, in many situations.

Certainly to an important extent as chief executive, further, as a very oldtime and experienced "oilie" in the Oklahoma oil patch, Bill Jennings had access to information about financial conditions

of companies that could have been and perhaps was very helpful to the lenders.

The degree of his day-to-day involvement in the oil lending, Mr. Wylie, is a mystery to me.

As I said in my prepared statement, I was flabbergasted by Beller's position. I thought that the bank had hired an excellent technician with many years of operating and credit experience to come in and relieve Jennings of some of this responsibility for overseeing Patterson.

I had conversations with Jennings on several occasions this year where he indicated there was a need to control Patterson, the implication being that Beller should do it or that he was doing it.

Certainly Mr. Jennings must bear a portion of the blame for the failure of Penn Square Bank.

Mr. WYLIE. So, should Bill Patterson bear a portion of the blame?

Mr. LYTLE. Well, to the extent that the discrepancies I have hinted at and certainly will come out eventually by the investigating authorities, yes.

To a lesser extent, in that his lending authority was perhaps limited, yes.

I agree he should bear a portion of the blame.

Mr. WYLIE. Thank you, Mr. Chairman.

I believe that is all I have right now.

Thank you, Mr. Lytle.

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. Thank you, Mr. Chairman.

Mr. Lytle, your statement is indeed interesting. I would have been more receptive to your statement if it had been more complete.

I think that in your statement you are being too modest. I also want to point out to you that I am not here to defend Continental or any other bank. They are big boys. You soon learn that on this committee, and they should be willing to take their lumps, but what bothers me is that in your statement there is not a single mention of the personal relationship you had with Penn Square and its officials.

Why have you not mentioned the rather large and strange loan of \$560,000 that was made to you by Penn Square?

I also would like to ask—answer me if you think there was not a conflict of interest. I am of the opinion there was a conflict of interest.

I don't think you could have received \$560,000 from Penn Square if you were not doing business with Penn Square. I don't think as an individual you could go to Oklahoma City and Penn Square, out of the goodness of their heart, give you a loan of \$560,000 on a piece of property outside of the city of Chicago.

I would like for you to answer that question.

Mr. LYTLE. I will try to remember all of the questions.

If I exclude one, please remind me.

The first question—I forgot. I didn't mention it.

In the letter Mr. St Germain sent to me inquiring into the subject that we are talking about today, there was no reference to my personal involvement.

However, I am aware that it has gotten tremendous publicity and it has also been carefully looked into by Federal authorities. I left it up to your level of interest to mention it.

Second, I have mentioned that in my opinion, as a credit man, the loan that I had at Penn Square was a good solid loan; one of the best evidences of a good solid loan is when you decide to pay it, you can pay it.

I further volunteer that Continental Bank criticized my participation with Penn Square in December 1981 and within 25 or 30 days I moved the full \$565,000 to another bank in Oklahoma City with whom I had no affiliation.

I got a commitment from that bank within 5 days.

Mr. ANNUNZIO. Tell us why you moved the loan.

Mr. LYTLE. Because Continental Bank criticized my participation, my borrowing from Continental—pardon 'me, my borrowing from Penn Square Bank, and while they didn't say move it, I said, you want me to move it, they said that would be fine.

I said I will move it.

Mr. ANNUNZIO. I yield to Mr. Barnard.

Mr. BARNARD. Did you get any help from Penn Square to move that loan?

Mr. LYTLE. Yes, sir.

Mr. JAMES COYNE. Could you have paid off the loan if you had not been able to roll it over?

Mr. ANNUNZIO. Do you want me to yield to you? I will yield. Go ahead.

Mr. JAMES COYNE. Could you have repaid that loan were you unable to find another bank to refinance it?

Mr. LYTLE. The answer to that question is, probably not in 5 days, but I have a house which the record will show has had an appraised value a year, 1½ years ago, of \$600,000, or a package of real estate, two contiguous lots.

Second, I had oil properties at the time which would be—and I am afraid I can't estimate it, but which had \$200,000 to \$300,000 in value.

I sold those oil properties at those values in March of this year, 60 days after I paid off the loan. So, frankly, Mr. Coyne, it would have taken longer than 5 days, but there was enough liquidity in the available assets to have paid it off, yes, sir.

Mr. ANNUNZIO. Mr. Lytle, if you thought there was no conflict of interest on these loans, why did you move the loans? I just cannot understand it.

Mr. LYTLE. I worked for the Continental Bank. I have been there 23 years. When I get a suggestion, I consider it a request or order. That is what I did.

Mr. ANNUNZIO. But in earlier testimony you thought that it wasn't necessary to report this loan that you made to your superiors at Continental Bank?

Mr. LYTLE. I did not report that loan. I did not report the \$170,000 loan which I made in our real estate department.

That may seem strange to you, but they weren't aware of that. We were a big enough organization so that that would be logical. I didn't report the Winnetka loan.

Mr. ANNUNZIO. After 23 years of working for an institution like Continental, you didn't feel that you had an obligation to report these types of loans being made with a bank that Continental was doing business with through you?

That sounds inconceivable to me because you are dealing—you know, you people that work in banks have an idea that this is your money. You are dealing with the people's money. It was the people's money that you were pushing back and forth.

Mr. LYTLE. Well, your opinion is consistent with that of some of the senior people at Continental. I differ with it.

Mr. BARNARD. Will the gentleman yield?

Mr. ANNUNZIO. I yield.

Mr. BARNARD. Just the reverse though, isn't that against the law?

I mean, from the standpoint of insider loans as covered by the Financial Institutions Regulatory Act of 1978?

Mr. LYTLE. I am not a lawyer, but it is my opinion that I am not an insider.

Mr. BARNARD. What about in the reverse? Didn't Mr. Patterson have some loans with you?

Mr. LYTLE. Let me continue on the first point. Of course, subsequent to this I have inquired of counsel and we have talked with Federal authorities about it and nobody has suggested that the loan was illegal or improper.

In answer to your question regarding Patterson, the answer is not to my knowledge. We never made a loan to Bill Patterson at Continental Bank.

Mr. ANNUNZIO. Mr. Lytle, one more question.

My time has expired. You say that there was no conflict of interest. Can you name for me the names of any other individuals at Continental Bank who received loans from Penn Square, and I assure you that if you name those individuals, I will ask the chairman of this committee to subpoena those individuals to this hearing?

You say you are the scapegoat. Tell us what other individuals at Continental got loans?

Mr. LYTLE. I am aware of only in name, not detail, that Mr. Brednick, Gary T. Brednick, and Mr. Ralph Kramer—K-r-a-m-e-r—both had credit relationships at Penn Square. I might also add, Mr. Annunzio, I am aware in an equally superficial way that Mr. Jennings had a very significant personal loan at Continental Bank, \$7 to \$10 million would be my guess.

Mr. ANNUNZIO. Are you the scapegoat for these people? Do you consider yourself the scapegoat for these people?

Mr. LYTLE. No.

Mr. ANNUNZIO. Mr. Chairman, my time is up. I would like to know who you are the scapegoat for.

The CHAIRMAN. For the record, Mr. Lytle, could you give us the titles of the two gentlemen whose names you mentioned?

Mr. LYTLE. Vice presidents in the Mid-Continent Division.

The CHAIRMAN. In other words, the same division you were in?

Mr. LYTLE. They reported to me.

The CHAIRMAN. They were under you?

Mr. ANNUNZIO. Did they have the same sweetheart deals that you had?

Mr. LYTLE. I said I had no knowledge of the details. I might add that I had no knowledge of the loans. I was not informed by either one of them of their credit relationship and have learned of it in the last 30 to 60 days.

The CHAIRMAN. To clear up the record again, as far as the loan to Jennings is concerned from Continental, was that a personal loan or a stock loan?

Mr. LYTLE. Well, a stock loan might be a personal loan.

The CHAIRMAN. Was it a loan to the holding company?

Mr. LYTLE. No, sir.

The CHAIRMAN. It was to Jennings as an individual?

Mr. LYTLE. That is my information.

I might explain that that kind of a loan, a loan to an individual secured by real estate or whatever interest Mr. Jennings has wouldn't be handled by my division in the normal course of business, which explains my lack of knowledge of the credit facility.

I believe it has been subsequently paid, I might add.

The CHAIRMAN. Mr. Paul.

Mr. PAUL. Thank you, Mr. Chairman.

Mr. Lytle, I have a question that is not nearly as specific as those you have been receiving.

It is more generalized and more philosophic. My understanding of the inflationary process is that when governments create money and credit there is bound to be malinvestment and misdirection of investment.

I am of the firm conviction that we as a government have been creating a lot of new money and credit out of thin air. For this reason it is inevitable that we will have misdirection and malinvestment of many, many funds.

If we have a sound monetary system, one can make good decisions in banking, but loans can go sour. I would like you to respond as to what you think is the most important here: Did we come upon this problem because of bad decisions, in a major sense, or has it come about because there has been an inflationary climate, a massive creation of new money and credit out of thin air, which causes an inevitable misdirection and malinvestment of money?

Do you think both are involved? Which one is the most important?

Mr. LYTLE. That is a question for an economist. My initial or superficial reaction is that we certainly benefited in building our portfolio by the tremendous increases in oil values in the late seventies and early eighties; but you must look back at why those oil values occurred and then you get into the general U.S. economy and you get into questions about controlled prices in the Middle East.

I am not sure that it really is an oil answer, but very clearly a lot of the growth and outstanding things that we saw was a result of increased asset values.

I might say further a lot of the losses that apparently are contemplated by the overline banks are the result of decreased asset values in the portfolios they held as collateral.

One of the reasons those asset values has decreased is that credit in the Oklahoma environment is now frozen. There is a panic down there. There is no credit available. When you don't have a buyer who can borrow, you don't have a price. That is one of the reasons why these losses are being incurred.

So it is a two-edged sword. The lack of credit certainly hurts the economy. Perhaps as you are suggesting, an excess of credit could hurt the economy.

Mr. PAUL. It seems to me that if there is a massive increase in asset value and a reaction where the asset value drops at least on paper, it is the result of a bad monetary system.

I happen to believe that our problems are a result of the monetary policy that exists here, for it entices people to participate in exactly what happened down there, and that is a lot of bad decisionmaking because people are getting the wrong information from the marketplace.

That is all I have, Mr. Chairman.

Mr. LYTLE. I might make just one further comment, Mr. Paul. An additional problem, which I certainly wouldn't suggest is a problem with this committee, was the irregular effects as the result of the Natural Gas Policy Act passing and the tremendous emphasis that it placed on deep unregulated gas.

A huge portion of the money spent in Oklahoma in the last 3 years went into the sub 15,000 drilling area and a huge portion of the losses that are going to be incurred went into that.

One of the effects of this concentration was a deemphasis and a deeconomization of the value of the shallow gas. We also were plugged at much earlier times in their history because so much deep gas was available.

As that stopped, the economy slowed down.

If full deregulation had been enacted at the time of the NGPA, I think this problem would have been severely mitigated.

Mr. PAUL. I think that is an important point too. Not only do we put out a lot of misinformation by messing up the monetary system, but we send out a lot of misinformation regularly with our policies of regulation, deregulation, and whatever.

Thank you.

The CHAIRMAN. Ms. Oakar.

Ms. OAKAR. Thank you, Mr. Chairman.

Mr. Lytle, to what extent in your position as vice president in charge of this division were you part of the decisionmaking process dealing with Penn Square?

Mr. LYTLE. Would you like to know what my loan limit was and the administrative process of approval?

Ms. OAKAR. I just want to know if you had any part of the decisionmaking process. Did you make the recommendation, for example?

Mr. LYTLE. Certainly, I understand.

All accounts or prospective accounts are assigned to loan officers. A loan officer in my division in large part working with a professional engineer who is on our staff in payroll prepares a loan proposal, a formal written proposal, suggesting that a credit be enacted. That proposal is approved by himself and by the engineer

where it is required and then circulated up the chain of management to a predetermined altitude.

That altitude is determined by the size of the loan.

If the loan were \$5 million and my limit—and it was for a while—was \$5 million, then the loan officers, the engineers, and my approval would be sufficient to commit and disburse the credit.

At that point a review process is automatically enacted which is completely out of the control of the lending division.

First, the loan division, the operating area, follows for documentation and makes sure that the document package is complete, with backup from our inside or outside counsel.

Ms. OAKAR. So you were the number one individual to make the recommendation and it was up to a committee afterward to either disprove or approve your recommendation, is that right?

Mr. LYTLE. That is not correct. The No. 1 person making the recommendation in all cases is the loan officer responsible for the account. I only used myself as an example.

If the loan were a legal limit loan, or \$150 million or something like that, the same process would occur. The loan officer would prepare a recommendation. He would give it to his section head or in the absence of his section head, which was the case in Oklahoma, his division manager.

I would give it to my group manager. The group manager would give it to the department head and all of those requirements would be necessary for approval.

Ms. OAKAR. When you give it to your department head, would you have any recommendation attached?

Mr. LYTLE. Yes.

Ms. OAKAR. And you recommended that this be granted?

Mr. LYTLE. That is correct.

Ms. OAKAR. Now you worked for this institution for 23 years?

Mr. LYTLE. Yes, ma'am.

Ms. OAKAR. Is there anything in the bylaws of your bank Mr. Chairman, this is a little faintly reminiscent of the *Bert Lance* case where this committee, which I was a member of at the time, looked at bylaws of his bank.

Is there anything in the bylaws or were you ever told during the course of your 23 years of experience that it would be perceived as a conflict of interest if you indeed engaged in using your position for any perception of personal gain?

The CHAIRMAN. With a correspondent bank?

Ms. OAKAR. Right.

Mr. LYTLE. I am not comparable to Bert Lance in that I am not a comptroller or executive officer in the bank, I might say parenthetically.

The CHAIRMAN. Mr. Lytle, we looked—what we looked at with Bert Lance had nothing to do with his being the Comptroller or at OMB.

Mr. LYTLE. No; I said a control person at the Continental Bank. I am not an executive officer by any definition and there is a very clear definition of that.

The bank has rules, a policy. I have never seen the bylaws of the bank. It has rules of personal conduct and policy.

Ms. OAKAR. What do they say?

Mr. LYTLE. They are 15 or 20 pages.

Ms. OAKAR. Anything that relates to your requesting of a client a half million dollar loan. This is flabbergasting to me. So many people, you know, are probably trying to get mortgages from your bank, just average kinds of loans. You get a half a million dollar loan.

Mr. LYTLE. The bank doesn't discuss size at all with regard to this area.

It specifically says you should not borrow from a correspondent bank unless it is for certain personal needs including homes and then gives two or three other examples, personal investments I believe is another one.

Ms. OAKAR. They do caution you about dealing with—

Mr. LYTLE. They describe very carefully the parameters under which you should deal with a correspondent bank.

Ms. OAKAR. You were within those parameters?

Mr. LYTLE. It was my opinion I was within those parameters. That is correct.

Ms. OAKAR. When you mention that you had a hand shake agreement—and I am referring to your response to a question—for this loan, what do you mean by that?

You were talking about your relationship with Mr. Patterson, how much you trusted each other, all that.

Mr. LYTLE. A handshake agreement in my opinion means that I have said to Bill Patterson I will supply collateral to him whenever he asks for it.

Ms. OAKAR. Didn't you have to fill out forms like most normal people who deal with a bank do? How did you get this loan?

Mr. LYTLE. When he asked for it, if he ever had, I would have plenty of forms to fill out.

Ms. OAKAR. You mean you never filled out the normal—you were not treated under the normal conditions that an individual who tries to get any loan, whether it is \$20,000, \$5,000?

Mr. LYTLE. That is not correct at all.

Ms. OAKAR. Let alone one-half a million.

Mr. LYTLE. That is not correct at all. I completely complied with all of the documentary requirements of an unsecured loan from Penn Square Bank.

Ms. OAKAR. What do you mean by a hand shake—

Mr. LYTLE. The hand shake relates to my commitment to Patterson to provide collateral which would convert the existing unsecured loan to a secured loan.

When you pledge real estate, as you well know, that is a lot of documents.

Ms. OAKAR. My time has expired, but I have to say that it occurs, at least to this member, that this was extraordinary conditions and it certainly appears to be a conflict.

Thank you.

The CHAIRMAN. Mr. Lytle, at any point did Continental, with its vast resources and outstanding energy team, did they at any point have engineers and energy experts in Oklahoma City or in Oklahoma who went to the sites of these loans, energy loans, to determine if the information and documentation from Penn Square was accurate?

Mr. LYTLE. Mr. Chairman, routinely in every case that I am aware of Continental Bank's engineers made independent—that is, independent of Penn Square—verification of the engineering information on which we made the basis of our loan values.

The CHAIRMAN. Excuse me. Let's be a little more specific. Because the board of directors down at Penn Square thought you had engineers living there 365 days a year. Were these engineers—did they go to Oklahoma? Did they actually look at the sites, or did they just look at data and analyze data?

Mr. LYTLE. Site viewing doesn't really provide very much in the way of loan value. Historical performance and engineering interpolation is what provides loan value.

Our engineers went either to the offices of the borrowing customer of Penn Square and looked at their internal records, or they went to a third party, independent consulting petroleum engineering firm, much like an auditing or CPA firm, and looked at the records which that firm had prepared on behalf of the borrower.

Most frequently, at one time or another, they visited both offices. Always in the case of a new customer, we would visit both the borrower and the outside engineering firm. There were some cases where large independent oil companies did not feel the need for an outside engineering firm.

A private firm with no SEC reporting responsibilities might hire a purely professional staff of reservoir engineers who did all of their inside work. In that case, Continental Bank's engineers would go directly to that firm and obtain decline curve production information, estimates of comparable reservoirs, and form their opinion directly as a result of their own observations.

The CHAIRMAN. Which would lead this Member to wonder about the qualifications of that high class group that you had at Continental to evaluate.

Mr. LYTLE. Well, I can only qualify my answer by saying that I am not privy to the details of the reported lost reserves. I have not seen that. I also must say, in all fairness, that there has been a very severe decline in reserve values. It was common practice a year ago, and I say common—

The CHAIRMAN. Excuse me, Mr. Lytle. I have to call on other members.

You know, don't keep harping on the fact that the price of oil went down. The problem at Penn Square began long before the price of oil ever started to go down.

Mr. Weber.

Mr. WEBER. Mr. Lytle, we are here today to determine whether there is a need for new legislation to obtain the information needed to find out what went wrong, whether the laws and regulations on the books today were properly executed or not properly executed, or do we need new laws, or do our laws need to be strengthened, or new instruments of public protection need to be provided.

You are telling us that what went wrong is a lack of notification and disclosure. That may be the case. We may need a notification and disclosure system rather than the longstanding policy of non-disclosure we have had under existing law.

But, before we go into that kind of a system, I think that we need to know more about your conduct with this bank, and I am

not here to say whether or not the personnel policies of your bank were violated, much less whether any violation of law occurred, but in my judgment I will say that I cannot think of a situation in which there was a more clear case of a conflict of interest than the unsecured loan of \$560,000 that was granted to you, whether or not it was at market rates of interest, whether or not it was adequately secured by your own personal net worth in that situation.

You were in a situation where apparently you were granting loans to this bank which had given you that unsecured loan, extended that loan to you without adequate loan documentation.

Were you on the team of investigators that went to Penn Square to determine this problem with the past due accounts?

Mr. LYTLE. No, I was not. That was done by a group of operating, experienced people from the loan division and from other areas of the bank.

Mr. WEBER. Apparently they didn't turn up anything they should have turned up if the investigation had received to the truth of the matter. Apparently also you were extending loans on representations, oral representations that there was an unlimited guarantee from some individual.

What I want to know is, you mentioned in response to Congresswoman Oakar's line of questioning that before extending a loan you and your department would review the loan package, the document package. If the document package was being reviewed, why did you in fact make advances to Penn Square on the basis of where a documentation was missing? Especially not only the routine documentation, but especially relying on what was apparently a guarantee which had never been shown to you?

Mr. LYTLE. I can only answer that in the second person. I did not have the responsibility for reviewing documentation packages. I have explained our procedure for making these loans. I very seldom saw a document as it passed from customer to Penn Square to us to our loan division, but I can envision a number of circumstances that I would regard as normal where a loan officer might make a commitment based on a sufficient amount of documentation, but not full or complete documentation in the interests of completing the transaction for some outside reason, and, as you know, customers are always in a hurry.

We might make the commitment without full documentation. Then follow forward later. That was the case in the failure to receive the fully—the unlimited guarantee that I referred to in my opening statement. We also had cases where documentation was given to us in photostat and then released by Penn Square without our knowledge.

Ms. OAKAR. Will the gentleman yield?

Mr. WEBER. I will be happy to yield.

Ms. OAKAR. Did you approach Mr. Patterson concerning your personal loan prior to your reviewing the Penn Square deal?

Mr. LYTLE. What do you mean by deal, Ms. Oakar?

Ms. OAKAR. The transaction between your bank and Penn Square.

Mr. LYTLE. Well, our relationship with Penn Square was ongoing. It began in 1978 and continued until July 5 when the bank failed.

Ms. OAKAR. Then let me rephrase it. I am sorry to take the gentleman's time on this.

Precisely when did you approach Mr. Patterson concerning your own personal loan?

Mr. LYTLE. July 1980.

Ms. OAKAR. Precisely when did you have anything to do with the Penn Square review?

Mr. LYTLE. I was a section manager in the oil and gas division beginning in 1977. It is my recollection that our first contacts with Penn Square began in 1978.

Ms. OAKAR. When did they finally get approval of the transaction?

Mr. LYTLE. As I said just a moment ago, we had continuing transactions.

The first transaction, if it was in 1978, would have been consummated in 1978.

Ms. OAKAR. When was the final approval? What date?

Mr. LYTLE. Of the first transaction at Continental with Penn Square?

Ms. OAKAR. Of the final transaction.

Mr. LYTLE. July 5, 1982, I presume. We had daily contact and did daily transactions until the bank closed. I am afraid I am not quite following the gist of your questioning.

Ms. OAKAR. I guess my questioning relates to whether or not part of the deal was that you would get this loan and possibly be influenced in terms of your sanctioning of the continuing relationship between your bank and Penn Square.

Mr. LYTLE. Well, I can only say that we were buying loans actively before my first borrowing. When I terminated it on January 25, there was no down turn in our activity. We, in fact, put another quarter of a billion dollars worth of loans on after that date.

Mr. WEBER. May I reclaim my time? I know my time is expiring or has expired.

May I ask one further question? How much blame would you attribute to the poor loan documentation and the review for the money that Continental Bank lost?

Mr. LYTLE. Mr. Weber, an answer to that would be a guess and that I believe would be irresponsible. I have not been in Penn Square or reviewed the documentations that led to the poor loan documentation except on June 30 and July 1.

We have had 30 people down there working 6-day weeks since then. That is where the discoveries come from. It has not been reported to me.

If you want me to guess, I would say substantial. That is almost an irresponsible guess because I don't know.

The CHAIRMAN. Mr. Lytle, you and Mr. Patterson, as you say, became close personal friends. It has been brought to our attention Penn Square did some rather lavish entertaining of customers as well as correspondents and people in institutions like yourself that were doing business. Were you the recipient of any of this lavish entertainment? Lavish could be—depends on the eyes of the beholder.

Some might say taking you to McDonald's for a hamburger was lavish. Others might say well, it was Burger King. I don't know if you like them stir fried, pan fried, or charcoal fried.

Did you have dinner with Mr. Patterson when he was in Chicago?

Mr. LYTLE. Quite frequently.

The CHAIRMAN. I don't know if you saw the article in Fortune magazine, where it shows a picture of Mr. Patterson standing there, heaving drumsticks around. In other words, he was throwing food around the restaurant; in the Cowboy's Club in Oklahoma City, drinking beer out of his boot. Were you ever with him when he was a little cantankerous?

Mr. LYTLE. Yes. Apparently, if the press can be accurate—is accurate, I missed most of it, but on occasion I saw Patterson acting cantankerous.

The CHAIRMAN. Did that give you reason to question—the people from Manufacturers-Hanover in the Cowboy's Club saw him drinking beer out of a boot and said, "We don't want any part of that guy."

Sometimes one looks at the activities of an individual who is supposedly a good businessman and how responsible they are after hours as well. That didn't give you cause to pause?

Mr. LYTLE. Bill was a new business producer. He wasn't a loan officer at Continental and he wasn't responsible for any of the decisionmaking that was made at Continental. There weren't any loans put on at Continental by Bill Patterson. If that was his style and if it was offensive to some—and on occasion it was to me——

The CHAIRMAN. You found it amusing?

Mr. LYTLE. I said on occasion it was offensive to me. On occasion I found it amusing. If that was his style, that was what made Bill the best oil and gas new business producer in the Southwest, and we accepted it with a grain of salt and continued to process our loan applications in the same rigorous detail that we did in other loans that didn't come from Penn Square.

The CHAIRMAN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

Mr. Lytle, what percentage of the oil and gas division business in your years of experience were extended to Penn Square activities as one of the corresponding banks that had business with you?

What percentage of the business went to that particular institution compared to the total that you had responsibility for?

Mr. LYTLE. I had, on June 30, \$1.056 of overlines and direct shared credits from Penn Square originated customers.

Of that approximately one-third was direct business and two-thirds was participations.

At that date or near that date, I had \$2.2 billion of outstanding loans so that \$1.2 billion was generated from other correspondent banks and in direct credit relationships.

Mr. VENTO. Sounds like about two-thirds. Two-thirds, three-fifths of your business in this area was solely with Penn Square?

Mr. LYTLE. Not quite. If you mean participations from Penn Square and if we use for the record \$600 million, that would be less than one-third.

I should add further, when you mention oil and gas business, that I was manager of, but one of four divisions and they all had substantial outstandings, so that Penn Square's involvement at Continental might have been a substantially lower percentage, 10 or 15 percent.

Mr. VENTO. Ten or fifteen percent, but a major portion of the business that you were engaged in was with Penn Square and your responsibility—

Mr. LYTLE. Certainly in my area of responsibility.

Mr. VENTO. Were any other customers approaching that particular level?

Mr. LYTLE. No, sir.

Mr. VENTO. Could you give us an order of magnitude for the committee and perhaps give us more precise information for the record?

Mr. LYTLE. I don't have it. We did not keep records of total outstandings per correspondent bank, but instead looked through the bank in keeping with our credit analysis procedure to the borrower himself and kept records of total outstandings per borrower or per group of affiliated borrowers.

Mr. VENTO. I understand the dynamics, Mr. Lytle, but there is nothing that approached that where any of them make up 5 percent of the total portfolio you had at any given time?

Mr. LYTLE. Not in my opinion and specifically not in my division.

Mr. VENTO. I understand it is a general answer. This was an extraordinary relationship that you had with this correspondent bank in your division, is that correct?

Mr. LYTLE. Yes.

Mr. VENTO. It had unusual characteristics in other respects, but in any case it was very unique?

Mr. LYTLE. Yes; we had been very successful in obtaining overline business from Penn Square in spite of the perceived competition by the four or five other major banks who were trying hard to get it all.

You will hear that later today.

Mr. VENTO. On page 3 of your statement you point out some shortcomings of the Comptroller of the Currency, I guess, in terms of their regulation and the fact that they did not notify you of some of the activities. Did you ever ask for any information from the Comptroller of the Currency?

Did you ever ask for information from them as to the status of Penn Square Bank, its financial solvency? Its loan portfolio? Any other information?

And were you refused or given that information?

Mr. LYTLE. The answer is no. I had no access to the Comptroller of the Currency and never personally tried to obtain it. If the bank did, I am not aware of it and did not have it reported to me.

Mr. VENTO. You are not aware of the bank having done that. You did not seek—did you encourage your other officers at the bank to make some inquiries of any regulator in terms of their oversight responsibilities that utilized that information and brought that to bear on the decision that you were responsible for?

Mr. LYTLE. We had no reason to be suspicious and continued to encourage our officers to look to the ultimate borrower for full doc-

umentation and credit support and communication rather than Penn Square.

Mr. VENTO. And you are satisfied within your division, the oil and gas division at Continental, that that verification was forthcoming? You personally did not see it, but did you ever receive any communication or any information from the employees that were responsible to you as to any questionable verification process or any problems with verification?

Mr. LYTLE. From time to time I was helpful to the employees in putting a little pressure on Patterson to get this document or that. We constantly, over the time of my responsibility, had a pipeline of incoming documentation. What is significant is that the overall performance by Penn Square appeared to be satisfactory.

There may have been at any given time a list of 24 things that were needed; but 2 months later there was a list of 24 things that were needed and only 2 of them were still on it, so that the pipeline appeared to not be sluggish and that Penn Square appeared to be performing as had been requested.

Mr. VENTO. Mr. Lytle, one of the things that strikes me as a little unusual is the loan program, the personal loan program you are involved in. I understand that that is a sensitive subject.

Did you have any loans of this magnitude or seek any loans from other correspondent banks over the history of your working as an officer at either this institution or others, other than for a home mortgage?

Did you seek any other types of loans of this magnitude with correspondent banks that you had a direct responsibility over or to in your past work as an officer at any financial institution?

Mr. LYTLE. No; I had no need to. I had no apparent desire or need to borrow any significant amounts until I began this addition. Penn Square was, as I have pointed out, what I thought was my logical choice for this one, and subsequently I have reduced my indebtedness by over half, by sale of oil properties.

Mr. VENTO. You sought no other loans with any other correspondents that you had responsibility from or over, just from Penn Square?

Mr. LYTLE. That's correct. They were the first ones I went to. They said fine. That is all I went to.

The CHAIRMAN. Mr. Coyne.

Mr. JAMES COYNE. Mr. Lytle, you state in your statement that you feel you have been made a scapegoat for the failure of Penn Square. I am concerned about your statement that the Comptroller of the Currency did not tell you about the bank's problems.

Following up on the question of Mr. Vento, did you ask Mr. Patterson or anybody at Penn Square whether they were being examined by the Comptroller of the Currency? Did you ask to delve into the bank's own records as we would expect somebody who had 1 billion dollars' worth of liabilities?

Mr. LYTLE. With one exception, I did not. I asked him about the results of the 1981 audit report which showed a writeoff of \$4 million of bad loans. Bill reported to me that I believe the number was \$3 million of the \$4 million were non-oil and gas loans, which I thought was exceptional.

Mr. JAMES COYNE. You said you were surprised not to have been told they were on the so-called watch list. Did you ever ask if they were on the watch list?

Mr. LYTLE. No; I did not ask him that.

Mr. JAMES COYNE. Wouldn't you think it would be prudent of you to ask a major customer like that what their status was in the eyes of the Comptroller?

Mr. LYTLE. No; I have never asked any bank that.

Mr. JAMES COYNE. You also blamed your mistakes on the energy marketplace, the dramatic drop in energy prices in the Oklahoma area. Is it not true that the economists at Continental Bank early in 1982 were saying energy prices were going to be coming down and, of course, after early 1982, you were still making big loans into the Anadarko Basin. Did you discuss the energy marketplace with your bank's economist; and what kind of expert advice did you get from him?

Mr. LYTLE. We don't have a professional petroleum economist. We do have occasional discussions with our economists, and we have an informal pricing committee in the oil and gas group that had periodic discussions about prices.

In the spring of 1982 we made severe cutbacks in our estimates of escalation of prices to the point where we stopped escalating deep gas prices at existing contract levels.

We did not anticipate—nor did our economists—that deep gas prices would drop the \$2 to \$4 that they have dropped since May.

Oil prices had already dropped the year before and we had already implemented adjustments on those.

Mr. JAMES COYNE. But you did not discuss with your economist at the bank what his predictions were for oil prices?

Mr. LYTLE. On occasion—and I have no specific recollection of it—we did talk to our economists about it. They sat in on our discussions of pricing.

Mr. JAMES COYNE. Did they ever give you any reason to be cautious or more cautious?

Mr. LYTLE. I don't recollect any.

Mr. JAMES COYNE. Of course, you also blame others for not fully documenting the credit or maintaining accurate fulfillment of the documentation.

I am interested in your 10-K of last year; there is a quote on page 21 that brags about the emphasis of your bank on credit quality.

On page 5 you say "Our longstanding emphasis on credit quality has become increasingly important."

On page 21, you say "The basic policy governing the management of a lending portfolio is the diversification of risk over a variety of customers, industries, and countries."

Did you not read this report, or did you not think it applied to your division at the bank?

[The "1981 Annual Report and Form 10-K" of the Continental Illinois Corp., parent of the Continental Illinois National Bank and Trust Co., of Chicago may be found at the end of the hearing as Appendix A.]

Mr. LYTLE. I can't remember reading it. If I had read it, I would have agreed with it and felt that the \$1 billion or \$2 billion loan

portfolio that I managed didn't represent an intense concentration because I felt that it was a good quality portfolio and continued to do so up until May or July of this year.

Mr. JAMES COYNE. The reliance you placed on that was based on the engineering studies that said you were fully collateralized?

Mr. LYTLE. That is correct.

Mr. JAMES COYNE. Did you observe engineers like DeGallier & McNaughton make analyses of these secured collaterals?

Mr. LYTLE. Yes, sir, with the exception I mentioned earlier. We received engineering reports either from a DeGallier & McNaughton, a Keeling or a Lawson, and then independently analyzed them with our in-house staffs.

Mr. JAMES COYNE. So you accepted their quantification of the reserves, but then you applied your own dollar value to the MCF?

Mr. LYTLE. Not at all. Very frequently the reason for the physical visit of my engineers to DeGallier—not to specify them in particular, but to anybody, was to make changes in the physical volumetric predictions made by DeGallier to fit our feelings about a specific group of wells or field.

Mr. JAMES COYNE. Have any wells proven to be poorly analyzed by them or do you feel their reserve analyses are accurate? Is it just because the price changed so dramatically you find yourself undercollateralized?

Mr. LYTLE. I haven't been around to see the chapter and verse of the decline. I can tell you from personal knowledge that one of the problems that developed has been the lack of gas takes in the Deep Anadarko. Nobody is buying gas. I don't think the engineers are responsible for predicting that. I don't know who should have been. I wish we had known it.

That has been one of the problems, but I can't say with any specificity to what degree the engineers were inaccurate as to volumetric predictions as compared to dollar predictions.

Mr. JAMES COYNE. Did Ernst & Whinney ever come into your division and audit your assets?

Mr. LYTLE. I have never had any contact with any of the auditors from Ernst & Whinney.

Mr. JAMES COYNE. So there has never been any audit by any of your bank's auditors?

Mr. LYTLE. I cannot agree with that, Mr. Coyne. Information about my division is readily available to any authorized people in the bank and our comptrollers or audit division could very easily have supervised an outside audit.

I had no contact and no discussions on a subjective basis which would be the only way I could help.

Mr. JAMES COYNE. Did your auditors contact Penn Square, Mr. Patterson, or any of the people with Penn Square?

Mr. LYTLE. Yes.

Mr. JAMES COYNE. Finally, if I may, one last question, Mr. Chairman.

Mr. LYTLE. Excuse me, Mr. Coyne. Our internal auditors contacted them. I am not aware whether Ernst & Whinney did.

Mr. JAMES COYNE. When you began with Continental 15 years ago, did you take a credit class?

Mr. LYTLE. I began 23 years ago and spent the first 3 years trying to learn credit.

Mr. JAMES COYNE. Did they ever warn you in credit class about developing close personal relationships with major credits?

Mr. LYTLE. I can't remember.

Mr. JAMES COYNE. Did they ever warn you about the vagaries of the commodity market and the ease with which prices can come down in volatile commodities just as easily as they go up?

Mr. LYTLE. Probably not, but I certainly learned that over the course of my career as a lender. I learned it again in spades this summer.

Mr. JAMES COYNE. Finally, did the credit class teach you not to accept the documentation provided by a lender but to demand that you go beyond that documentation for your own independent verification?

Mr. LYTLE. It sure did. That was our practice. If you remember, Penn Square wasn't a lender—wasn't a borrower. It was an independent oil man. We went directly to them for verification of all our engineering.

Mr. JAMES COYNE. Could you give me the interest rates you paid on these various loans you had during 1981 that were rolled over?

For example, the interest rate that you were paying on your Penn Square loan, the Continental mortgage that you rolled over to it, and the loan interest rate paid on the Community Bank loan that basically refunded your own personal loan. Not just the rate, but any other terms that might be relevant to the loan.

Mr. LYTLE. The rate I paid at Continental was prime, I believe.

Mr. JAMES COYNE. Your home mortgage was a prime rate floating loan?

Mr. LYTLE. This was an interim mortgage, construction facility. It was prime rate, fixed, I believe.

Mr. JAMES COYNE. So this was a new house then, that \$170,000?

Mr. LYTLE. It is a new house in my back yard. It is part of the house we live in.

Mr. JAMES COYNE. You had no mortgage then? No other mortgage?

Mr. LYTLE. I had a \$17,000 mortgage that still exists.

Mr. JAMES COYNE. The prime rate was on the Continental loan. What was the rate on the Penn Square loan?

Mr. LYTLE. First off, when I began the relationship, I asked what the rate would be. Independently both Patterson and President Jennings said it would be a similar rate charged by us for other borrowers on a mortgage basis.

The facts of the rates were that they ranged from 10.5 to prime, Oklahoma prime, which is 1 or 1½ percent over national prime. They were different rates on each of the seven or eight notes that I took down.

Mr. JAMES COYNE. Let's say you had seven notes then on December 1981, \$490,000 with Penn Square. At the time I believe the prime rate in the country was about 19.5 percent. What was your rate that you were paying on that \$490,000?

Mr. LYTLE. It ranged on each note. Some of it was 10.5 or 21; others of it was as low as 11. I did a study after the fact, looking into this, because basically I accepted Jennings and Patterson's

representations as true and found that on occasion I could have borrowed on a normal mortgage rate at a lower rate from other institutions.

In most cases I found that the rate that I was borrowing at was 1 or 1½ percent under what I perceived to be another mortgage rate that was comparable.

Mr. JAMES COYNE. So you felt you were getting a lower price than you would otherwise?

Mr. LYTLE. In some cases—the dollar amount, and if you look at the takedowns in the loans, you realize most of this borrowing occurred in the last part of 1981.

Mr. JAMES COYNE. So you had roughly 50,000 dollars' worth of interest liability for 1981, is that right?

Mr. LYTLE. I think it was closer to about \$42,000 or \$43,000.

Mr. JAMES COYNE. What was your salary from the bank during this period that you had a \$50,000 interest liability?

Mr. LYTLE. My total compensation from Continental for 1981 was—including bonuses, profit sharing, and exercise of some options—in the \$125,000 range.

Mr. JAMES COYNE. How much was salary?

Mr. LYTLE. \$69,000.

Mr. JAMES COYNE. So you had 42,000 dollars' worth of interest on a \$69,000 salary, is that right?

Mr. LYTLE. Yes, sir.

Mr. JAMES COYNE. Thank you, Mr. Chairman.

Mr. LYTLE. I might add, I also had drilling income in 1981.

The CHAIRMAN. Mr. Lytle, we have provided your attorney, and he should have for you, a letter dated January 28, 1981, from you to Bill Patterson describing certain participations involving Penn Square, Continental, and Michigan National.

The letter reads that there was a meeting with Michigan National that determined the people were “pleased with the package of credits you put together last November. I feel they are grateful to you and to us for the help. As we did previously”—and now I read slowly—“I reassured them that we would take the credits out at maturity or whenever they felt unconfident.”

That is a tacit buy-back agreement that was in effect, is that not correct?

Mr. LYTLE. I would disagree. There was never any agreement by Continental to buy back Michigan National loan participations.

The CHAIRMAN. What does that mean? “I reassured them that we would take the credits out at maturity or whenever they felt unconfident?”

Mr. LYTLE. I must point out the letter was addressed to Bill, not Michigan National. It was a chatty update on what—we had been responsible for introducing Michigan National to Penn Square as a result of Michigan coming to us and asking for some overline participations from Continental. We said try Penn Square.

When this letter was called to our attention in connection with a routine audit of Continental Bank by the Federal examiners in May 1981, I assured the examiners at the time that there was no such understanding, that Michigan National was purchasing directly from Penn Square, and there was no recourse against Continental.

The CHAIRMAN. But indeed, weren't these repurchased prior to maturity?

Mr. LYTLE. I misunderstood the first two words.

The CHAIRMAN. Were these not repurchased prior to maturity?

Mr. LYTLE. We have never purchased any loan participations from Michigan National.

The CHAIRMAN. Did Penn Square purchase them prior to maturity?

Mr. LYTLE. I have no knowledge of that.

The CHAIRMAN. Well, as a matter of fact, they did; they did, sir; they did. "Thanks again for your help. I think that this is a service, that working together we can provide to others."

Were you working for Continental Bank or were you working for Penn Square?

Mr. LYTLE. I was very clearly working for Continental Bank and trying to maintain our position as the lead overline correspondent with Penn Square.

The CHAIRMAN. That means that in so doing, I guess Michigan will tell us you snared Michigan into the net. That is the way they feel, by the way.

My point is, is it—was it your ordinary function to go out and seek out other banks to purchase these wonderful participations for Penn Square as an officer at Continental?

Mr. LYTLE. No.

The CHAIRMAN. Isn't that an unusual thing to do?

Mr. LYTLE. The only occasion where I got involved with introducing a third-party bank was Michigan National.

The CHAIRMAN. What did this sentence mean? "Thanks again for your help." Which help was that? What kind of help?

Mr. LYTLE. As I said at the beginning, this was kind of a chatty letter to Bill I wrote just before I took a month's vacation and it was just—

The CHAIRMAN. Had he arranged for you to go fishing someplace or something?

Mr. LYTLE. No, sir.

The CHAIRMAN. What kind of help are you talking about?

Mr. LYTLE. I don't remember any specific reference to this help.

The CHAIRMAN. It is not a wordy letter.

Mr. LYTLE. It is pretty wordy.

The CHAIRMAN. When you see a cryptic letter, you know it has been dictated and lined and looked at with care. For example, reading again from the letter, "I think that this is a service that working together we can provide to others."

What do those words mean? Is that chatty or does it have meaning? It has meaning to me.

Mr. LYTLE. I am not sure I know what it means. I might add I have had on numerous occasions conversations both after I talked to the examiners about this letter and prior on several occasions with various personnel at Michigan National and all of which I reassured them if they bought participations directly from Penn Square that they were on the hook themselves and that Continental had no involvement.

The CHAIRMAN. Who were the others you were going to provide service to?

Mr. LYTLE. Possibly other correspondent banks.

The CHAIRMAN. I ask you again, was it part of your duties at Continental Bank to seek out other correspondent banks on behalf of Penn Square?

Mr. LYTLE. It was part of my duty at Continental Bank to maintain a continuing good relationship with Penn Square.

The CHAIRMAN. Would you answer my question? Was it part of your duty to seek out other correspondents for Penn Square?

Mr. LYTLE. My answer is directly responsive. We were unable to handle the workload of loan requests that came to us from Penn Square in 1981 in spite of the very obvious rapid growth we had in 1981.

I didn't have the staff or numbers of experienced personnel to do so. Therefore, introducing Patterson to other banks, turning them loose on their own as I have stated I did with Michigan was a help to Continental, even though the direct help was to Penn Square in that it took the pressure off Continental to try to process more loans than they had the personnel for.

The CHAIRMAN. What obligation did Continental have to process loans for Penn Square?

Mr. LYTLE. We had no obligation—

The CHAIRMAN. Did you receive any remuneration from Penn Square for these added duties you took on to yourself as a service to Penn Square and Mr. Patterson?

Mr. LYTLE. No; specifically not. I felt the duties I took on were to relieve the pressure on Continental because of our weak manpower position.

The CHAIRMAN. Therefore, are you telling us Continental was buying more loans than they could really process and that is perhaps why they had these participations from Penn Square that proved to be not as valuable as they should have been?

Mr. LYTLE. I would not say so. I would say we were buying as many loans as we had the ability to process and couldn't increase the rate until we got more time, people, and experience.

The CHAIRMAN. At this point, I would like to put in the record, the January 28, 1981, letter we are referring to.

[The letter referred to follows:]

CONTINENTAL BANK

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO • 231 SOUTH LA SALLE STREET, CHICAGO, ILLINOIS 60661

January 28, 1981

JOHN R. LYTL
VICE PRESIDENT
312/828-434

Mr. William Patterson
Executive Vice President
Penn Square Bank
1919 Penn Square
Oklahoma City, Oklahoma 73126

Dear Bill:

Just want you to know that Caroline Janda and her crew had a meeting with Arnold Middeldorf and his people at Michigan National and determined that they are pleased with the package of credits that we put together last November. I feel they are grateful both to you and to us for the help. It looks like they are growing both in confidence and understanding of oil related lending, but as we did previously, I reassured them that we would take the credits out at maturity or whenever they felt unconfident.

Thanks again for your help. I think that this is a service, that working together, we can provide to others.

Sincerely,

JS

Michigan Nat'l Participation Loans

LADA Cap

Old Dominion

Dobbins + Sons (partial)

Not Informal take out agreement for certain loans by Continental - The subject loans were either renegotiated or repurchased by PSB subsequent year end - No disclosure of above agreement is proposed. ul 4/81 08173 JRC

SUBSIDIARY OF CONTINENTAL ILLINOIS CORPORATION

The CHAIRMAN. Mr. Barnard.

Mr. BARNARD. Mr. Lytle, to follow up the chairman's inquiry to you about this letter from you to Bill Patterson, and I repeat, in that letter it says "I reassured them."

How did you reassure them? by letter? by commitment?

How did this informal agreement take place?

Mr. LYTLE. There was never any agreement by Continental to buy back Michigan National loans. I cannot explain the meaning of the sentence that I wrote in January 1981.

Mr. BARNARD. You don't feel that created an obligation?

Mr. LYTLE. Absolutely not.

Mr. BARNARD. It didn't? You said it did. "I reassured them that we would take the credits out at maturity or whenever they felt unconfident."

Unless all of my little knowledge is gone, I think that a formal takeout, or even an agreement—how did you reassure these people?

Did you do it with a letter?

Mr. LYTLE. I think you have put your finger on the exact point. This was a letter to Bill Patterson. This was not a takeout agreement with Michigan National.

Mr. BARNARD. You are on record in this letter stating that you made a commitment to Michigan National or to Mr. Arnold Middledorf. That is not a participation.

Mr. JAMES COYNE. Would the gentleman yield to me?

I would like to know why you felt you had to tell Bill Patterson that you had reassured these people that you would take them out.

Mr. LYTLE. I don't remember.

Mr. JAMES COYNE. Can you think about it a little bit? As a banker, why is there any reason you would tell him that you have reassured a third party bank that you are taking them out? Is there any reason you can think of to do that at all?

Mr. LYTLE. This letter was brought up to me by the examiners. They apparently dismissed it in May 1981. It was brought up again in June 1982 by the Comptroller, and I have had plenty of time to think about it. I do not know of any reason why I would have said that, and to get back to Mr. Barnard's comment, it is very clearly the opposite of an agreement. There was no agreement, and there is nothing in writing between Continental and Michigan National which would constitute an agreement.

Mr. BARNARD. Mr. Lytle, why were you fired?

Mr. LYTLE. I was fired because—and I am quoting—the bank lost confidence in my managerial and credit ability. Period.

Mr. BARNARD. Were you designated as a marketing man or market business development officer or were you a combination of marketing and technician?

Mr. LYTLE. I am not a qualified engineer. I think the word "technician" would mean that in the oil and gas area.

Mr. BARNARD. I don't necessarily mean that. I mean anybody that has been in the banking business 23 years has accumulated naturally—in the position that you had—a very important responsibility. You had acquired a general knowledge of the operations of banking, right?

Mr. LYTLE. Well, I was the lowest level of management in the lending scheme at Continental. That certainly was important to me, but it is a valid point.

Mr. BARNARD. You managed a portfolio of over \$2 billion in loans?

Mr. LYTLE. Correct, but it must be put in perspective at a very large bank that it was the lowest level of management because there was no section head in the Oklahoma side.

Second, I have and had almost no operating knowledge. I don't understand how a loan division works or any of the operating portions of a bank.

My entire experience at Continental has been on the lending platform as an officer and then junior manager.

Mr. BARNARD. How did the Penn Square Bank come to be a customer of Continental? Did you develop that relationship?

Mr. LYTLE. In 1978 I was introduced to Bill Patterson by Dennis Wingat [phonetic] who was then the only loan officer responsible for the State of Oklahoma and reporting to me. Mr. Winget brought in and introduced to the bank and initiated the credit requests that constituted the beginning of our relationship.

Mr. BARNARD. Then from that point on, it developed to be your responsibility? Were you not at some point in time suspicious or concerned that this little small neighborhood bank in Oklahoma City was effecting or creating a loan portfolio of over \$2.5 billion?

Mr. LYTLE. Well, I wasn't suspicious of it. I was aware of it. I was not suspicious about Penn Square's activities until—

Mr. BARNARD. Isn't it unusual for a bank to have an 80 percent concentration of loans in just one particular area? Isn't that blatantly poor bank management?

Mr. LYTLE. We brought in, Penn Square introduced a major customer to us in January of this year. I asked Bill how he did it and how did he get it out of one of the downtown banks. Bill said, Mr. Jennings loaned money to his daddy and the relationship goes back three generations. That is only one impact Mr. Jennings has on the Oklahoma oil and gas economy. He was primarily the oil and gas lender in town and was receiving very little in the way of compensation from the downtown banks.

On numerous occasions we had borrowing requests from Penn Square to do overline credits for directors of other banks in town, for example—

Mr. BARNARD. The point I am making is that you in your testimony have indicated that you think legislation is necessary to protect banks like the Continental. It looks to me though that the conditions were so obvious to most experienced bankers that they themselves would have been concerned about the status of Penn Square.

Mr. LYTLE. Penn Square had a lock on the oil and gas business in Oklahoma. Why, I don't know. You would have to ask the banks—

Mr. BARNARD. They were not the biggest bank in Oklahoma, were they?

Mr. LYTLE. No, they weren't.

Mr. BARNARD. Why didn't the other banks want to lock it up?

Mr. LYTLE. Nor were they the only bank with competence to loan in the oil and gas business. The fact is, and we have relationships with a half dozen other banks in Oklahoma, is that we saw no or little business being produced in the last 1½ years from banks other than Penn Square. It was our only access to major portions of new credit.

Mr. BARNARD. For the record you indicated that the Penn Square account was brought to you by Mr. Dennis Winget.

Mr. LYTLE. Winget.

Mr. BARNARD. What happened to him?

Mr. LYTLE. He resigned from Continental in August 1981 and went to Penn Square.

Mr. BARNARD. That is a good deal.

In your personal financial statement, evidently you must have had a tremendous markup of all properties in 1982, because if I read it correctly, according to the March 30 statement you decreased indebtedness by \$437,000, yet your assets were not decreased but \$175,000.

How did you get the money to pay off these loans?

Mr. LYTLE. I sold a substantial portion of my oil properties in March—

Mr. BARNARD. So you had that undervalued. You showed a value of—

Mr. LYTLE. I showed values at cost I believe on my personal—

Mr. BARNARD. \$182,000. Then you liquidated that and that is how you paid off the loans?

Mr. LYTLE. Yes, sir.

The CHAIRMAN. Mr. Leach.

Mr. LEACH. Mr. Chairman, I have no questions for Mr. Lytle.

The CHAIRMAN. Mr. Lowry.

Mr. LOWRY. Thank you, Mr. Chairman.

Mr. Lytle, thank you for your testimony. I was just wondering before I get to my question, did the other energy loan officers in the Oklahoma banks drink beer out of their boots?

Mr. LYTLE. Not to my knowledge.

Mr. LOWRY. That may be the reason that they had the market. I don't know.

I am concerned about the lack of time and communication between the situation that the bankers had determined in Oklahoma and the amount of time by which that information was available in Illinois. Your testimony says that over \$500 million in loans, new participation, were made after July 1981 when the Comptroller's reports on Penn Square were flirting with disaster.

During that period of time, there must have been bank examinations going on with Continental on essentially the same participation loans. If examiners in Penn Square thought there was a real problem with these loans, I wonder about examiners in the participation loans of Continental, did they state problems with these Continental participation loans?

Mr. LYTLE. In May 1981 we completed an examination conducted by the FDIC—by the Comptroller of the Currency's office, and there were no Penn Square overlines cited for special mention of any sort.

The next examination was in process in May and June 1982. We had no examination in the interim. At that time there was discussion of a growing number of loans. We had had two bankruptcies occur, one in May, one in June. And there were going to be some names that were cited in the May 1982, or June 1982 report.

Back to your original comment, the examiners at Continental had recourse to Continental Bank's records. They were essentially in agreement with both my divisions opinion about the credit, and second, Continental Bank's rating committee, quality control effort that also looked at all of these credits.

Apparently, there was no dissatisfaction or suspicion. The flirting with disaster may not have referred to overline credits at Continental or it may have referred to the discrepancies and documentation where we thought we had something and the Penn Square Bank had something else.

I cannot speculate any farther than that, Mr. Lowry.

Mr. LOWRY. Do you believe the performance by Continental's participation would have been different had this information been available to the bank examiners?

Mr. LYTLE. In all probability it would have been dramatically different. In fact, I cannot quote the individual who said it from the Comptroller's office but he said if we let this information out, it will be a disaster, or some words to that effect. What he meant was probably, the overline banks would pull the strings shut and stop and have a full examination and look at the record.

We might have a healthy Penn Square now if that had happened.

Mr. LOWRY. There are of course reasons for confidentiality requirements on the examination. As a banker, would there be a way that with participating loans this information could have been available to the participating bank, Continental, and still not have been creating a big problem with the lack of confidentiality?

Do you see a way that that could be done?

Mr. LYTLE. There already is a mechanism. For example, in the International Harvester loan, it is examined at only one bank. The mechanism apparently is not fully implemented by the Comptroller, or maybe there are restrictions which prevent him from fully implementing it. It may not include participation purchases rather than joint bank credits. The latter being separate notes by each bank rather than the purchase of a note.

My only hope is that that can be examined, strengthened if necessary and certainly implemented to a greater degree than it has been in the past.

Mr. LOWRY. Would you suggest this committee look at oversight responsibilities with the Comptroller as far as the exercising of that information between the different offices?

Mr. LYTLE. Yes, sir.

Mr. LOWRY. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. McCollum of Florida.

Mr. MCCOLLUM. I will pass, Mr. Chairman.

The CHAIRMAN. Mr. Wortley.

Mr. WORTLEY. Mr. Lytle, do you think that the loan participation instrument is well suited for energy-related loans in an environ-

ment like Penn Square, where there were so many noncollateralized loans, and high charge-off rates?

Mr. LYTLE. No.

Mr. WORTLEY. Do you have any further comment on that? Why was your bank accepting so many, then, if you didn't think it was a good idea yourself?

Mr. LYTLE. Well, you put it in the concept of now, not then. We then preferred to have direct facilities as compared to overline participation facilities for a number of smaller and apparently less important reasons. But the main reason I answer emphatically is it eliminates the possibility of the upstream bank not having authentic collateral and loan obligation documents, because they will be party to the executions.

Mr. BARNARD. Would the gentleman yield?

Mr. WORTLEY. Yes, I will.

Mr. BARNARD. Isn't that up to the policy of the bank? Couldn't the bank require that they have the proper documentation?

Mr. LYTLE. Yes, sir.

Mr. BARNARD. And you didn't do that?

Mr. LYTLE. We were desirous of improving as many direct as we could. But it is not clearly a legislative matter. It is a bank policy matter.

Mr. BARNARD. That is true. And would you say that is a good policy?

Mr. LYTLE. It certainly is.

Mr. BARNARD. To not have the documentation, to rely completely upon the corresponding bank.

Mr. LYTLE. I beg your pardon, sir. I misunderstood you. It is a good policy to insist on direct original documentation.

Mr. BARNARD. But you didn't do that, did you.

Mr. LYTLE. No, sir.

Mr. BARNARD. Was that because of your friendship with Bill Paterson?

Mr. LYTLE. No, sir.

Mr. BARNARD. Was that because of your confidence in Bill Paterson?

Mr. LYTLE. It was until Penn Square, fairly standard banking practice in buying credits from smaller banks to buy on a participation basis rather than to put together—

Mr. BARNARD. But you are dealing with a small bank in Oklahoma City. You are not dealing with the Michigan National Bank or Seattle First National Bank. You are dealing with a bank that is probably not nearly as sophisticated as Continental in lending practices.

Aren't you letting them guide your policies?

Mr. LYTLE. Not at all. Our policy was to try to implement as many direct credits as possible, but we bought participation loans from banks throughout the country, both in the oil patch and outside of it. And Penn Square was no exception.

Mr. BARNARD. But there couldn't be any legislation that would mandate that you get good documentation, could there?

Mr. LYTLE. No, sir, I don't believe so.

Mr. BARNARD. Thank you.

Mr. WORTLEY. Mr. Lytle, do you think that the Penn Square affair has affected the national corresponding banking system?

Mr. LYTLE. Yes, sir.

Mr. WORTLEY. It has been badly damaged would you say?

Mr. LYTLE. Yes, sir.

Mr. WORTLEY. Do you think the secondary loan market has become inhibited as a result of this fiasco?

Mr. LYTLE. By secondary loan, you mean participation purchases?

Mr. WORTLEY. Yes.

Mr. LYTLE. Yes, sir.

Mr. WORTLEY. I yield back the balance of my time, Mr. Chairman.

The CHAIRMAN. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

I think that so far these hearings have been extremely helpful in two ways. One way which has been discussed repeatedly is alleged conflicts of interest. I just have one question on that, Mr. Lytle. Do you think it should be made illegal for you as a major loan officer at Continental to take out a \$500,000 loan or any loan from a bank you are dealing with like Penn Square? Do you think that is wrong?

Mr. LYTLE. I don't think it is wrong. Bankers have to borrow somewhere just like everybody.

Mr. SCHUMER. I would say there are lots of banks that you were not dealing with personally, wouldn't you say?

Mr. LYTLE. I would further recommend perhaps that reporting responsibilities might be implementing, not in a legislative level but at a bank policy level.

Mr. SCHUMER. You don't think it should be made illegal?

Mr. LYTLE. I have stated earlier the bank criticized me for this facility fairly severely. I would have liked very much to have known I made a wrong judgment in their opinion when I owed \$30,000 rather than when I owed \$565,000, and regret not having reported it.

Mr. SCHUMER. Thank you.

The other area which I think deserves a lot of focus is the area of bank operations. This is a unique look for all of us into how a major bank functions and I, quite frankly, am appalled. I don't think a small businessman would, without some better controls, do the kind of things that you allege Continental Illinois has done.

You say that the inspection agencies were lax—and they certainly were—but what about the bank? You mentioned that when you found out long after buying a participation that some of the collateral for some of the loans Penn Square sold you was nonexistent or made up. Don't you check those out? Isn't it bank policy that you should have some written document certifying that the collateral exists?

How does it happen? Your friend Mr. Patterson says, "Well, we are collateralizing this with the Statue of Liberty" and you write down "collateral"? I don't understand.

Mr. LYTLE. We check them out. We take photostatic copies of all the documentation.

Mr. SCHUMER. You don't run an independent check on what a correspondent bank says is collateral? You don't send out anybody to check?

Mr. LYTLE. We have had audit reviews—

Mr. SCHUMER. Routinely. Do you or don't you? Is that standard policy at Continental?

Mr. LYTLE. It is standard policy to get examples of documentation, photostatic copies—

Mr. SCHUMER. That is not my question.

Mr. LYTLE. Then please repeat it.

Mr. SCHUMER. Is there an independent verification of collateral?

Mr. LYTLE. By an outside—

Mr. SCHUMER. By Continental in a loan Penn Square has made.

Mr. LYTLE. Our audit division is empowered to do that and does it with correspondent banks.

Mr. SCHUMER. So what happened here? Let's talk about Continental Illinois' audit division. Why didn't it discover that this marina didn't exist?

Mr. LYTLE. I am not prepared to discuss that matter, not being responsible for or involved in the audit division's activities and not being here as a representative of Continental. I do know—

Mr. SCHUMER. So, as the loan officer, all your job entails is getting a Xeroxed copy of a loan agreement and putting it in the file somewhere, something which by your own testimony wasn't done too well. Is that your only responsibility?

Mr. LYTLE. Our responsibility was to forward it to the loan division who reviewed it for completeness with the help of their counsel.

Mr. SCHUMER. Did the loan division on any of these loans ever send you information stating that the collateral didn't exist or was exaggerated?

Mr. LYTLE. No.

Mr. SCHUMER. No. Why?

Mr. LYTLE. They had no way of knowing. All they could say was that the collateral wasn't in yet, in which case we would attempt to obtain it as I mentioned in my earlier comments, opening comments.

Mr. SCHUMER. I am not a banker so I don't understand that. They say the collateral wasn't in yet. What does that mean, the marina wasn't built?

Mr. LYTLE. That means that the documentation supporting the credit wasn't complete according to our files, and that we should provide more information to them.

Mr. SCHUMER. In other words, but that gets to the heart of my question. There is no independent verification? What you are just saying is that Penn Square, because of all these loans you are buying, hasn't sent you the actual paper. That is not what I am asking.

I am asking if there are independent verifications; whether an auditor just looks to see that the paper is there or whether he goes and checks the collateral randomly, regularly, or ever?

Mr. LYTLE. I have referred to our independent internal auditing division. Although I am not competent to comment on the degree of their investigation. I also should mention that I have no idea of

the degree of investigation performed by our outside auditors, Ernst & Whinney. There may be verification there.

All I can tell you with specificity is what my divisions and my loan officers—

Mr. SCHUMER. So you, who are in charge of roughly \$2 billion of loans, had no idea, after 23 years in the bank, of what kind of verification procedures existed? I find that appalling. I am not a businessman, but I would hope that that is not typical of the way banks conduct business in America. I will ask the president of your bank, I would like to ask every banker in this room, because if it is, we are in a lot of trouble.

Mr. LYTLE. I think that characterizing it as “no idea” is entirely inaccurate. We prepared, assembled and provided for the loan division and these subsequent outside reviewing authorities the package of loan documentation. In the case of an overline, they were given to us by a bank instead of by a borrower.

But the question applies just as directly to a borrower—

Mr. SCHUMER. So if I am in the oil and gas business, and I say I have, I don't know, 5 million barrels in my little oil well, and I send in a piece of paper that says, I sign 5 million, Charles Schumer, no one goes out and checks?

Mr. LYTLE. I may have testified to this earlier, Mr. Schumer. But we check in every case on an example exactly like that. A qualified Continental staff reservoir engineer physically visits the place of records of the production that shows or made the estimate that your 5 million barrels was in the ground—

Mr. SCHUMER. Did they visit the marina? That is what I don't understand.

I am really confused by all of that.

Mr. LYTLE. Are you satisfied with my answer about the physical visit on the reserves?

Mr. SCHUMER. Is it done randomly?

Mr. LYTLE. It is done in every case.

Mr. SCHUMER. Every case.

Mr. LYTLE. Yes.

Mr. SCHUMER. With a correspondent bank or only a direct loan?

Mr. LYTLE. We don't visit a corresponding bank to determine loan values. We visit an outside competent engineering firm or visit the company directly. In the case of the marina as my prepared statement indicates, we didn't know we had a marina for collateral. We were told we had oil and gas leases for collateral.

Mr. SCHUMER. But my point is, you were told.

Mr. LYTLE. We were shown—

Mr. SCHUMER. You seem in your statement to absolve yourself and everybody else because somebody lied to you. The whole idea of an independent check is to find out whether someone is lying to you.

Mr. LYTLE. We were told that there was oil and gas leases supporting that loan. We had no incidence or occasions where there had been misrepresentations—

Mr. SCHUMER. How did you know—

Mr. LYTLE. Penn Square. We had no discovery of any incidents over the 5-year relationship or 4-year—

Mr. SCHUMER. But you never sent an outside person to investigate it because it was a corresponding bank.

Mr. LYTLE. That is not correct. We sent our audit division, outside of my division.

Mr. SCHUMER. The audit division sent independent investigators or did it just check and see that the paper was signed right and said something correctly?

Mr. LYTLE. The paper that I am referring to that made me think I had oil and gas leases was in Continental Bank.

Mr. SCHUMER. Right; who said there were oil and gas leases there?

Mr. LYTLE. The photostatic copy of the note.

Mr. SCHUMER. Signed by Penn Square?

Mr. LYTLE. No, sir; signed by the borrower of the funds from Penn Square. It was a Penn Square note.

Mr. SCHUMER. Then there was independent verification of that?

Mr. LYTLE. Then there was a photostatic copy of that note mailed up to us.

Mr. SCHUMER. And no independent verification?

Mr. LYTLE. Except to the extent that our audit division visited Penn Square and other correspondent banks and could physically have gone to that note and said look, this note doesn't say oil and gas leases, it says a marina, if that is the case.

That is what I was told by the examiners. There was no independent verification. That was our routine——

Mr. SCHUMER. That is my point, that there was no independent verification. I find——

Mr. LYTLE. Except for that, which was fairly extensive.

The CHAIRMAN. Would the gentleman yield on that point?

Mr. SCHUMER. Yes, I yield to the chairman.

The CHAIRMAN. Now, Mr. Lytle, who signed the note?

Mr. LYTLE. The borrower of Penn Square.

The CHAIRMAN. Who was the borrower? A fellow you knew, wasn't it, a good friend of yours, went out drinking with him?

Mr. LYTLE. Never went out drinking with him.

The CHAIRMAN. Never went out drinking with Patterson?

Mr. LYTLE. Patterson wasn't the borrower.

The CHAIRMAN. Patterson is the one who borrowed the money for the marina.

Mr. LYTLE. No.

The CHAIRMAN. Who borrowed it?

Mr. LYTLE. We were only involved in a small portion of it. The borrower was an independent oil and gas man who was one of his partners. I don't know if that name has been made public, Mr. St Germain. If it hasn't, I probably——

The CHAIRMAN. Everybody's name has been made public here.

Mr. LYTLE. Then you tell me and I will confirm——

The CHAIRMAN. Well, I mean——

Mr. LYTLE. We had one-third of the three, and I am quoting Fortune magazine, one-third of the three upstream facilities.

The CHAIRMAN. Pardon? I am sorry.

Mr. LYTLE. Quoting Fortune magazine, there was a \$7 or \$8 million investment in a marina. We funded a small portion of that,

either \$2½ or \$3½ million of it, on a note signed by an independent oil and gas man out of Penn Square.

The CHAIRMAN. Patterson's name was not on it?

Mr. LYTLE. No, sir.

The CHAIRMAN. It seems I recall the board of directors of Penn Square approving—Mr. Barnard, you were there in Oklahoma City. Didn't the board approve loans to Patterson for the marina as well? That seems to be my recollection.

Mr. LYTLE. Continental Bank was not involved in funding that portion of the credit. This was an unrelated funding from an independent oil man who had—

The CHAIRMAN. With the marina as collateral?

Mr. LYTLE. Apparently. We were told that it was oil and gas leases and we had other credits—

The CHAIRMAN. Mr. Schumer is trying to find out how come those wonderful engineers that were checking, verifying the oil and gas leases couldn't tell the difference between an oil and gas lease and a marina. Is that correct, Chuck?

Mr. SCHUMER. That is what I am trying to find out, Mr. Chairman.

Mr. LYTLE. Well, I think we have got a little misunderstanding in terms. This was a loan against oil and gas leases, not against oil and gas reserves.

Mr. SCHUMER. But you still have to check out some collateral—

Mr. LYTLE. That is correct.

Mr. SCHUMER. I mean, you seem to be—well, we didn't have the Xerox copy. So if somebody, man on the Moon, would have sent you a copy and just signed it, I, man on the Moon, say that this is collateral, you would have put it in the file and everyone would have been happy?

Mr. LYTLE. Depending on the nature of the collateral.

Mr. SCHUMER. Then the audit division would make sure it is in the file. I wouldn't run a candy store like that.

The CHAIRMAN. Mr. Schumer, you see, if you fly in in a Lear jet, drive up in a Mercedes convertible, you have got diamond rings on both hands and gold chains around your neck, you are a fantastic oil man and the loans come easy. You weren't aware of that?

Mr. SCHUMER. I am not a—

The CHAIRMAN. Mr. Schumer, I might mention to you that we were down in Carrizo Springs, Tex., a few years ago. There was a bank there that was so small, I could understand their making mistakes. They loaned money on half a Mercedes, on the air-conditioner in the president's wife's beauty parlor, third-hand air-conditioner.

Ms. Oakar.

Ms. OAKAR. Mr. Chairman, the gentleman, Mr. Lytle, has indicated that he feels there is corrective legislation that should be enacted. I just wondered, a lot of bankers are going to say, not another layer of bureaucracy.

I wonder, do you personally hold yourself responsible in anyway, shape or form for what you term the Penn Square debacle?

Mr. LYTLE. It is very apparent that I made some credit misjudgments in looking at some of the credits. I can't speak with any specificity because I haven't seen the turndown.

We had some problem credits in June, when I left the bank, and we had them a year ago. That was part of the portfolio and part of the job. If I could look back at any time over my past year's experience, today or a year ago today, I would have pointed out things I would have done differently. Yes, I was involved.

The CHAIRMAN. Mr. Lytle, we want to thank you for your stimulating appearance and for your cooperation and assistance to the committee. We may have some further written questions to send you once we have heard from the ivory tower and others. Behind you we have got the ivory tower about to approach the witness table.

Mr. LYTLE. I will be happy to answer any questions, and personally speaking as an independent I have thoroughly enjoyed discussing this with you. I think some of my opinions have been changed as a result of your questions.

Thank you.

The CHAIRMAN. Thank you, Mr. Lytle.

Now we would ask Mr. John Perkins, president; Mr. George Baker, executive vice president; Mr. Edward Cummings, executive vice president; Mr. James Cordell, vice president—I have got to mention this—Texas division, oil and gas group worldwide, to approach the table.

Mr. Perkins, Mr. Baker, are we ready to stand and raise our right hands?

[Witnesses sworn.]

The CHAIRMAN. Thank you, gentlemen.

Mr. Perkins, you have a prepared statement.

Mr. PERKINS. Yes, I do.

The CHAIRMAN. Since you have been here before, you know how it goes and you may proceed.

TESTIMONY OF JOHN H. PERKINS, PRESIDENT, CONTINENTAL ILLINOIS NATIONAL BANK; ACCOMPANIED BY GEORGE R. BAKER, EXECUTIVE VICE PRESIDENT, GENERAL BANKING SERVICES; EDWARD M. CUMMINGS EXECUTIVE VICE PRESIDENT; JAMES C. CORDELL, VICE PRESIDENT, TEXAS DIVISION, OIL AND GAS GROUP WORLDWIDE; RICHARD S. BRENNAN, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL; AND ROBERT E. L. WALKER, ASSOCIATE GENERAL COUNSEL

Mr. PERKINS. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am John H. Perkins, president of Continental Illinois National Bank and Trust Co., of Chicago. With me today are George R. Baker and Edward M. Cummings, executive vice presidents, and James C. Cordell, senior vice president, of Continental Bank.

Mr. Baker, as head of our general banking services group, has principal responsibility for the corporate lending areas of the bank.

Mr. Cummings, an experienced and highly regarded senior lending officer, is a member of the committee of present and former Continental officers, which has been charged with responsibility for investigating the events surrounding Continental's dealings with Penn Square Bank.

In his investigative role Mr. Cummings has developed considerable familiarity with the facts and history of Continental's relationship and transactions with Penn Square and its parent, First Penn Corp.

Mr. Cordell is the widely respected head of our oil and gas group's Texas division and the bank's senior oil and gas lending officer. He is also a petroleum engineer, has 40 years' experience in the oil and gas industry, and is an active member of various associations of specialists in oil and gas finance and petroleum engineering.

Also here with me today are Richard S. Brennan, executive vice president and general counsel, and Robert E. L. Walker, associate general counsel, of Continental Illinois.

Since 1954 Continental has been a leader among banks in financing the development of this country's oil and gas resources and lending to established and emerging businesses directly engaged in or providing services to the oil and gas industry.

Continental has played a major role in financing the independent sector of the oil and gas producing industry and has maintained important lending relationships worldwide with most of the oil and gas industry majors.

Virtually all lending carries risk, and lending to the oil and gas segment of our economy is certainly no exception. However, the record of Continental's oil and gas lending from 1954 through 1981 was exceptional. Throughout that entire period the incident of loss was negligible.

Many emerging companies which have since become significant factors in the oil and gas industry could not have achieved their success if major U.S. financial institutions, such as Continental, had not been willing to go on the line with substantial financial support.

This has not been a one-way street. For Continental and others, oil and gas lending has been a profitable business. From 1954 through 1981, Continental consistently enjoyed attractive returns from its oil and gas activities.

One of our strategies over the years has been to grow with major and vital industries which offer the bank a better than average return on investment. The energy sector is one such industry.

Moreover, financial support of the oil and gas industry accords with a broadly perceived public interest. Indeed, in recent years adequate financing for domestic energy has been an essential ingredient in this country's program to reduce U.S. dependency on foreign suppliers.

In 1978 Continental began to participate in what ultimately became a large volume of oil and gas financings originated by Penn Square Bank in Oklahoma. By summer of 1982, Continental held interests in such financings aggregating approximately \$1,050 million.

These were not direct loans to Penn Square Bank, although Continental did from time to time make available to Penn Square Bank a Federal funds facility of as much as \$3 to \$4 million and made available to its parent, First Penn Corp., a credit which, at its maximum, was \$7 million.

The CHAIRMAN. Mr. Perkins, at that point I would ask you to hold for a moment. Staff is going to hand you some documents. Now, you have just stated that Continental's maximum loan to First Penn Corp., was \$7 million. The first three-page item that I have asked staff to give you consists of a letter dated February 24, 1982, from Frank Murphy, vice president, First Penn Corp., addressed to Continental Illinois, 231 South LaSalle Street, Chicago.

Mr. Murphy is asking that Continental verify for Peat, Marwick, and Mitchell First Penn Corp.'s indebtedness to Continental Illinois.

As you can see, the letter indicates that the loan was for \$10 million. As you will also note, that information was verified as correct by an official of Continental Illinois National and returned to the bank. Penn Square, that is.

The second part of the package is a copy of the loan note from Continental Illinois, again for \$10 million. The third sheet indicates that stock backing this loan was transferred from Fidelity Bank in Oklahoma City to Continental.

The second matter is a page from the consolidated financial statements of First Penn Corp. for year end 1981. This page was included in the Peat, Marwick, and Mitchell audit. It reflects that the holding company had a note payable for \$10 million at an interest rate floating with Chicago prime.

Now, Mr. Perkins, would you or one of your colleagues address the signature on the verification? We can't seem to determine who signed the verification. More importantly, would you clear up the discrepancy between the amount you have just stated, maximum amount of \$7 million, and the \$10 million on the note and verification?

Mr. PERKINS. I am trying to find the signature.

The CHAIRMAN. The signature is on the first page. Pardon? On the verification, that first item that you have.

Mr. PERKINS. Mr. Chairman—

The CHAIRMAN. It looks like "Surl Scholar."

Mr. PERKINS. I really can't offer you any light on that. I don't recognize the signature. These kinds of verifications normally would come directly to the audit division—

The CHAIRMAN. Could you see if you could identify that signature for the record?

Mr. PERKINS. Oh, yes, be glad to.

[The document referred to by Chairman St Germain requesting Mr. Perkins verification of the signature on the first page follows:]

100
Notes payable Confirmation
12/31/81

DATE	3/18/82
INITIALS	R-11

Mr. Perkins
Page 3
22-0000-150

Penn Square Bank..

February 24, 1982

CONTINENTAL ILLINOIS
231 South LaSalle Street
Chicago, IL 60693

Dear Sir:

Peat, Marwick, Mitchell & Co., Suite 1200E, First National Center, Oklahoma City, OK 73012, are making their usual examination of our financial statements, and we shall be obliged, therefore, if you will kindly confirm to them the amount of our indebtedness to you as of the close of business on December 31, 1981. According to our records, our indebtedness to you on that date was as follows:

Date of note:	September 21, 1981 ✓
Due date:	March 31, 1982 ✓
Original amount:	\$10,000,000.00 ✓
Unpaid balance:	\$10,000,000.00 R-1
Interest	
Rate:	Continental Prime R-1
Date paid to:	11-23-81 R-1
Brief description of collateral:	PSB Stock

Yours truly,

Frank L. Murphy
Frank L. Murphy
Vice President
First Penn Corporation

The information stated above is (X) correct
() not correct

(Please give details of differences, if any.)

Signature Continental Illinois National Bank
Title and Trust Company of Chicago
Date _____

\$ 10,000,000.00

Chicago, Illinois, September 22, 1941
Date

ON DEMAND, the undersigned, for value received, promises to pay to the order of

-Continental Illinois National Bank and Trust Company of Chicago, at its office in Chicago, Illin

Ten million and 00/100

Doll

with interest thereon from date until paid at a rate per annum equal to the prime rate from time to time in effect ;
-0% per annum. The term "prime rate", as used herein, shall m
at any time the rate per annum then charged by said Bank (hereinafter, together with any holder hereof, called the Bank
Chicago, Illinois, for 90-day unsecured commercial loans to large corporate customers of the highest credit standing; and
rate at which interest accrues hereon shall change from time to time concurrently with each change in the prime rate. All inte
shall be payable ~~monthly~~ and be computed for the actual number of days elapsed on the basis of a year consisting of 360 d
The undersigned shall have the right to prepay this Note in full or in part at any time.

The term "Collateral", as used herein, shall mean: (i) the following described property, if any:

98,354 shares of the common shares of

~~First Penn~~ Square Bank, N.A.

*quarterly

(ii) any and all other property of every kind or description (a) of or in the name of the undersigned now or hereafter, for any reason or purp
whatsoever, in the possession or control of, or in transit to, the Bank or any agent or bailee for the Bank, or (b) in which the Bank now
hereafter has a security interest securing any of the Liabilities (as hereinafter defined) pursuant to the provisions of any written agreement
instrument other than this Note; and (iii) any and all dividends, distributions and other rights on or with respect to, and substitutions for i
processes of, any of the foregoing. The term "Liabilities", as used herein, shall mean all obligations of the undersigned under this Note ;
all other obligations of the undersigned to the Bank, howsoever created, arising or evidenced, whether direct or indirect, absolute or conting
or now or hereafter existing, or due or to become due. The undersigned agrees that, to secure the payment of this Note and all other Liabilit
the Bank shall have a lien upon and security interest in the Collateral and any and all balances, credits, deposits, accounts or mon
of or in the name of the undersigned now or hereafter with the Bank; and the undersigned further agrees to deliver to the Bank, upon re
quest, in due form for transfer, any of the Collateral which may at any time be in or come into the possession or control of the undersign
The cancellation or surrender of this Note, upon payment or otherwise, shall not affect the right of the Bank to retain the Collateral for
other Liabilities. The Bank shall be deemed to have exercised reasonable care in the custody and preservation of the Collateral if it ta
such action for that purpose as the undersigned shall request in writing, but failure of the Bank to comply with any such request shall
of itself be deemed a failure to exercise reasonable care, and no failure of the Bank to preserve or protect any rights with respect to
Collateral against prior parties, or to do any act with respect to preservation of the Collateral not so requested by the undersigned, sh
be deemed a failure to exercise reasonable care in the custody or preservation of the Collateral.

All obligations of the undersigned, and all rights, powers and remedies of the Bank, expressed herein shall be in addition to, and
in limitation of, those provided by law or in any written agreement or instrument (other than this Note) relating to any of the Liabilities or
security therefor. In addition to all other rights possessed by it, the Bank may from time to time, whether before or after Default (as hereina
defined), at its sole discretion and without notice to the undersigned, take any or all of the following actions: (a) transfer all or any part of
Collateral into the name of the Bank or its nominee, with or without disclosing that such Collateral is subject to the lien and security inter
hereunder; (b) notify any obligors on any of the Collateral to make payment to the Bank of any amounts due or to become due with res
thereto; (c) enforce collection of any of the Collateral by suit or otherwise, or surrender, release or exchange all or any part thereof; (d) i
control of any proceeds of any of the Collateral; and (e) extend or renew for one or more periods (whether or not longer than the origi
period) this Note or any obligation of any nature of any obligor with respect to this Note or any of the Collateral, and grant any releas
compromises or indulgences with respect to this Note or any extension or renewal thereof or any security therefor or to any obligor hereu
or thereunder.

If the undersigned shall fail to pay, when due, any amount payable with respect to any of the Liabilities or to perform any ot
obligation to the Bank, or if the undersigned or any Collateral or any balances, credits, deposits, accounts or moneys of or in the name of
undersigned now or hereafter with the Bank shall become subject to order of any court or to any other legal process, or restraint or to a
adverse claim, or if the Bank shall feel insecure for any reason whatsoever, such event shall constitute a Default hereunder. Upon Defa
(1) this Note and all other Liabilities may (notwithstanding any provisions thereof), at the option of the Bank, and without demand or not
of any kind, be declared, and thereupon immediately shall become, due and payable, (2) the Bank may, from time to time, without demand
notice of any kind, appropriate and apply toward the payment of such of the Liabilities, and in such order of application, as the Bank r
from time to time elect, any and all balances, credits, deposits, accounts or moneys of or in the name of the undersigned then or hereaf
with the Bank, (3) the undersigned agrees to pay all expenses, including reasonable attorneys' fees and legal expenses, incurred by the B
in endeavoring to collect any of the Liabilities or to enforce its rights with respect to any of the Collateral, and (4) the Bank may exercise fr
time to time any rights and remedies available to it under the Uniform Commercial Code as in effect from time to time in Illinois or othe
available to it. Without limiting the foregoing, upon Default the Bank may, to the fullest extent permitted by applicable law, without not
advertisment, hearing or process of law of any kind, (a) enter upon any premises where any of the Collateral may be located and te
possession of and remove such Collateral, (b) sell any or all of the Collateral, free of all rights and claims of the undersigned therei
thereto, at any public or private sale or brokers' board, and (c) bid for and purchase any or all of the Collateral at any such sale or broke
board. The undersigned hereby expressly waives presentment, demand, notice of dishonor, protest and, to the fullest extent permitted
applicable law, any and all other notices, advertisements, hearings or process of law in connection with the exercise by the Bank of any of
rights and remedies upon Default. If any notification of intended disposition of any of the Collateral is required by law, such notification
mailed, shall be deemed reasonably and properly given if mailed at least five days before such disposition, postage prepaid, addressed to
undersigned either at the address shown below or at any other address of the undersigned appearing on the records of the Bank. A
proceeds of any of the Collateral received by the Bank may be applied by the Bank to the payment of expenses in connection with t
Collateral, including reasonable attorneys' fees and legal expens, and any balance of such proceeds may be applied by the Bank tow
the payment of such of the Liabilities, and in such order of application, as the Bank may from time to time elect. No delay on the part of
Bank in the exercise of any right or remedy shall operate as a waiver thereof, and no single or partial exercise by the Bank of any right
remedy shall preclude other or further exercise thereof or the exercise of any other right or remedy. If more than one party shall exec
this Note, the term "undersigned" as used herein shall mean all parties signing this Note and each of them, and all such parties shall
jointly and severally obligated hereunder.

The loan evidenced hereby has been made, and this Note has been delivered, at Chicago, Illinois, and shall be governed by a
constructed in accordance with the laws of the State of Illinois. If this Note is not dated when executed by the undersigned, the Bank is here
authorized, without notice to the undersigned, to date this Note as of the date when the loan evidenced hereby is made. Wherever possi
each provision of this Note shall be interpreted in such manner as to be effective and valid under applicable law, but if any provision of t
Note shall be prohibited by or invalid under such law, such provision shall be ineffective to the extent of such prohibition or invalidity, with
invalidating the remainder of such provision or the remaining provisions of this Note.

FIRST PENN CORPORATION

Bill P. Jennings
Bill P. Jennings, President

Address P. O. Box 26208
Oklahoma City, Oklahoma 73126

110 506

CONTINENTAL BANK

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO
231 SOUTH LASALLE STREET, CHICAGO, ILLINOIS 60693
(FEDERAL RESERVE FORM U-1)

A FALSE OR DISHONEST STATEMENT ON THIS FORM MAY BE PUNISHABLE BY FINE OR IMPRISONMENT (U.S. CO TITLE 15, SECTION 781f AND TITLE 18, SECTIONS 1001, 1005 AND 1014). A BORROWER WHO FALSELY CERTIF THE PURPOSE OF A CREDIT ON THIS FORM OR OTHERWISE WILLFULLY OR INTENTIONALLY EVADES T PROVISIONS OF REGULATION U WILL ALSO VIOLATE FEDERAL RESERVE REGULATION X, "RULES GOVERNI BORROWERS WHO OBTAIN SECURITIES CREDIT".

Instructions:

- (1) Section 221.3(a) of Regulation U requires that a statement of purpose must be obtained in connection with any extension credit by a bank secured directly or indirectly by any stock. The term "stock" is defined in section 221.3(f) and includes security commonly known as a stock; any voting trust certificate; any security convertible, with or without consideration, i such security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right.
- (2) Part I (3) and (4) need be filled in only if the purpose of the credit described in Part I (1) is other than to purchase or c margin stock. The term "margin stock" is defined in section 221.3(v) and generally means (1) stocks that are registered c national securities exchange and stocks that are on the Federal Reserve Board's List of OTC Margin Stocks, (2) debt secur (bonds) that are convertible into such stocks and (3) shares of most mutual funds.
- (3) Part II "Date and source of valuation" need be filled in only if such source is other than regularly published information j journal of general circulation.
- (4) Part II, except for the certification by the officer of the bank, need not be completed in the case of a credit of \$5,000 or which is not for the purpose of purchasing or carrying margin stock. However, in such cases, Part I must be completed.
- (5) Please print or type (if space is inadequate attach separate sheet).

PART I To be completed by borrower(s)

- (1) Is this credit in the amount of \$ 10,000,000.00 , or any part thereof, for the purpose of purchasing or carrying margin stock? YES
 If "no", describe the specific purpose Purchase bank stock

- (2) In addition to this credit, do you have any other outstanding credit that has been extended by this bank, or has this bank agreed to extend additional credit to you? *
 Is any of the collateral listed in tables (1) and (2) of Part II to be delivered, or has any such collateral been delivered, from a bank, broker, dealer or person other than you?
- (3) If "yes", from whom? Fidelity Bank N.A. Against payment to deliverer?
- (4) Has any of the collateral listed in Part II been owned less than 30 days?

The undersigned has (have) read this form and any attachments thereto and hereby certifies and affirms that the best of my (our) knowledge and belief the information contained therein is true, accurate and comple Furthermore, to the best of my (our) knowledge, the securities listed as collateral in Part II are authentic, g; uine, unaltered, and not stolen, forged or counterfeit.

Execution of this form shall not constitute a Bank commitment to renew or extend additional

SIGNED _____ SIGNED _____
(Borrower's signature) (Date) (Borrower's signature) (Date)
 By: Bill P. Jennings, President
(Print or type name) (Print or type name)

THIS FORM SHOULD NOT BE SIGNED IN BLANK

FIRST PENN CORPORATION

Notes to Financial Statements, Continued

During 1981, the Company sold certain of its unimproved land at a gain of \$401,000. Also during 1981, the Company acquired the Bank's land used principally for its drive-in facility at its recorded cost of \$469,426.

(6) Deposits

Included in time deposits of the Bank at December 31, 1981 and 1980 are approximately \$162,400,000 and \$116,473,000 (including \$32,000,000 and \$8,300,000 held by First Penn Corporation), respectively, of certificates of deposit in denominations of \$100,000 or more. Interest expense on such deposits approximated \$20,761,000 and \$8,765,000 (including \$1,824,000 and 270,000 on deposits held by First Penn Corporation), for the years ended December 31, 1981 and 1980, respectively.

(7) Commercial Paper

The Company obtains funds to support its investment activities through the issuance and sale of commercial paper. Commercial paper aggregated \$38,674,788 (with weighted average interest rates approximating 10.94%) and \$14,640,252 (with weighted average interest rates approximating 17.57%) at December 31, 1981 and 1980, respectively.

(8) Notes Payable

The following summarizes notes payable for which the Company is obligated:

	<u>1981</u>	<u>1980</u>
Interest rate floating with Dallas prime, due February 27, 1981, secured by land with a recorded cost of approximately \$1,240,000	\$ -	1,106,800
Interest rate floating with Chicago prime, due on demand, secured by 98,354 shares of Bank common stock	<u>10,000,000</u>	<u>7,500,000</u>
	<u>\$ 10,000,000</u>	<u>8,606,800</u>

The interest at Chicago floating prime will increase by 1/2% in February 1982 with subsequent bi-annual increases of 1/4%. Interest is payable quarterly. Quarterly principal payments of \$250,000 begin March 1982 with final payment in March 1992.

(9) Income Taxes

The consolidated income tax provisions for 1981 and 1980 differ from the normally expected income tax rate of 46% principally because of income from tax-exempt municipal securities and investment tax credits. The income tax benefit for the parent company represents the excess of amounts payable by its subsidiaries in lieu of paying income taxes on a separate return basis over the taxes payable on the consolidated return.

(Continued)

The CHAIRMAN. Then would you address the second part of my question, the difference between the \$7 million and the \$10 million?

Mr. PERKINS. Yes; as I understand it, based particularly on what Mr. Baker has just told me, this loan was a \$10 million loan which we were the agent for the loan, and it is on our form. We participated \$3 million of this loan to the Seattle First Bank in Washington. That is my understanding. I would like to verify that independently but I believe that is correct.

The CHAIRMAN. Good. We will ask the Seafirst people as well and get double verification.

I am sorry for the interruption, but you can see why we had this little dilemma.

[Subsequent to the hearing, the following information was received from the Continental Bank for inclusion in the record:]

Pursuant to your request we have reviewed the confirmation signature appended to the First Penn Corporation's letter to us asking for confirmation of a Peat, Marwick, Mitchell and Co. audit request, dated February 24, 1982, concerning the loan Continental Bank had made to the First Penn. This is a standard auditing request and our investigation shows that it was handled in a normal manner by our Operations Control Division which had the loan records of the Bank reviewed by Dyanne Scholvin, who signed the request, confirming the original loan and current balance outstanding of \$10,000,000.00. As we explained during our testimony, we were acting as an agent bank in the transaction with Seattle First National Bank which had purchased \$3,000,000.00 of the original loan. With an audit inquiry of this nature it is usually not material to the auditing firm what banks may be holding portions of the original loan since the purpose of their inquiry is to confirm an outstanding liability owed by the audited company.

Mr. PERKINS. Yes; I can.

We were talking about what we were in effect liable for. With these exceptions, the loans we are talking about were financial accommodations to customers developed by Penn Square Bank largely in the Oklahoma market or to borrowers who had previously been customers of both Continental and Penn Square. I would like to emphasize that point. These were some almost 300 different loans at the time, June 30 date, to a whole series of customers, not to the Penn Square Bank.

As one medium for establishing a lending presence in various markets, Continental has for many years worked with, and in many cases purchased loan participations from, local correspondent banks operating in such markets, including a number of Oklahoma banks.

In the late 1970's Penn Square Bank appeared to be in a favorable position to provide Continental with loan participations which would accord Continental additional access to the Oklahoma market for oil and gas credits. This market was comprised predominantly of independent producers; that is, producers other than the major oil and gas companies.

These Oklahoma independents tended to deal primarily with Oklahoma-based financial institutions. Continental had over the years enjoyed considerable success in financing oil and gas independents in various locales, including Oklahoma, and further expansion in the rapidly growing Oklahoma market seemed attractive.

In the period preceding the second half of 1981, primarily because of high oil and gas prices, oil and gas exploration activity was at a high level. Moreover, U.S. energy policy exempting deep well gas from price control triggered a flurry of deep well drilling which, because of the large outlays required for specialized rigs and other added costs, resulted, even when successful, in recovery of high cost gas.

The activity level was especially high in Oklahoma, where new deep gas and other discoveries in the Anadarko Basin encouraged heavy investment, the major part of which was financed.

Early in 1982 oil and gas prices dropped significantly from prior levels, and the volume of gas purchased declined. This drastically affected the oil and gas industry and the financing of its activities.

Drilling for high cost deep well gas has become less attractive. Activity slackened as investment incentives were reduced and as discoveries provided less valuable than originally thought. The result has been a severe decline in industry activity, putting many medium sized and smaller businesses under severe cash flow and debt service strain.

Penn Square was a primary lender in the Oklahoma oil and gas production industry and marketplace, and many of its loans were adversely affected by the unexpected downturn in Oklahoma's economic fortunes.

This turn of events was obviously not favorable for Penn Square Bank. However, Penn Square's situation did not by any means appear to be all negative. Between 1978 and 1981 Penn Square's parent holding company, unlike the vast majority of U.S. banking institutions during the same period, had been successful on a number of occasions in selling additional stock for the purpose of increasing Penn Square's capital base.

This was especially reassuring because Penn Square Bank's needs for additional capital were unusually large by reason of its fast rate of asset growth over these years. In addition, Penn Square's earnings history and rates of return on assets and capital had been very healthy.

Penn Square had become the fifth or sixth largest bank in the State of Oklahoma, and it appeared to be making further inroads on its competitors there. It is true that Penn Square had had prior auditing problems and bank examination criticisms, which were known. However, the qualified auditors' letter regarding Penn Square's 1980 audit, which was received in the spring of 1981, appeared to relate primarily to housekeeping matters. The same was true of criticisms made during early 1981 by the national bank examiners.

Subsequently, moreover, Penn Square had hired a highly regarded new president and several executives with experience in back office problems. It seemed to be making significant progress. This progress was recognized in a satisfactory special supervisory examination completed by the national bank examiners in November 1981.

In March 1982 Penn Square received an unqualified audit for its 1981 fiscal year from Peat, Marwick, Mitchell & Co. In short, the fact that Penn Square had a severe problem did not become appar-

ent until well into the national banking examiners' review, which began in April 1982.

On June 29, 1982, Continental was notified by the Comptroller of the Currency that the examination of Penn Square Bank had revealed very serious loan problems. On July 5, 1982, the Comptroller closed Penn Square Bank and the FDIC took over as receiver in liquidation.

Continental's involvement in the Penn Square loans has had severe consequences for Continental. As has been announced in the press, at the end of the second quarter of 1982, an extraordinary \$220 million provision was made to Continental's reserve for possible loan losses, to accommodate anticipated possible losses from Penn Square loans.

What caused all of these problems? There are several obvious causes. The extent to which each contributed, however, is a question we are still seeking to sort out. The adverse economic events—and the particular severity with which they impacted on the Oklahoma market—were a significant factor, as I have indicated.

Production loans to oil and gas independents which are excellent or good credits in a period of satisfactory energy prices become more marginal credits in a period of sustained price weakness, and loans collateralized by rigs or other production equipment, which are secure credits at a time when rigs are in short supply, become much less secure when large numbers of rigs suddenly become idle and unmarketable.

However, economic adversity was not the sole cause. The energy credits originated by Penn Square appear to present more problems than could have been caused solely by the economic downturn, drastic as it was.

Penn Square as an originator and servicer of a large amount of loans in which our bank participated was, to say the least, a disappointment. Not only did Penn Square fail properly to complete essential analytical and followup work necessary to underwrite, document, collateralize, and report on a number of the loans which it originated, but Penn Square appears to have misled Continental regarding material aspects of some of the transactions, including, among other things, the existence of collateral and secondary obligations which had been held out as the basis for some of the transactions.

In the complicated and somewhat frenzied workout which commenced hard on the heels of the closing of Penn Square, the FDIC and the participating banks are learning more each day about the loans which Penn Square originated.

Until this process is complete, a comprehensive assessment of the underwriting and loan documentation deficiencies, and a detailed chronicle of instances in which participants may have been misled by Penn Square, cannot be made.

With regard to some of the Penn Square participations, there appears the possibility of departures by Continental personnel from our bank's own procedures. We are in the process of reviewing and evaluating the 300 loans in which Continental participated to determine the extent to which our personnel may have failed to adequately check and review underlying loan and collateral documentation.

We are also seeking to determine whether and to what extent there are situations in which our personnel may have made hasty credit decisions contrary to Continental's credit evaluation procedures and to what extent there have been other departures from standard Continental procedures in specific transactions or from other directives.

We are fully cognizant of the magnitude of the Penn Square matter and its considerable impact on our institution. We have designated a committee of respected present and former officers of Continental, none of whom has been otherwise involved in any way with Penn Square, to investigate the history and circumstances of our relationship with Penn Square, to review the performance of Continental personnel in connection with the Penn Square transactions and to reevaluate our systems and procedures.

Our board of directors has established a special committee of unaffiliated directors to review the investigation conducted by the officers' committee. The special committee of the board has its own outside counsel and independent auditors to advise it and has broad powers to determine the scope of the investigation. In short, the Penn Square matter is receiving unstinting, careful attention.

Continental, like other major banking institutions, has rigorous and exacting procedures for credit approval and loan documentation and for periodic annual loan review of all credits. These procedures apply whether a loan is originated directly by Continental or is a participation in a loan originated in a bank.

Although our investigation of the Penn Square transactions is not completed, it has progressed sufficiently that I can tell you that we believe that our problem in Penn Square was with human error, not with the bank's procedures.

We have taken action to assure that henceforth our procedures are systematically followed. As an additional precaution, our officers' committee, in conjunction with the special committee of non-affiliated directors, is midway through an intensive study to determine whether additional controls are needed.

Since the closing of Penn Square Bank on July 5, 1982, Continental's management and its advisers have devoted a great deal of time and attention to the Penn Square situation as it affects our institution.

We believe that we are addressing our problems in an orderly and careful manner. We believe in our basic business principles, and we are confident that these principles, supported by the fundamental strengths of our institution and reinforced by what we have learned from this experience, provide the basis for a successful future.

We would be very pleased now to respond to your questions. With your leave, I will call upon Mr. Baker, Mr. Cummings, or Mr. Cordell to answer those questions which they are better able to address than I because of greater familiarity with Penn Square events or other matters or more extensive knowledge of the energy industry.

The CHAIRMAN. We are in hopefully what might prove to be, if the Senate can get its act together on the continuing resolution, the last week of this session prior to the eventful day known as November 2. That is a very meaningful date for many of us who sit

here who do have contested races. We have tried to convince our constituents that we have civil service status, but that hasn't worked.

Under the circumstances, a lot of things are happening, and there was no way to predict what today's schedule might be. It turns out that it is absolutely imperative that there will be a conference on legislation coming within the purview of this committee dealing with thrifts and commercials and credit unions.

Mr. PERKINS. We have heard of that.

The CHAIRMAN. I hope and trust that the other witnesses who are going to be appearing later on today after this panel are aware of it as well.

Under the circumstances, we have to beg your indulgence and that of the members of the committee. We are now going to recess, go into conference without benefit of sustenance, and return here at no later than 3 p.m. We would ask you if you would be good enough to let staff know where you are going to be. If we hit a snag and can get here before 3 p.m., I would like to resume prior to that time for the convenience of the witnesses.

So, why don't we say that in any event we will be in recess and start out at about 2 o'clock and no later than 3 o'clock, but at least about 3 o'clock we would like to have you back here, as well as the people from Michigan National, Mr. Driggs and Mr. Peterson.

All of the witnesses that are scheduled to testify today, please be available here along about 2 o'clock—actually, it will take an hour for this panel, so 3 o'clock. If we don't get back until 3 o'clock, we don't start up until 3 o'clock. We have no control over that because we will be arguing with Senators, and you never know how long that takes.

Mr. PERKINS. Mr. Chairman, your ability in that field is quite legendary.

The CHAIRMAN. Mr. Barnard said the last one took 14½ minutes. The committee will be in recess to the call of the Chair.

[Whereupon, at 12:18 p.m. the committee recessed, to reconvene the same day at the call of the Chair.]

AFTERNOON SESSION

The CHAIRMAN. The Banking, Finance and Urban Affairs Committee will resume its sitting.

We trust you gentlemen enjoyed your respite. We worked.

Mr. PERKINS. I trust you got everything solved.

The CHAIRMAN. The conference is all over with, the papers have been signed, the Senate is going to the floor momentarily.

Mr. Perkins, Mr. Lytle was dismissed from your institution; and this morning, in answer to questions from the various members of the committee as to why the dismissal, he restricted himself to repeating the statement that was issued by the bank. He was with the bank for, what, 22, 23 years?

Mr. PERKINS. Twenty-two or twenty-three years, I believe.

The CHAIRMAN. Good employee all that time?

Mr. PERKINS. That was—

The CHAIRMAN. Obviously, he was promoted as time went along.

Mr. PERKINS. Yes, I would say a good employee, yes.

The CHAIRMAN. It seems peculiar that he restricted himself to that statement.

Upon his departure did he take with him any pension benefits, and so forth, or had they accrued? He was what, 53 years old?

Mr. PERKINS. Forty-seven, I think. In his late forties, I believe.

The CHAIRMAN. Does anyone at the table, among this distinguished group of individuals with you have knowledge of what the terms of his departure were?

Mr. PERKINS. I had knowledge of that, Mr. Chairman, but I really don't have it on the tip of my tongue.

The CHAIRMAN. How about Mr. Baker, Mr. Cummings?

Mr. PERKINS. The technical questions on pension plans and things of that type get pretty complicated, and I would hesitate to try to just call it off the top of my tongue because I really don't remember.

The CHAIRMAN. You have no technicians with you that would be familiar with that.

Mr. PERKINS. No, that is one area we didn't think to bring along. We have all the—

The CHAIRMAN. To be honest with you, Mr. Perkins, as I reflect upon this morning's hearings, I asked myself, well, now I wonder what the terms of the departure were or dismissal or severance. Was there severance pay? Does he still get a certain amount? Is he on pension? Is he getting an early pension?

Suppose we submit a set of questions to you on that and have them answered in writing?

Mr. PERKINS. If you would like to submit them, I would be delighted.

[The information referred to is retained in the committee files.]

The CHAIRMAN. I can understand, you have how many employees at your institution?

Mr. PERKINS. It is about 13,000.

The CHAIRMAN. So you might have a bit of a problem. We don't quarrel with that.

Now, did any of you—Mr. Perkins, did you, yourself, ever meet any of the individuals at Penn Square Bank and sit down with them, such as Mr. Jennings, Mr. Patterson, and any of the others, during this period of time that the loan participations that were being purchased from Penn Square sort of went up rather dramatically on the charts?

Mr. PERKINS. No, I know none of them. I have never been in the Penn Square Bank.

The CHAIRMAN. Mr. Baker.

Mr. BAKER. Yes; I met some of the people. I met Mr. Patterson on two occasions, and Mr. Jennings on two occasions, and have been introduced to a number of the customers.

The CHAIRMAN. Did you meet them in Chicago or in Oklahoma City?

Mr. BAKER. Once in Chicago and once in Oklahoma City.

The CHAIRMAN. You did go to Oklahoma City?

Mr. BAKER. In April of this year.

The CHAIRMAN. April of this year, you were not yet aware of the problems that existed?

Mr. BAKER. No; it was a routine trip to Oklahoma City in connection with an economic briefing that we were having there. Our economists were speaking.

The CHAIRMAN. You went to Oklahoma City for a convention? With all due deference to Oklahoma City, and I was there and I didn't think they had many conventions there. You had a convention there?

Mr. BAKER. No; our economists go and make a presentation on their current view of the economy in a number of cities.

The CHAIRMAN. For the benefit of the local financial institutions? Or investors?

Mr. BAKER. Customers, banks in the area. We invite there—there were probably 75 or 100 there that night.

Mr. PERKINS. It is part of our marketing effort.

The CHAIRMAN. As far as the participations that Continental had that they purchased from Penn Square, what was the amount at its high point?

Mr. PERKINS. Approximately \$1,050 million.

The CHAIRMAN. \$1,050 million?

Mr. PERKINS. Yes.

The CHAIRMAN. When you and I were young, Mr. Perkins, there used to be the "Lucky Strike Hit Parade," most people wouldn't remember that. They used to rate the songs, you know, from 1 to 10 on the list. Now they rate other things 1 to 10. But take a Lucky Strike rating. How would you rate the amount of participation loans purchased from Penn Square by Continental? Would they be—these were all energy loans, correct?

Mr. PERKINS. Yes.

The CHAIRMAN. Energy-related loans. Where would they rank on your chart, your popularity charts at Continental?

Mr. PERKINS. In terms of total volume?

The CHAIRMAN. Yes; compared to other financial institutions from which you were purchasing participations.

Mr. PERKINS. As I said in my statement we have had participations with correspondents; we have been active in correspondent banking for many, many years.

The CHAIRMAN. I am well aware of that.

Mr. PERKINS. But this situation was a statement which we made in our July 21 press release on our financial results for the quarter, we said that this was a unique situation and I believe that same wording applies to the Penn Square situation. This is—the amount of these participations are just—not comparable to anything else. The others tend to be figures of \$20 or \$25 million at the most.

The CHAIRMAN. All right. Now, the gentleman who was here this morning, he was given a pink slip. He seems to have been penalized. However, you know I have quite a few employees and I remember old Harry Truman said "the buck stops here." Right?

Now here is a chap down the line, as a matter of fact he obviously didn't have to report his loans he made or he sought from Penn Square, or anything of the sort, because he wasn't considered, obviously, that important at Continental. Yet he was—he seems to be the gentleman who has taken the, you know, he has taken the brunt of the blame. Didn't anyone, Mr. Baker—Mr. Cummings, I

understand you were in Europe so we couldn't ask you about it. But Mr. Cordell, the Texan, you are the Texas expert, Mr. Baker, and you, Mr. Perkins—don't you think that you share a little of that? Didn't that \$1 billion figure come to your attention?

Mr. PERKINS. Not to my attention until last spring when it appeared in some publications. On the other hand, it had come at various places at various times, and as I recall, Mr. Chairman, there were several people that have left the bank since that time.

The CHAIRMAN. Mr. Baker.

Mr. PERKINS. Let me say, I think from the chairman on down we all share responsibility. Obviously.

The CHAIRMAN. Mr. Baker.

Mr. BAKER. Yes, sir.

The CHAIRMAN. Since you had met Mr. Jennings and Mr. Patterson you probably knew about the extent of the participations here.

Mr. BAKER. I knew about the magnitude of our involvement, although we were of the impression that many of those were direct loans as opposed to participations.

The CHAIRMAN. You were under the impression?

Mr. BAKER. Yes.

The CHAIRMAN. Oh, that is good.

Mr. Baker, did you ever meet Mr. Hefner?

Mr. BAKER. Not prior to June 29. I have met him since then.

The CHAIRMAN. Mr. Swan.

Mr. BAKER. I may have met him—well, I am sure that I met him in Oklahoma City that day we were there.

The CHAIRMAN. How about J. D. Allen? He was a partner of Mr. Swan.

Mr. BAKER. I presume so, although I—

The CHAIRMAN. Nothing that really would have impressed you.

Mr. BAKER. No.

The CHAIRMAN. Mr. Patterson obviously on occasion would go into Chicago and entertain some of the people at Continental. Were you ever the beneficiary of his lavishness, his entertainment?

Mr. BAKER. No, I was not.

The CHAIRMAN. You mean he never took you for a drink?

Mr. BAKER. Never.

The CHAIRMAN. Mr. Cordell, how about you and Mr. Patterson, did you ever meet him along the way?

Mr. CORDELL. I met him probably twice, once in Chicago when I just happened to be there, and I met him, shook his hand in the hallway probably twice at an industry convention, and that is all I ever recall.

The CHAIRMAN. How about other individuals I have asked about? Mr. Jennings.

Mr. CORDELL. No, sir.

The CHAIRMAN. Mr. Hefner.

Mr. CORDELL. No, sir.

The CHAIRMAN. Mr. Swan.

Mr. CORDELL. No, sir.

The CHAIRMAN. Mr. J. D. Allen.

Mr. CORDELL. No, sir.

The CHAIRMAN. Mr. Cummings, you were brought in to conduct an inquiry, brought in from the European branch I imagine be-

cause you have ties, your ties were not that close with the people working at the Chicago main office and you were brought in to conduct an inquiry and look into the overall situation. Is that correct?

Mr. CUMMINGS. To conduct it together with two other officers of the bank and some outside people. I was the senior officer.

The CHAIRMAN. You were brought in to bring an unbiased view probably because you were not as close as some individuals involved?

Mr. CUMMINGS. Well, that is right. I was not close to the Penn Square situation or the customers at all. Of course I knew the people in the bank.

The CHAIRMAN. Can we be sure that the microphones are on?

You have a soft typical voice, were you stationed in France or England?

Mr. CUMMINGS. I was stationed in London, but I was responsible for covering the Continent.

The CHAIRMAN. OK. Now, during this period of time that you have been looking at the situation in Chicago have you made any recommendations for change to the parent institution?

Mr. CUMMINGS. The review process we are going through really has had two phases. We, first of all, in the phase that I was most closely involved with was discussing the personnel side of the problem to see whether there had been failures in the management of the various divisions and departments concerned. That phase really has been completed and recommendations or evaluations were made by the group that I was working with.

Now what is going on in the bank is what we call phase II of this same review process, which is to look into the policies and procedures of the—primarily of the lending activities of the bank and see whether there were any recommendations that should be made for changes there.

I was really principally and only involved with the first phase which was completed and evaluations made of the people in the way responsibilities were carried out.

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. Thank you, Mr. Chairman.

Mr. Perkins, I have read your statement once and I have listened to the testimony this morning, and I have listened to the testimony in Oklahoma City. I can't help but compare, you know, when I read some of the swindles of Yellow Kid Wild. I think that this fellow Jennings and the other principal involved at the bank bamboozled a lot of people, including people in Oklahoma City. It is shocking that they got away with it for so long.

In the examination of the bank at Penn Square by the Comptroller's Office, when they examine a bank, here you are a large depositor, if you please, at Penn Square. Was there any way that you could know what was happening? In other words, when the Comptroller of the Currency comes in and examines the books at the Continental Illinois Bank and then at Penn Square, is there ever any coordination?

Mr. PERKINS. Congressman, I would be hard-pressed to answer that not knowing the inner workings of the Comptroller's Office. We have had during these recent—these recent months we have seen quite a bit of coordination as we are all trying to get at these

problems and work our way through it. But what they do internally or how their reports are circulated from one office to the other I just don't know.

Mr. ANNUNZIO. The thing I am getting at is, if the Regional Director's Office of the Comptroller of the Currency in Oklahoma City is making an examination of the books, and if they come in with a problem, they find a severe problem—after all they did issue a cease and desist order—don't they come back to let an institution like yours that has a couple of billion dollars invested, know what is going on?

Mr. PERKINS. Well, as I said, I really don't know what their procedures are. As I recall, the cease and desist order that was issued was after June 29 and at that time, from June 29 on we were in constant communication with the Comptroller and his people as well as with other regulatory authorities.

Mr. ANNUNZIO. Would you tell the committee just where you stand now? In other words, the Federal Deposit Insurance Corporation has ordered this bank closed.

Mr. PERKINS. Right.

Mr. ANNUNZIO. They are in the process of liquidating assets. How will Continental share in this liquidation?

Mr. PERKINS. I would ask Mr. Baker to answer that. He has been working with the people there as we said earlier. We now have an office in Oklahoma City. There are 33 or 34 people in that office. They are working their way through this loan by loan and item by item in cooperation with the FDIC and the other banks.

George, would you like to comment?

Mr. ANNUNZIO. Give us some idea of what the amount is that you probably can recoup or recover?

Mr. BAKER. Well, as to the amount, Congressman, you will recall we started out with \$1,054,000,000 in loans involved in Penn Square and in July made a provision for loss of \$220 million against those loans which would suggest that our best judgment at that point in time was that our realization net, net would go in the magnitude of \$835 million. Obviously that is a difficult judgment to make and can be affected by further changes in the economy, declines in gas prices or what have you. But it will be a matter of working out a whole series of loans.

We are involved in some 250 loans. Some of them Penn Square has a participation in, some of which they don't. We will have a crew of people in Oklahoma City for several years because many of these are long-term loans that will theoretically be paid from the production of gas.

So we are interdependent to some extent in that in some cases the Penn Square and ourselves and the SeaFirst or the Chase might be involved in the same situation with sometimes looking at the same collateral, sometimes looking at different pieces of collateral, but obviously it will require a very close coordination and cooperation. But our best judgment as to the realization has not changed. We continue to think that it will be in the neighborhood of \$835 million.

Mr. ANNUNZIO. What is the total amount of the deposits in Continental?

Mr. PERKINS. Well, deposits are a little difficult to measure because they adjust quite a bit when you get into Eurodollars, but the—

Mr. ANNUNZIO. Assets?

Mr. PERKINS. Assets of the bank, it runs in the \$45 or \$46 billion area. The total, the loan portfolio, is commonly thought of as the loan portfolio, is in the area of \$34 billion or so.

Mr. ANNUNZIO. How severely can you tell, in view of the fact you have assets between \$40-some billion, and Mr. Baker estimates a loan writeoff of \$220 million?

Mr. PERKINS. Yes.

Mr. ANNUNZIO. I have read the papers, I know what their stock reports are. But how severely have you been hurt, and is there an opportunity to recoup if the economy changes?

Mr. PERKINS. Well, certainly if the economy were to improve and the demand for oil and gas improve, it would help this liquidation process. No question about that. But it is a very severe problem obviously when we have to provide \$220 million as a special provision for losses on top of the normal provision that we make quarterly. That varies with the state of the economy.

Mr. ANNUNZIO. My time has expired, but I want to ask one question. To your knowledge, did Continental Illinois have personal loans to any officers of Penn Square?

Mr. PERKINS. Perhaps I could ask Mr. Cummings to cover that?

Mr. CUMMINGS. No, we did not. The loan referred to this morning to Mr. Jennings was a loan that was made and repaid, I think, in 1978. At any rate it was before we had had any participations from the bank. In fact, before we had the loan to the bank holding company.

Since that loan to Mr. Jennings has been paid we have had no other loans to officers of the Penn Square Bank.

Mr. ANNUNZIO. My time is up, Mr. Chairman.

The CHAIRMAN. Why don't you ask him what the purpose of that loan was and the amount of it in 1978?

Mr. CUMMINGS. As I recall that loan was—the amount was \$1 million, whether it had built up to that or not, I don't know. But it was secured by stock in, as I remember, a utility company in the Southwest. We had no problem with that loan. It was repaid on schedule.

The CHAIRMAN. Do you recall what the purpose of the loan was?

Mr. CUMMINGS. I believe it was to make investments in another company.

The CHAIRMAN. Wasn't it 1978 that Jennings retook control of Penn Square?

Mr. CUMMINGS. To my knowledge—

Mr. BAKER. Yes.

Mr. PERKINS. To my recollection, Congressman, it is that it was several years before when he took control of it. The figure 1975 sticks in the back of my mind.

The CHAIRMAN. Thank you.

Mr. Weber.

Mr. WEBER. Thank you, Mr. Chairman.

Mr. Perkins, I notice on page 10 of your testimony the statement that our problem in Penn Square was with human error, not with the bank's procedures.

My question is, whose human error are you talking about? Internal error within the bank, or are you talking external error on the part of Government supervisors? Or can you clarify that?

Mr. PERKINS. Well, what we mean by that statement is the question really, I was trying to address there is, are our basic policies and ways of doing business and our procedures and practices as spelled out in the way we are supposed to be doing things, are they basically at fault or is it because some of our practices and procedures were not followed as they should have been through human failure of one kind or another.

What I was trying to say here is that we think that basically this was a unique situation and that as we look at the total picture we still have a very strong situation. But in this situation there was human failure to completely follow the practices and procedures that are in place.

Mr. WEBER. So basically I guess what you are saying is that the bank had certain procedures that were good, but that you are satisfied with apparently, pending any corrections that may come through your study; but your people apparently failed to execute those procedures properly?

Mr. PERKINS. Yes; and of course, as I said here, our investigation is still in place but it has been going on for some time now. That is our conclusion at this time.

Mr. WEBER. Do you feel, based on your conclusion at this time, that if your bank procedures had been followed, to what extent do you feel that that would have reduced your losses?

Mr. PERKINS. I would think it would be extremely difficult to quantify and I hesitate to do it, but I would think it would have been sizable.

Mr. WEBER. Do you have any complaint with or recommendation regarding changes or corrections in the Federal law or Federal regulations of any kind?

Mr. PERKINS. No, I don't believe I would at this point. This is obviously a very, very large subject that you are all addressing in this area. But as you well know, there are good reasons for some of the problems, both good reasons legally and financially and otherwise, of the confidentiality of certain types of institutions like banks and relationships and there are other problems that you have been raising this morning. I think I would hesitate to just try to get at that in just a few lines.

Mr. WEBER. You have no particular recommendations at this time as to legislation, then, that Congress ought to adopt?

Mr. PERKINS. No, I don't believe so. I would be glad to address specific things, issues, but I don't believe so.

Mr. WEBER. Do you have any fault with auditors, either at Arthur Young Co. or Peat, Marwick, Mitchell & Co. people? I noticed earlier in your testimony you reviewed their qualifications to their audit report and concluded that that was basically what you called housekeeping matters.

Have you made any demand upon Arthur Young or Peat Marwick with respect to recouping your losses or liabilities in this matter?

Mr. PERKINS. No; we have not. But I would like to ask Mr. Cummings to comment on a phase of that.

Mr. CUMMINGS. We were particularly interested in those opinions more in connection with our loan to the First Penn Corp., which is the holding company that owns the bank. In that area we were—we saw, of course, and were aware of the qualified opinion from Arthur Young which we got in the spring of 1981 and then we followed that situation during that year to see whether the Penn Square Bank was taking corrective measures.

As far as we could tell at the time because of the new president, for instance, new petroleum engineers and improvements in the backroom and other things, then the fact that there was a clean opinion given on the audit which we received in the spring of 1982, we were, as far as we could tell the condition within the bank was satisfactory.

Mr. WEBER. OK.

Mr. CUMMINGS. I would say we had no reason to be critical of the Arthur Young or Peat Marwick audits.

Mr. WEBER. Are you saying that based on the information that was available to you, if you had executed your own banking procedures properly you would have been well satisfied to have received any losses in this situation? Perhaps that question isn't clear.

You have no criticisms of the way in which our laws relate to financial disclosures in this situation. Your main criticism is the self-criticism of the way in which your own procedures were executed?

Mr. PERKINS. Yes; in a broad way. Obviously to the extent that we were given incorrect information or to the extent that things were said to us on which we relied that were just plain not true or maybe perhaps even more than that, obviously that is a different matter.

Mr. WEBER. In connection with fraud or—were there any forgeries of instruments that you are aware of?

Mr. PERKINS. I don't believe so, but I don't believe we can answer that question. I don't believe at this stage that that is an answerable question.

Mr. WEBER. My time has expired.

The CHAIRMAN. Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Perkins, just a moment ago you said that everyone in the bank from the top echelon down shared in the responsibility. How did you mean that?

Mr. PERKINS. Well, perhaps that was too broad a statement when I said everyone in the bank. I think what we call the corporate office or senior management level, different people had different responsibilities but overall you can't be chairman or president of a large organization without sharing some broad responsibility in those areas at least.

Going down from that, down the chain of people that were involved, both in the lending side and in the processing auditing and

other sides, certainly there are degrees of responsibility in these specific lines and channels.

Mr. BARNARD. Not meaning to put words in your mouth, what you—

Mr. PERKINS. I didn't mean that Mr. Cummings had any responsibility for it.

Mr. BARNARD. What you say is that you had in place policies and practices of performance which normally would not have allowed a situation like this to develop?

Mr. PERKINS. We believe that is correct.

Mr. BARNARD. And possibly somewhere along the line the checks and balances that you had in place fell apart and—

Mr. PERKINS. That was what I meant in the sense of it was a human problem.

Mr. BARNARD. Did you have a loan review committee or a loan administration committee that checked behind the lending officer to be sure that all the documents were in place, somebody who was unbiased in their dealings with the customer?

Mr. CUMMINGS. Maybe I should answer that since I have been involved in trying to review this.

Mr. BARNARD. I was thinking of Mr. Cordell because he was working in the department. Aren't you in this department?

Mr. CUMMINGS. He is in a different division of the oil and gas department.

Mr. BARNARD. Excuse me. I came from a country bank. I don't know all about this.

Mr. CORDELL. I am in the oil and gas group, but I run a separate division, and I was not involved in the midcontinent division, nor did John Lytle work for me nor did I work directly with him. I was in the oil and gas group in a similar position running the Texas division.

Mr. BARNARD. What is the practice in your division? Do you have checks and balances to examine this?

Is this a normal volume of activity, whether it be oil and gas or any other particular lending operation? Is this a normal volume of activity for a bank this size, a \$400 million bank, generating 2.5 billion dollars worth of loans, of which your bank participated over \$1 billion? Is that a normal volume for a bank this size?

Mr. CORDELL. That is a large volume from one source, but we do not look at that bank as the entity to whom we are loaning. Each loan and each separate note is a separate deal, and we should look at it, we should evaluate it, and we did as a separate deal. Every loan is looked at separately no matter whether it is a participation or not.

Mr. BARNARD. When do you look at it, Mr. Cordell, before the loan is made or after the loan is made? Did you know that there were supposed to be records where the collateral value was doctored after the loan was made?

Mr. CORDELL. If those kinds of things happen, that obviously is fraud, but you would look at the documentation and determine whether or not it was all there before you put money out the door.

Mr. BARNARD. Well, I think I have pursued that long enough.

Did the audit and the statement of either of the auditors influence the bank at all?

Mr. PERKINS. The audit of the Penn Square Bank?

Mr. BARNARD. Yes; you had two audits. You had one with one paragraph qualifying a matter and you had a second audit which really didn't in essence offer any qualification at all. Did either one of these letters or audits influence the bank?

Mr. PERKINS. They were obviously part of our analysis and thinking. How much it influenced the people that were directly involved one way or the other, I don't know, but it is clear from the records that these were looked at and analyzed and appraised.

Mr. BARNARD. Of course you come from one direction as far as a participating bank, a lot of other institutions involved in this matter, such as credit unions, who had money invested there, and they were relying on advisers and other people.

Do you think possibly legislation should develop that would put some legal emphasis to statements of auditing firms?

Mr. PERKINS. Again, I don't feel qualified enough on that. I am sure there has been a lot of debate on that in many ways. On the other hand, it does seem to me that the responsibilities on them are very heavy and, as you know, there is a body of court rulings and opinions built up which do place pretty heavy responsibility.

So, I am not so sure there is—my offhand view would be that there is no need for a legal prescription on that. Nor do I think it would be very easy to write the law.

Mr. BARNARD. Mr. Cummings, when we were in Oklahoma City and we were talking with directors of the Penn Square Bank, to the person, if I am correct, not one of them felt that the Comptroller of the Currency should have closed this bank. Every one of them felt that the bank was sound. Every one of them said that they felt that the bank could have been salvaged.

Being bankers and knowing something of what makes a sound bank and an unsound bank, do you think this bank should have closed?

Mr. PERKINS. Not having been a part of all the details on the bank or with the history of it or the data available, I would be very hard pressed to have a firm opinion on that.

On the other hand, I did spend several days in Washington at various meetings at the Comptroller's and the FDIC. I know an enormous amount of analysis was made on this, and it seemed very clear to everyone that the bank was not viable.

Mr. BARNARD. Did you have any question as to why it took them so long to make a decision if the history of this situation goes back several years? On two occasions they asked the board of directors to come to Dallas and discuss the very involved situation of the bank. Maybe they threatened cease and desist, maybe they didn't. Nobody is very clear on that.

Wouldn't you think that over a period of 2½ years it took the Comptroller's Office a long time to make a decision?

Well, I know you are in a ticklish situation of having to criticize the Comptroller of the Currency, but in your position you have a better evaluation of it than those of us on the committee.

Mr. PERKINS. Of course, the Comptroller has been at this many, many years in the office, and on the whole I think the record has been quite good. The facts of any individual situation it seems to me are very, very difficult to appraise, and there is also an enor-

mous legal responsibility on the Comptroller in taking an action of this type.

Mr. BARNARD. But in this situation, though, this delay has cost some innocent institutions, many credit unions, one right here in the building, hundreds of thousands, millions of dollars.

Mr. PERKINS. Well, I agree with that, and I really hesitate to comment whether something should have been done sooner or not, but in any case I think it is fair to say that when we are in an economy such as we are in, it is not a risk-free economy, and I think it is very hard to make by law or anything else a completely risk-free situation.

Mr. BARNARD. May I have just one other question, Mr. Chairman?

The CHAIRMAN. True, but you know by the same token, Mr. Barnard, as one who has been in the hierarchy of high finance—

Mr. BARNARD. Who?

The CHAIRMAN. Thee, thou. Isn't it true there is a prudent man rule? There is prudent man rule, isn't there?

Mr. BARNARD. I understand there is one in the law.

The CHAIRMAN. I didn't want you to forget about it. You keep telling me about it. You exercise it. I am proud of you.

Mr. BARNARD. I try to. I wish everybody on this committee did.

Mr. Perkins, do you think the bankers in this country generally believe that the Office of the Comptroller of the Currency, those who come within his jurisdiction, has the power to remove management if they don't correct practices that they feel are unsound?

Mr. PERKINS. Oh, I believe that the general view is they have that ultimate power one way or another. That seems to be an issue that is not quite all that clear from some of the things I have read recently.

Mr. BARNARD. I told the Comptroller when he was before us, that if he didn't think he had that power, I hoped we were in executive session because he was turning loose every national bank in the country if they decided that he didn't have that power.

How many other members of your bank, personnel of the bank, officers, or otherwise, were dismissed because of Penn Square Bank?

Mr. PERKINS. Let me see if I can call it off. In the chain above Mr. Lytle there were three officers that resigned or retired. In the other side, in the loan review area, the head of that group retired and the auditor—the internal auditor that is—was reassigned and was replaced as an auditor.

Mr. BARNARD. One final question. Do you have a policy in Continental about officers of your bank borrowing from customers, borrowing from a participating bank?

Mr. PERKINS. I need to get some recollection here. We have a code of conduct, or whatever we want to call it, and this covers a fairly extensive code. It covers all these kinds of issues as to how this should or should not be done, terms and conditions, reporting of things, things of that type, and it also requires each officer to review it annually and sign a statement on that.

Mr. BARNARD. Thank you very much.

The CHAIRMAN. How frequently do you revise your code?

Mr. PERKINS. Could I ask one of the people that worked on it? I think it is reviewed fairly regularly. I don't remember when the last basic revision took place.

Mr. WALKER. We reviewed the code about 2 years ago, and I don't believe anything was changed because it was found to be covering the problems and circumstances that we saw. The code is probably 7 or 8 years old now. As said earlier, it was reviewed about 2 years ago for sufficiency and was found to be adequate.

The CHAIRMAN. Has it been reviewed and changed since July of this year?

Mr. WALKER. We have looked at it again and see no changes that are necessary.

The CHAIRMAN. Would it be possible to supply the committee a copy of the code of conduct?

Mr. PERKINS. Normally, we consider that a proprietary internal matter. On the other hand, given the significance of this and given the fact that certainly we want to be cooperative, we can probably make that available. I would like to consult with my associates.

The CHAIRMAN. We are looking at not the entire code. We are not concerned with that, but rather—

Mr. PERKINS. I understand.

The CHAIRMAN [continuing]. Rather at the loans, loan officers and high ranking personnel, what they would be borrowing from correspondent banks and participating banks, whatever.

Mr. PERKINS. Let me discuss that with my associates and Mr. Walker will get in touch with Mr. Lewis or somebody from your staff.

The CHAIRMAN. Thank you. That would be helpful.

Mr. Baker, we on the committee have become very familiar with the GHR. We read now about GHR in Good Hope, La. I am going to ask unanimous consent to insert in the record a copy of an article from the Wall Street Journal of September 21, 1982, describing the current problems of this company, which is another oil and natural gas company—this company, by the way, is run by an amazing gentleman named Jack Stanley, who took the company into bankruptcy in 1975, expanded while in bankruptcy and somehow got Continental to lend him \$115 million late in 1979 to get out of bankruptcy.

This same article indicates that the creditors questioned Stanley's expansion while they were not getting paid, and introduced the company to John Lytle. At the same time Banque de Paris, known as PariBas, began extending letters of credit and eventually involved none other than Chase, Seattle First National, and other American banks along with Continental Illinois. This amazing company has about \$70 million in past due bills, still owes about \$20 million from its chapter 11 period, most of it to the Department of Energy.

One company, Grinell Fire Protection Systems from Providence, R.I., filed in court a log showing some 70 phone calls over 5 months to GHR, trying to collect a \$298,000 claim. The log says in December 1981 Grinell was being told "the till was empty". Apparently in February of this year the cash shortage got so severe that the bottled water and coffee were taken out for nonpayment.

[The article from the Wall Street Journal referred to by Chairman St Germain follows:]

[From The Wall Street Journal, Sept. 21, 1982]

HOW AN OIL FIRM GREW WITH AID OF BIG BANKS DESPITE ITS CASH BIND

GHR CONVINCED THE LENDERS EXPANDING ITS REFINERY WAS BEST WAY TO PROSPER

JACK STANLEY'S RAPID CLIMB

GOOD HOPE, LA.—A quarter century ago, Jack Stanley was an 18-year-old high-school dropout pumping gasoline. Today, he is the unquestioned boss and sole owner of GHR Cos., a \$3.3 billion-a-year oil and natural-gas empire that ranks as the nation's third largest private industrial company.

The building of GHR often has been tumultuous. In 1975, with dozens of creditors clamoring for money, Mr. Stanley took his company into Chapter 11 of the bankruptcy code, where it stayed for five years, expanding enormously all the while. The GHR refinery here, one of the country's biggest, has regularly been accused of breaking environmental laws and has suffered fires, chemical spills and worker unrest; and even swallowed the town of Good Hope when it needed room to expand.

But such turbulence didn't stop some of the world's biggest banks from putting up hundreds of millions of dollars to fuel Mr. Stanley's dreams. Within the last two years, a consortium of 14 banks, headed by Continental Illinois National Bank & Trust Co., Chase Manhattan Bank and Banque de Paris et des Pays-Bas, has lent GHR \$750 million. Now, however, the bankers are having reason to regret their stake in this little-known empire.

UNPAID BILLS

The company's rapid expansion coincided with a decline in oil prices and demand, and GHR is suffering a cash shortage. Dozens of suppliers that sell the company products ranging from drilling equipment to stationery have sued GHR for millions of dollars in unpaid bills. Fifteen percent of GHR's white-collar work force has been laid off in the past few weeks for "economic reasons." The company has been unable to make its interest payments. The banks and GHR have agreed to delay repaying part of the debt.

In an interview, Mr. Stanley acknowledges his company's cash crunch but expresses confidence that the company will work out its problems. Besides obtaining the restructured bank agreement, the company is in the process of selling \$100 million of gas reserves to raise money. "I can't see any real problems," he says. "We just need to figure out how to get a few more dollars."

But some of his bankers are less confident. Says a top executive of one lead lender of GHR: "I wish to hell we weren't in it."

Many of the country's most aggressive banks, including Citibank, Bank of America and Security Pacific National Bank, declined to lend money to GHR last year. Several of the banks that did lend to the company—notably Continental Illinois, Chase and Seattle First National—have been hurt badly by other energy-loan losses, especially in the demise of Oklahoma City's Penn Square bank.

In GHR's case, these banks say their loans are sufficiently covered by the company's natural-gas reserves, valued at more than \$1 billion. But they acknowledge that trying to recover money by taking over assets is an expensive and time-consuming process they strive mightily to avoid. Says one banker: "It's one thing to have oil and gas in the ground and another thing to get it out."

Thus, the GHR story is in part an account of how banks have eagerly pursued risky energy loans carrying the promise of big returns: GHR has been paying 2½ percentage points over the prime rate. It is also a testament to the persuasive powers of John R. Stanley.

He is an enigma, an intensely private man who regularly refuses to have his picture taken for fear it might aid would-be kidnappers and endanger his wife and four children. In nonbusiness relations, the 43-year-old Mr. Stanley is a reticent man, associates say, who shows little interest in the trappings of wealth. One exception: three vintage Jaguar sports cars.

A PIONEER

Some outsiders who have dealt with him speak of Mr. Stanley almost reverently. Edwin Edwards, who while governor of Louisiana helped lure Mr. Stanley and his

corporate headquarters from Massachusetts says, "If you were writing an epic about America 150 years ago he'd be the pioneer, the one who climbed the mountain, the one who beat the odds." And a Houston banker observes, "He can make you a believer in what he wants to do."

To some employees, he is a hard-driving mean-talking boss. One former GHR geologist recalls that when he went to work at the company Mr. Stanley told him: "I'm a greedy son of a bitch. If I ever catch you giving anything away, I'll have your ass."

Even some bankers seem to fear him. One lending officer begs a reporter not to quote him by name, after discussing Mr. Stanley.

Mr. Stanley is a tall man with thinning light-brown hair and boyish mannerisms; he sometimes answers questions by shrugging his shoulders, rolling his eyes skyward, or grinning sheepishly. He is a jogger who generally avoids alcohol, seeming to reserve indulgence for his business. He has been seen working at his refinery until 2 a.m. At home, a computer terminal allows him to monitor the business.

Details of his early years in Springfield, Mass., are sketchy. After dropping out of high school (he eventually received a diploma), Mr. Stanley tried a local engineering school for two years while pumping gasoline to earn money. He quit school again and turned his full attention to the oil business.

Mr. Stanley leased the station he worked at and called it "Jack's Gas." Later, using the name of Gasland Inc., he acquired more stations; by 1970, he controlled about 230 in New England and New York.

He wanted more. Soon he went into oil-and-gas exploration in Texas and bought a small, 7,000-barrel-a-day refinery in the Louisiana town of Good Hope.

When Mr. Stanley found large natural-gas deposits in Texas, he used reserves valued at about \$200 million as collateral for bank loans to finance an ambitious new venture: building an ammonia plant that would use his natural gas as a feedstock. Not one to start small, Mr. Stanley embarked on building what would have been the largest ammonia plant in the country. He changed his company's name to Good Hope Industries.

The project was never completed. The price of ammonia fell sharply. Reevaluation of the gas reserves halved their value. As a result, a \$100 million financing package to be headed by Citibank fell through.

Banks, led by the First City National Bank of Houston, which had extended short-term credit, began pressing for immediate repayment and urged him to sell his gas properties for \$65 million. Instead, Good Hope on Oct. 31, 1975, filed in a Massachusetts bankruptcy court for protection under Chapter 11 of the bankruptcy law, which allows a company to continue to operate while it figures out a plan to pay its creditors.

The move didn't appear to stunt Mr. Stanley's ambition. "Most people slim down during bankruptcy. He had the vision to expand," says Sumner Darman, a lawyer who represented one of the creditor committees for the proceeding. For five years Mr. Stanley kept 2,000 creditors at bay while he poured millions of dollars into expanding his refinery. By the middle of 1980, when the company came out of bankruptcy proceedings, its assets stood at \$530 million, at least double the level of five years earlier.

COMMUNICATIONS PROBLEM

Mr. Stanley accomplished this growth by convincing his creditors that the company's survival—and their repayment—depended on his spending huge amounts on upgrading and expanding his refinery. His banks, as secured creditors, by early 1977 were paid off the nearly \$35 million they were owed; hundreds of unsecured creditors didn't receive a penny of their \$35 million during the bankruptcy. (Most now have been paid, with interest.)

On more than one occasion, creditors complained that Mr. Stanley was abusing their forbearance. In a September 1977 letter to the court, William Neary, a creditors' lawyer, complained that the company was expanding far beyond what had been agreed upon, raising "serious questions . . . as to the real motives of the debtor and its objectives in this proceeding."

Says Mr. Stanley: "A lot of that was a communications problem. In a bankruptcy, everything isn't absolutely peaches and cream."

During the Chapter 11 period, Mr. Stanley's growth continued to strain his capacity to pay for it. In a July 1978 status report, Mr. Neary wrote that he had been told by Mr. Stanley of "a severe cash-flow problem" that was causing the company to run "extremely late" in paying refinery bills.

The creditors, seeking a way to get off the hook, introduced the company to John Lytle of Continental Illinois (whom the bank recently dismissed as head of its energy lending group for his role in the Penn Square fiasco). Banque de Paris, known as Paribas, also had struck a relationship with Good Hope Industries, issuing letters of credit to finance oil deals.

Continental was then building a reputation that would for a time make it the envy of the banking world. Rising oil prices had spurred the domestic oil industry, and Continental moved aggressively to finance that growth. Since the bank could often demand rates well above prime from these untried companies, the business was lucrative.

Continental Illinois memos show that the bank was well aware of GHR's cash problems—and perhaps even welcomed them. One memo from Mr. Lytle noted the company anticipated that prospective cutbacks by GHR customers “will cause a cash problem in January which will force the creditors to allow some form of outside financing.”

In late 1979, Continental Illinois agreed to lend Mr. Stanley \$115 million, paving the way for Good Hope's May 1980 emergence from bankruptcy proceedings with a plan to pay off all creditors 100 cents on the dollar over a period of years.

Continental's interest soon drew other investors, who say they were impressed by Mr. Stanley's plans to transform his refinery into a state-of-the-art operation that could turn inexpensive heavy crude into such high-value products as gasoline. They were comforted by his sizable natural-gas reserves and his successful exploration ventures.

In addition, “we thought Stanley was a survivor,” says Donald Christie, who handles the GHR account for Paribas.

Mr. Stanley's cash requirements soon exceeded the banks' initial commitments. Within months after lending \$50 million a year ago, Chase raised its ante to \$125 million. Paribas increased its loans and letters of credit to GHR to \$245 million, and Continental's exposure grew to \$165 million. In December, 11 other banks were brought in, increasing Mr. Stanley's loans to the current \$750 million.

Banks that declined to lend the company money cite the generally poor condition of the refining business. More than one also indicate doubts about Mr. Stanley. One banker, asked to elaborate, says, “I don't want to get into personalities.”

Here is a list of GHR Cos. banks and the amounts they've lent the company:

List of GHR Co. Banks

	<i>Millions</i>
Banque de Paris et des Pays-Bas	\$245
Continental Illinois National Bank & Trust Co.....	165
Chase Manhattan Bank.....	125
National Bank of Detroit.....	50
Seattle-First National Bank.....	30
North Carolina National Bank.....	25
European American Bank & Trust Co.....	25
Banque Arabe et internationale D'Investissement.....	25
Mercantile National Bank of Dallas.....	13
Industrial National Bank of Rhode Island.....	10
Canadian Commercial Bank.....	10
First National Bank & Trust Co. of Oklahoma City.....	10
American Security Bank, Washington, D.C.....	10
Capital National Bank of Houston.....	7
Total.....	\$750

Mr. Stanley's personality and idiosyncracies pervade GHR. The company often operates without formal budgets, former executives say. “Forget about getting a budget,” one former department head recalls being told by the accounting department. “I was just supposed to spend money until I was told to stop.”

William D. Crays, GHR's executive vice president for finance, says that with the company's rapid growth, GHR wasn't able to develop “highly sophisticated budgets.” But now, he says, GHR is “trying to develop more formalized types of approach.”

Former executives say Mr. Stanley inspects nearly every bill paid. He acknowledges scrutinizing bills down to \$1,000. One former GHR executive recounts how, during an 8 a.m. business meeting, he received a phone call from Mr. Stanley questioning a \$20 lunch tab.

GHR has a stormy history of employee relations. The company has a running battle with the Oil, Chemical and Atomic Workers union over contract and organizing issues. GHR claims individual employees have sabotaged the plant, and last year it fired 24 workers for refusing to take lie-detector tests.

A string of executives, lured by the fat salaries Mr. Stanley offers, have come and gone. Some quit, others were fired, many of those interviewed said working for Jack Stanley was an experience they would rather not repeat. "Going into his office was like walking into a cave where there's a bear with a bad migraine," one former official says.

"I don't think I have a temper," says Mr. Stanley. "But if I find something isn't being done, I've got to do something about it."

One three-year GHR veteran who was dismissed as part of this month's cost-cutting effort says he learned of his dismissal from a curt note left on this desk telling him he had been "terminated for economic reasons."

GHR's boardroom setup is unusual, too. Xavier J. Grilletta Sr., chairman of B & G Crane Service Inc. of Jefferson, La., was listed as a GHR director in a company mailing to suppliers. But Mr. Grilletta, whose company is a supplier of GHR, says, "I've never agreed to be on the board of directors and don't consider myself a member. Jack once told me he owed me so much money he was going to name me to his board. I thought he was joking."

Mr. Crays says GHR sent out a "proposed list" of directors, but hasn't yet put together a board. "Mr. Stanley is the board of directors," he says.

Supplier lawsuits against the company this year have included a \$480 claim—which was settled—for an unpaid airplane flight and many claims for hundreds of thousands of dollars of unpaid-for drilling or refinery equipment. One supplier, Grinnell Fire Protection Systems Co. of Providence, R.I., filed in court a log showing some 70 phone calls it said it made to GHR over five months trying to collect a \$298,000 claim.

The log shows that in December, Grinnell was being told by GHR that "the till was empty." Last February, according to the log, a GHR employee said the cash shortage was so severe the company's "bottled water and coffee" were taken out for nonpayment.

In many supplier cases settled so far, the court eventually ordered (or GHR agreed to) full payment of the claim, but the process took months and the payments often would be stretched out.

Mr. Crays estimates GHR has about \$70 million in past-due bills. Mr. Stanley says the company is in the midst of settling them and hopes to do so in 30 days—though payment may take longer.

Mr. Stanley's payment record has led many suppliers to demand cash on delivery or certified checks, says a former GHR accountant. Cashing GHR checks is complicated because many are drawn on the Third National Bank of Hampden County, located in Mr. Stanley's hometown of Springfield, Mass. Sources say W. R. Grace & Co. several months ago delivered chemicals to the refinery and immediately flew GHR's check to Massachusetts to cash it quickly. The check bounced anyway. A Grace spokesman declined comment on the matter but says GHR currently doesn't owe it any money.

GHR still owes about \$20 million from its Chapter 11 period, most of it to the federal Energy Department as a settlement of alleged oil-pricing violations in the 1970s. The Energy Department has filed a complaint with the bankruptcy court claiming GHR violated its agreement when it failed to post a \$13 million letter of credit with the government. The department has asked that GHR either post the letter of credit or be put in liquidation under the bankruptcy law.

Mr. Crays notes that meeting the government's demands would further strain GHR's cash problems. Mr. Stanley says the dispute is near a compromise and dismisses the bankruptcy threat.

"Lawsuits always sound ominous, but it doesn't ever work out that way," he says.

Mr. Stanley says he wants to focus on working out the operating problems at his refinery, which has added \$500 million in new equipment over the past two years. He talks like a man who has lost his yen to grow. "I'm 43, and enough's enough," he says. "I've got a good-sized company and I want to consolidate my gains and reduce the debt."

While such words are undoubtedly welcome to his banks, some question whether the man who built the GHR empire can slow down. "Cash-flow problems have caused him to pull his neck in," says Tom Crooks, an official of C-E Lummus, a Combustion Engineering Inc. unit that has worked on the GHR refinery. "But he is always sticking it out again."

Mr. Grilletta, the unwilling director, echoes that idea. "Jack Stanley," he says, "is either going to be the richest or the brokest man in the world."

The CHAIRMAN. Mr. Baker, could you tell us how Continental Illinois got involved with this intriguing situation?

Mr. BAKER. Well, I can't give you all the details of it. It occurred in late 1979, as you indicated, and it was in Mr. Lytle's area of responsibility, although obviously a loan of that magnitude would have other people participating in it.

Companies do in fact come out of bankruptcy, you know, as they go into bankruptcy, and we have not been averse to financing a company coming out of bankruptcy if it can make a logical reorganization plan.

In this case we obviously felt that there was a logical plan. Mr. Stanley is an unusual man, as you probably also saw from that article. He started with one gas station and now has a gigantic refinery in Good Hope and very valuable gas resources in Texas.

He has been very adversely affected by the economy and the drop in demand for crude and the throughput in his refineries, so he has a severe cash flow problem, evidenced by the trade credit and the bank situation and so forth.

More than that, as to the origination of the loan, I can't tell you a great deal. I wasn't involved in it. I am now probably more involved in it than I was before.

The CHAIRMAN. Now, do we have Mr. Brennan here?

Mr. BRENNAN. Yes.

Mr. PERKINS. Yes, he is here.

The CHAIRMAN. Mr. Brennan, I am going to ask staff to hand you a document titled "Assignment of Overriding Royalty Interests." Both on the first and third pages of that material you note the GHK Exploration Co. making the royalty assignment.

Is not GHK Exploration Co., one of the interests of Mr. Robert Hefner III? Do you recall working on this one?

Mr. BRENNAN. Yes. I am aware that—yes. GHK Exploration Co.—

The CHAIRMAN. Is it one of the interests of Robert Hefner III?

Mr. BRENNAN. GHK Exploration Co. is a partnership, an Oklahoma partnership, and Mr. Hefner I believe is the general partner.

The CHAIRMAN. On the first page, royalty interest is assigned to a "Continental Leasing Company," a general partnership in care of Bill Patterson, Penn Square Bank. On page 3 of the material, a royalty interest is assigned to Continental Illinois Energy Development Corp., a Delaware corporation with a Houston address.

Are either of these Continental-named entities which received these royalties a part of the Continental Bank of Illinois?

Mr. BRENNAN. Certainly Continental Illinois Energy Development Corp. is related to Continental Bank. Continental Illinois Energy Development Corp. is a subsidiary of Continental Illinois Corp., the parent company of the bank.

The CHAIRMAN. Were these royalty assignments collateral for a loan, do you know?

Mr. BRENNAN. I believe not.

The CHAIRMAN. Or were they part of—

Mr. BRENNAN. I am not familiar with this specific transaction.

The CHAIRMAN. Do you know if this was part of Continental's efforts at Oklahoma to go to direct rather than participation loans through another bank?

Mr. BRENNAN. May I consult with Mr. Baker?

The CHAIRMAN. Certainly.

Mr. BRENNAN. I am sorry; I ought to be familiar with this document, but I am not, and if you give me just a second to look through it.

The CHAIRMAN. Mr. Cummings, did you at any point happen to come upon these assignments and royalties, et cetera, et cetera?

Mr. CUMMINGS. No, we did not. In our review we really didn't review specific transactions loan by loan.

Mr. PERKINS. I think it fair to say, though, Mr. Chairman, that that kind of a thing wouldn't be for some purpose about direct versus indirect or anything. That was probably a particular transaction that had particular interests to our Houston subsidiary in this field and was a direct deal entered into on a businesslike basis.

The CHAIRMAN. In view of the fact that Mr. Brennan is not that thoroughly familiar at this point, what we will do is have staff address some questions to him.

Mr. BRENNAN. We will be delighted to answer them for the record.

[A legal document, "Assignment of Overriding Royalty Interests," dated April 7, 1982, was submitted for the record and may be found at the end of the hearing as Appendix B.]

The CHAIRMAN. Mr. Perkins, did you come to Washington sometime about July 1 at the behest of the Federal supervisory agencies to have discussions of Penn Square and its problems?

Mr. PERKINS. As a matter of fact, I happened to be in the Maryland area on June 28 or June 29, and we were having a dinner here in Washington with some customers, and when I got back to the hotel I had a telephone call from Roger Anderson, chairman of the bank.

He had received a call earlier in the day from the Comptroller indicating that there was a meeting of three of the banks involved in this credit with the Comptroller of the Currency. We talked on the phone, and we agreed that I would stay overnight and go over to the Comptroller's Office the next morning and meet with him and his staff with the Chase and Seafirst people.

The CHAIRMAN. Now, that was July—

Mr. PERKINS. That would have been July 1. It was June 29 in the evening when I got that call, or I had gotten it earlier in the day, but I answered it then.

The CHAIRMAN. And was there any discussion as to the feasibility of salvaging Penn Square at that time during that meeting amongst the parties involved?

Mr. PERKINS. I am trying to recall. It seemed to me that the discussions, as I recall them, were not on the feasibility of salvaging so much but rather on the form in which the closing of the bank would take place.

The CHAIRMAN. Had they decided at that point that they were closing it?

Mr. PERKINS. I really can't answer that, Mr. Chairman. There were several days then and there were a lot of discussions, and it is

a little hard to separate those first couple of days from that July fourth weekend, when there were a lot of back and forth discussions.

The CHAIRMAN. Now, we were told that Mr. Hefner, as well as Bill Jennings, were in the office of Continental June 30 seeking assistance, I think, with respect to the capital requirements.

Did you meet with them, Mr. Baker?

Mr. BAKER. No, I did not.

The CHAIRMAN. Mr. Perkins, you were in this area?

Mr. PERKINS. No, I was here in Washington.

The CHAIRMAN. You were here. Therefore, you didn't meet with them at that time?

Mr. PERKINS. We heard they were in the bank.

The CHAIRMAN. Mr. Cummings probably had not arrived yet from his sojourn in the British Isles.

Mr. CUMMINGS. Right.

The CHAIRMAN. Mr. Cordell, you were in Texas?

Mr. CORDELL. Yes.

The CHAIRMAN. Do you know who they met with on this occasion, Mr. Perkins?

Mr. PERKINS. It is my recollection—and again I would want to check the facts carefully—but it is my recollection that he was in the bank and that he did meet with certain people in the energy division, including Mr. Redding, who was then head of the oil and gas area.

Is that your recollection, George, of what we heard?

Mr. BAKER. Yes, I think those people were in Chicago for a day or two and I believe met with Mr. Lytle, Mr. Redding, and possibly Mr. Bergman.

The CHAIRMAN. This was Jennings and Hefner that went there?

Mr. BAKER. Yes.

The CHAIRMAN. Now, Mr. Perkins, if you had been aware of Mr. Lytle's loan relationships with Penn Square, you know the handshake loans from Bill Patterson, what would your reaction have been at the time that they occurred? Would you have consented to them? What would you have said about them? Obviously you were not aware of them at the time they occurred or transacted.

Mr. PERKINS. I was not involved in that, but I think Mr. Cummings has reviewed a good deal of that.

The CHAIRMAN. Before we get to Mr. Cummings, Mr. Perkins, you are the chief honcho. What I am asking you is without seeing your code of conduct, what would your feeling have been? What would your reaction have been to it?

Mr. PERKINS. Well, very questioning and very dubious and wondering why and what? Are there conflicts? Those kinds of questions.

The CHAIRMAN. This morning you were present when we were questioning Mr. Lytle about that.

Mr. PERKINS. Yes.

The CHAIRMAN. He said well, you got to go to some bank. Of course, there were 14,000 banks around the country you can go to. So you agreed that there should have been a little more discretion exercised—

Mr. PERKINS. Oh, yes.

The CHAIRMAN. Rather than play buddy-buddy with Patterson. That clouds your judgment. In other words, when somebody is doing what appears to be a favor for you.

Mr. PERKINS. Well, I would put it on the basis that arranging the loan situations with a bank for whom you are handling a great deal of the business raises real questions.

The CHAIRMAN. OK.

Ms. Oakar.

Ms. OAKAR. Thank you, Mr. Chairman.

Following up on your question, in Mr. Lytle's testimony, he says on page 8, August 30, 1982, "He was terminated. In a press release I charged I was being made a scapegoat", and on page 8 in your testimony, Mr. Perkins, you say the Penn Square transaction was, to say the least, a disappointment.

"They failed to properly complete essential analytical and follow-up work necessary," and so forth.

They deliberately failed to provide you with information and deliberately misled Continental.

Now, what was your responsibility? What was the bank's responsibility? What was the bank's responsibility in procuring the proper documents and analyses and indeed, is Mr. Lytle the scapegoat in this operation?

Do you assume, does your bank, beyond Mr. Lytle, assume any responsibility for the travesty that took place?

Mr. PERKINS. Well, I believe we talked about that, I think, before you were able to be here and clearly, there is a lot of responsibility for this and for the fact that procedures were not carried out properly and that the—

Ms. OAKAR. I am sorry I was not here, but do you blame it on Mr. Lytle essentially, or do you assume that some other people are responsible?

Mr. PERKINS. Mr. Cummings is the gentleman who has been involved in this investigatory process internally. I would like to ask him to comment on that.

Mr. CUMMINGS. The point of this phase of our management review when we were looking into the actions of our various officers was trying to see exactly where the responsibility lay and where it might have broken down.

The way lending is handled in our bank or in any large commercial bank is, I think, basically, the responsibilities start with the account officers and the managers of a particular division where a loan is to be examined, recommended, approved and booked.

That is, the basic responsibility lies for both making the original credit decision and getting it approved at the proper levels and seeing that the documentation is in good order and that the collateral has been received and is either received in-house or else it has been proved that it is in proper condition.

Ms. OAKAR. In such a large transaction, however, wouldn't the upper echelon of the—

Mr. CUMMINGS. What I was going on to say was that beyond the account officers and the section managers, then would be the division manager and the department managers.

Their responsibility would be principally in analyzing and approving larger loans referred to them and then, of course, they also do have a responsibility for seeing that the——

Ms. OAKAR. That the division is well managed.

Would your board of trustees get involved in a decision of approval or disapproval?

Mr. CUMMINGS. No.

Mr. PERKINS. Could I just make a comment. There may be some confusion. I have tried to make it clear.

This was a series of 200 and almost 300 different loan transactions ranging in amounts from several hundred thousand dollars up to many millions and it was not a big transaction with Penn Square so much as a series of loans, many of which came through Penn Square.

But they were a series of individual transactions and were handled in that fashion and took place over a period of time.

Ms. OAKAR. Just one last quick question. Mr. Lytle indicated at the end of his testimony that he felt that there was some corrective legislation that ought to be enacted to prevent a recurrence of this situation.

Do you agree with that?

Mr. PERKINS. No, I don't believe I do. I think as you get into your examination, you may or may not decide that there are certain aspects that would require something, but overall, this was a breakdown which we have been discussing and it seems to me that you cannot legislate complete perfect performance at all times.

Ms. OAKAR. Was he the only one fired? Mr. Lytle, was he the only one fired?

Mr. PERKINS. Depends on—well, there were a series of six or seven people involved, Mr. Lytle was dismissed, as you say; there were several other people, several senior officers that were either retired or resigned.

The CHAIRMAN. Ms. Oakar, it was the modern-day version—you realize it is Chicago—of the Valentine's Day massacre.

Mr. Leach.

Mr. LEACH. Mr. Perkins, I had the privilege of joining the chairman of the committee for the session in Oklahoma City. I came to the conclusion that perhaps Penn Square was an aberration, and I certainly can believe that problems in the midlevel of your bank, both with regard to judgment and perhaps conflict of interest, are also an aberration.

The question remains, however, whether the overextension of large banks is an aberration or whether it is a problem endemic in American banking. It is a question as to whether Penn Square was, in fact, the queen of spades in a house of cards that extends the length and breadth of American banking.

You have concluded in your testimony and I quote, "that we believe our problem in Penn Square was one of human error, not with the bank's procedures."

Mr. PERKINS. Yes.

Mr. LEACH. I would like to ask several questions in this regard.

Your bank has a long and distinguished history as the leading agricultural lending bank in America. I have talked with a number of rural bankers about Continental, and you are held in the highest

regard. But they also expressed to me their exasperation at the incredible loan documentation that you require with agricultural lending. Do you think you had comparably rigid standards in the case of your petroleum lending, particularly with regard to Penn Square?

Mr. PERKINS. Leave out the last phrase, "particularly with regard to Penn Square," I believe we do have the same kind of very specific requirements.

Mr. Cordell could detail in great detail, both from an engineering standpoint and credit standpoint, the kind of requirements we have and I think we have probably made some banks in other areas in the energy industry as distraught as some of our Iowa friends in documentation and the rest.

We believe that this was a unique situation and that the failure was in this area.

Mr. LEACH. One is left with the impression, frankly—

The CHAIRMAN. He qualified his answer deleting the words "Penn Square." Is he saying that they did not require this of Penn Square?

Mr. PERKINS. I am saying, Mr. Chairman, that we believe we have these same rigid standards and apply them throughout the organization, not just with Mr. Leach's Iowa friends in the agricultural area, but the breakdown in the failure was with this Penn Square situation.

The CHAIRMAN. In other words, you did not use the same criteria or requirements?

Mr. PERKINS. We had the same requirements and criteria but they were not carried out.

The CHAIRMAN. OK.

Mr. LEACH. Let me pursue this a little bit because from the perspective of an Iowan, a resident of a small-bank State, there is the sense that small loans are subject to very rigid standards and that the larger the loan, the less rigid the standards.

We have in the State of Iowa very strict standards regarding the condition of our banks. In 1980, I believe, Penn Square received a scope qualification in an audit conducted by one of the largest American auditing firms, by an auditor who holds a very prestigious position, or did, as head of the banking audit body of the CPA's of the country.

I would like to ask you whether that scope qualification caused your bank any alarm and whether you took any action because of it. A scope qualification, as I understand it, does not mean that the bank failed to meet capital requirements, but indicates that the auditors did not know what the loan liabilities were. What did your bank do when you looked at this audit statement, or did you not look at the audit statement?

Mr. PERKINS. We did—we obviously were concerned as everyone else was. I think I should distinguish, Mr. Leach, we had two relationships in a sense, one of them was the participations in the oil and energy and oil and gas and energy loans with the Penn Square through the division, Mr. Lytle's division, as discussed this morning.

The other relationship, which was much smaller, was handled in our U.S. banking division, which was loans to the Penn Square

Corp., the holding company, which ran as high as \$7 million at the most and then overnight, Federal funds loans, which ran \$3 or \$4 million.

There were considerable concerns about that audit and Mr. Cummings is very familiar with that, having reviewed that whole situation here and I would like him to comment on it, because we did take a number of actions because of it.

Mr. CUMMINGS. A similar question was asked before you were here, Mr. Leach, and I said that we had in mind the loan to the First Penn Holding Co.

We discussed it with bank management, we felt satisfied they were doing the things which had been required or recommended, which were, first of all, they hired a new president who at the time we understood was going to be the managing force in the bank; they hired new people in their petroleum and engineering department and the operations end of it; we followed the review—reviewed with the management of the bank the quality of their loan portfolio and were satisfied that things were apparently improving and, of course, the following spring of 1982, they had a clean audit from Peat, Marwick, Mitchell & Co.

So, in general, we thought that things were being corrected at the bank.

Mr. LEACH. Let me pursue this.

Mr. PERKINS. We also sent some teams of our own people down to help in and work with them to try to satisfy ourselves that things were getting improved.

The CHAIRMAN. When?

Mr. LEACH. The chairman asked when this occurred.

The CHAIRMAN. When did you send those teams down?

Mr. Cummings, would you be good enough to get the mike a little closer. Don't be afraid of it now, it does not bite. We are having trouble hearing you, sir.

Mr. CUMMINGS. We sent one group of, a team from our auditing department down in October 1981, another team in December 1981 and March or April 1981, there was a group of people from our loan operations division that went down to work and assist with the operating end of the bank.

Mr. LEACH. Coming back to the question of bank procedures, I would like to go beyond that to ask whether bank policies are at stake.

As you know, a number of banks in the country, and you are considered a leader in this area, have placed a great deal of emphasis on growth. There is some question, however, whether growth has occurred at the expense of prudence.

Now, hindsight is always an easy thing in this area, particularly hindsight when the American economy turns down a bit. But in this regard, there is one kind of dollar sign that was very interesting that Mr. Lytle presented to us.

It has been argued that some banks are not only growth oriented, but are rewarding growth-oriented employees. Mr. Lytle, for example, indicated he had a \$69,000 salary, but his total remuneration from the bank amounted to about \$125,000 a year.

The questions I would raise to you are: Are you reexamining your policy of promoting growth and do you think that you and

other banks in your general category are rewarding growth over prudence in terms of employee remuneration?

Mr. PERKINS. This is a very interesting question and it is certainly on the top of many bankers' discussions as to whether or not these things relate.

I would say that in terms of the bank's total growth, our aim was to grow soundly, to compete but to compete soundly, and in general have a high, strong position in the industry and indeed to increase our market share, but on the right basis.

We had always from a management policy standpoint taken the position that we wanted to grow but we wanted to grow with quality and we didn't want growth just for growth's sake but rather growth for the proper reason.

The second question relates to incentive compensation in the banking industry or you can say in most any industry, but particularly the financial industry. The banking industry was probably one of the ones for incentive compensation to come in later in the game than anywhere else.

But as the banks and particularly the major banks began to compete more and more with all kinds of other businesses, as indeed financial services business spread throughout all kinds of both depository and nondepository institutions and as managing the large worldwide corporations tended to compete for the same types of people, it was clear that we had to have certain types of incentive plans in our business if we were going to remain competitive and attract the first rate staff that we believe we have.

Now the question comes, how do you manage those incentive systems?

Our general incentive system is not one related to growth or production or things of that type. It is a system based on the performance of our bank in relationship and in competition with what we call our peer banks, the top 10 banks in the country as measured by total size.

This is for a total staff, it is not a quota type of thing, a sales type thing at all, not at all. It is the total performance of the bank. Indeed many of the criteria involved in appraising our record vis-a-vis the others have to do with the adequacy of our loan reserves, with the quality of our credit and many of those features just trying to avoid that situation.

I would conclude and say that we do have a few special situations where we are competing in very specialized markets where the incentive system is tied more to appraisal of individual performance. For example, in the Federal Government, municipal, and agency trading departments where we have a large and old and established department there, we are competing for people there not with the general banking market, but we are competing with the investment bankers and other trading houses, and we have had to gear a special incentive program more in line with what we have had because those people are very, very mobile.

Mr. LEACH. I appreciate that. Let me say coming from a small business oriented as well as a small bank State that the rural areas have been swept of funds by money market mutual funds and all sorts of other means including interbank lending. We have seen high-priced money chase higher priced money at the largest bank

extreme of less than perfect judgment while small banks have made tougher, harder, more prudential decisions.

Let me come back again to your bank as any other business. When you deal with a commercial client you deal on the basis of dollars and cents, but you also deal on the basis of judgment. That is, a bank deals with another company because of the people that head that company.

Mr. PERKINS. Right.

Mr. LEACH. How did you as a banker and as an individual assess Mr. Jennings and Mr. Patterson?

Mr. PERKINS. Well, as I said, I think before you came in, I do not know either of those gentlemen and have not met them. Certainly I think I would share what I assume is your assessment on the basis of what I have learned since the June 29 period.

Mr. LEACH. I think it is relevant, not only because of this unique situation, a bank operating differently from any other bank, as a merchant bank in essence, but because of the idea that a bank's very differentness would incline other banks to follow it carefully. The fact that your bank has \$1 billion in participation loans based on the judgment of a young lending officer is a reflection on bank management, which I think ought to be reassessed.

Let me go to another question. As I understand it, the day after the regulatory authorities informed the major banks that there was a problem with Penn Square, Seattle First made a public announcement of their potential bank lending losses. Your bank did not immediately make a comparable announcement. Do you think you were correct in not making an early announcement?

Mr. PERKINS. We believe we were correct, Congressman. We believe that the situation was so sudden in terms of what we were faced with, was so large and that we had so many legal responsibilities under the Securities Acts and others that prudent judgment would say we better know what we are, where we are before we make some statement.

We felt that it was absolutely necessary to go through that portfolio item by item and come to conclusions as to what our loss might be before we set such a loss. We felt it would be obviously imprudent to have a special provision of so many hundreds and hundreds and hundreds of millions that you just couldn't do that. We thought it would be equally bad to make a provision that we thought might be all right the first day and discover a couple days later when we learned more that it should have been twice as big and have to come back which is to destroy whatever credibility we might have.

Mr. LEACH. I understand that. Let me ask a different question—

Mr. PERKINS. Like I say, though, we felt also that we have very serious legal responsibilities when we published our second quarter financial statements that we had to say that in our judgment the provision for loan losses was adequate and that is not an easy statement to make when you are faced with that kind of situation.

Mr. LEACH. Understood.

One of the questions that a lot of us have stems from the regulatory authorities' assertion that they had problems with Penn Square over a long period of time. Do you feel that your bank was

adequately informed by regulatory authorities of the difficulties at this bank? Do you think upstream banks should have been given far more information since Penn Square was performing a merchant banking function, or should there have been a confidential relationship between the regulatory authorities and the bank in question?

Mr. PERKINS. This is a very difficult and interesting question. As you know, the whole concept of confidentiality and confidence in financial institutions, of legal responsibilities of the regulator for what action he takes, all of these things—and not the least of which is if they circulate bad information or information that doesn't turn out right and we act the other way, we might hurt somebody badly that would or should not have been hurt and would have a legal claim there.

So there are a lot of good reasons for confidentiality, not the least of which is the National Bank Act says so, for the comptroller.

But having said that, you get an interesting question when you get to this special nature of upstream participations and frankly, it is our feeling that we have to be responsible for what we do. We cannot go blaming this person or that person. But that was a very interesting thought and concept; I am sure that will need and get a lot of review.

Mr. LEACH. It has been alleged that Continental had loan officers on a permanent basis at Penn Square. Did your bank operate that way? Did you have what in essence were desks at Penn Square?

Mr. PERKINS. That statement has been made and we do not believe we did. Perhaps Mr. Cummings might comment on that. He was involved in looking at all those issues very carefully.

Mr. CUMMINGS. We talked about that because there have been comments about that in the press and it is not—it is not correct. We never had any people stationed permanently there. We had that one operating working force that spent a few days there and then of course from time to time our officers were naturally down in Oklahoma City seeing the bank and seeing other customers.

But they never had desks or were permanent fixtures at Penn Square.

Mr. PERKINS. It would be quite customary for officers who travel to a different territory to work with the customers there including the correspondent banks, generally the bankers get to be friends and they might borrow a phone once in a while or something like that, but this is just that kind of a thing.

Mr. LEACH. Finally, let me ask a broader question. Do you think that the problems brought to light in this situation are of such nature as to jeopardize the banking system in America today? Do you think in retrospect that large money center banks really have been chasing too high-priced money and putting that money out into lending situations that are less than credible?

Mr. PERKINS. Oh, I don't think so. We go through these cycles and surely when the business has been good for a long time and you get strong markets like the energy markets, has a tendency to push pretty hard sometimes. But I wouldn't label it to chasing every higher priced money and that kind of thing.

In hindsight obviously when the economy turns down and stays down for the long length of time that it has, you get a lot of problems and you ask yourself, "if," but I would say it is one of those cycle type of things.

Mr. LEACH. I will say this in defense of Continental, you have grown basically in the American economy in contrast with your principal competitors whose growth has been primarily abroad. Your being the sixth or seventh largest bank and yet first in American commercial lending is something, frankly, that I tip my hat to.

Mr. PERKINS. Thank you.

Mr. LEACH. Mr. Chairman, I have no further questions.

The CHAIRMAN. Thank you, Mr. Leach.

Let me ask you this question, Mr. Perkins. As you know, for a long period of time there has been discussions as to how secret we should keep the findings of the regulatory agencies in the area of financial institutions and whether or what the advisability would be of having a little more sunshine coming in through the cracks. As I stated earlier today, all major corporations have to file with the SEC their reports to the stockholders in detail.

Do you think perhaps there should be some review—without setting out of bounds or inner bounds but some review of this passion for secrecy that has predominated over such a long period of time?

Mr. PERKINS. I would make two comments on that. One, in terms of filing information and public disclosure and all the rest of that, I believe that the banking industry or at least the large publicly held organizations that are subject to SEC rules and the rest do just as much if not more than other industry does.

I remember well when our annual report—

The CHAIRMAN. Excuse me, Mr. Perkins, but do they have to make public if indeed one of the regulatory agencies asks them to sign a letter of agreement or if they are found to be too heavily—to have too many problem loans and put on a problem list? That is not made public, sir.

Mr. PERKINS. Yes, we have to—we publish quarterly under the accounting rules the nonperforming loan figures; we publish great detail and chargeoffs and recoveries. We publish all those things including all the 10-K's and things like that. We publish twice as much data as most major corporations.

Now having said that you raise the other very specific question because it happens to be a regulated industry of the type it is, whether or not there should be publicity if in fact on a bank examination, say of the results of a bank examination or some portion of it a statement like that, I think that is a very difficult question and cannot be answered.

It is not something that I would think should be done. At least, I would certainly have to be convinced. If you published that the examiners are in, at our last examination we had this criticism or that criticism and the directors, when the examination was reviewed with the directors as it is under the present procedure by the Comptroller's Office, that they were told that they must do this or that or the other thing—that kind of publicity would very quickly lead to potential runs on banks, it would certainly change the ability of banks, their access to the money markets, the money

market funds would very quickly stop depositing money in the banks.

The CHAIRMAN. Mr. Perkins, you are giving me the argument that has been cited over the years.

Mr. PERKINS. Yes.

The CHAIRMAN. I didn't know that, I thought perhaps since you were no longer president of the ABA you might have, you know, cut those traces and had second thoughts about this.

Mr. PERKINS. What I am saying, Mr. Chairman, is that this is a very touchy area when you get into it.

The CHAIRMAN. Definitely. I have been told over the years it is very touchy. By the same token, let me say this to you; as you know, Penn Square ignored the Comptroller, really, let's not kid each other. They ignored the Comptroller.

Mr. PERKINS. Yes.

The CHAIRMAN. Said, you know, who do you think you are? Jennings says, Hey, I will take care of you, and he brought this poor patsy in and set him up as president and he was president no more than Santa Claus was.

However, if you, Continental Illinois, Chase, Seattle, Michigan National, the multitude of credit unions and S&L's that put money into Penn Square had known that the Comptroller had asked that certain steps be taken and they had not been taken, don't you agree that Penn Square and Jennings would have taken the steps necessary had the public, the sophisticated public in particular like yourselves, known about the problems at Penn Square? Because otherwise you would not have bought one single loan from them.

That would be self-policing. Think on it that way. I know I am not going to convince you at this point, Mr. Perkins, but by cracker, I think that the time has come where we have got to revisit this. We have been looking at too many of these situations over the years where innocent people have been lead down the primrose path.

You know, on the one hand you want to stop the run on the bank. How about the run on—how about the people, the institutions, individuals, that took a bath on this and in previous instances going back to Sharpstown, the first one in 1972?

Mr. PERKINS. I am not trying to dismiss this lightly or say it doesn't need examination, but I do think there are some very serious considerations on both sides and I certainly can't speak for whether your statement makes sense as to what they might have done under those circumstances.

But frankly, I am not privy to what Mr. Patterson or Mr. Jennings might have done or what the Comptroller might have done or did.

Mr. LEACH. Will the gentleman yield?

The CHAIRMAN. Sure.

Mr. LEACH. There is a another question that is more profound than the question of possible conflicts of interest and petty crookedness. That is, we have a unique case in American banking: a very small bank that grew very fast and developed an upstream relationship with a series of other banks.

Mr. PERKINS. Yes.

Mr. LEACH. One aspect of policy worthy of review is whether a large bank should develop such a relationship with a fast growing small bank. Once it was developed, one would think this relationship would stick out within your bank, if not like a sore thumb, at least like a unique thumb. One would also think that the documentation would have to be doubly strong, that the review of the banking practices would have to be doubly energetic.

In retrospect, did you examine the relationship in a philosophical way as well as in a practical way?

Mr. PERKINS. No, these came up as individual loans as opposed to the other, and the answer to a lot of your comments of what one would think are very, very much part of this phase two of our examination asking just all of those questions and rethinking all of those issues to be sure that we are on the right track, or if we are not that we correct it.

On the other hand, I do think that while this aberration here is obviously in a class by itself, over many, many years given our unit banking system basically in this country, or our lack of interstate and national banking, given that, the system of correspondent banking with the upstream participations working with the customers around the country has been very, very significant in terms of getting business done.

I think of the many, many banks that were—where we work in Iowa, where we participate all the time and have for a century. Or more.

Mr. LEACH. But none that grew at that rate. Granted, oil is a unique case. I am sorry to take the gentleman's time.

Mr. PERKINS. All businesses in Iowa are very well managed. That has been our experience over the years.

Mr. LEACH. Don't I wish.

The CHAIRMAN. I quote from testimony, Mr. Perkins, we will hear in a few moments, and this testimony is given by Perry Driggs, Jr., who is testifying on behalf of Michigan National Bank.

Mr. PERKINS. OK.

The CHAIRMAN. I quote:

One of our correspondent banks, Continental Bank, was contacted to discuss loan participations with them—meaning Continental—and they discussed with representatives of our Battle Creek office the field of energy lending in which compared to Continental, we had relatively little experience.

A representative of Continental introduced us to officers of Penn Square Bank which Continental indicated was a source of high quality, secured floating rate loans. We were pleased initially as well as later to have been accepted into what we perceived was a fraternity of reliable energy lenders including Continental, Chase Manhattan, Seattle-First and Northern Trust.

Relying initially upon assurances of Penn Square's expertise, we proceeded in November of 1980 to participate in approximately \$12 million of Penn Square loans.

And we will hear the rest of it.

Now, had you known a little more of the problems of Penn Square; you, Continental, would you have taken these delightful people from Michigan National, friends of yours that you have been doing business with over the years, it is like taking one of your children, you know, and walking them into quicksand.

You know, that is my point when I asked you about perhaps it might be wise if the regulators when they find problems in the bank, had a little more sunshine in, a little more disclosure. Don't

you feel badly about the fact that people at Continental lead people in Michigan into the quicksand of Penn Square?

Mr. PERKINS. Well, Mr. Chairman, I am not familiar with whether our people did that or did not do it or the circumstances at the time, so I would hesitate to—

The CHAIRMAN. Do you doubt the veracity of Mr. Driggs?

Mr. PERKINS. I do not. But I—

The CHAIRMAN. I thought you were friends.

Mr. PERKINS. We are. I am not questioning that a bit.

The CHAIRMAN. I am reading to you from his testimony. In other words, he is saying that they went on your assurances. You are the big honcho at Continental. People understand, you are responsible for your bank. Right?

Mr. PERKINS. Of course.

The CHAIRMAN. Do you know who it was that met with the people of Michigan National, Mr. Cummings, and took them by the hand and introduced them to swinging Bill Patterson?

Mr. CUMMINGS. During our interview process we did learn, I believe, that the people from Michigan National were in the Continental Bank and as my understanding is, they were introduced by Mr. Lytle to I believe Patterson and maybe some other people from the Penn Square who as I understand it were in the Continental Bank not by prearrangement to meet Michigan National, but they happened to be there at that time.

I certainly can't answer anything as to what was said as far as assurances as to whether Penn Square was—

The CHAIRMAN. By the way, was it proper for Mr. Lytle in the capacity he had to be—to be introducing, as he admitted in the testimony or that famous letter that I read this morning, to Mr. Patterson, where he said, you know, I can introduce you to people in Michigan National and so forth, and we will introduce you to other people.

In other words, he was helping Mr. Patterson and Penn Square sell their loans. Let me read from the letter:

"Thanks again for your help. I think this is a service that we can provide to others," meaning other banks, of course. Was that part of his duty, Mr. Perkins, since he was working for Continental? Should he have been doing that as well?

Mr. PERKINS. Well, if you take it in the context that you take it, no. But if you take it in the context that Mr. Cummings just said where the people were all in the bank at the same time and they were talking about energy loans and they were introduced, that is another question.

The CHAIRMAN. I just read that testimony, it is more than an introduction, sir. It says:

One of our correspondent banks, Continental, was contacted to discuss loan participation. They discussed with representatives of our Battle Creek office the field of energy lending, which compared to Continental we had relatively little experience.

A representative of Continental introduced us to officers of Penn Square which Continental indicated as a source of high quality secured floating rate loans.

We were pleased initially as well as later to have been accepted into what we perceived as a fraternity of reliable energy lenders including Continental, Chase, Seattle-First—

You know, maybe you can take issue with Mr. Lytle's veracity but here is Mr. Driggs of Michigan National Bank and he is saying—do you think that is a description of a casual meeting, Mr. Cummings?

Mr. CUMMINGS. I can only tell you what we—

The CHAIRMAN. Did they happen to meet at the cigarette stand or the coffee machine?

Mr. CUMMINGS. I am quoting what Mr. Lytle and other people in—

The CHAIRMAN. Are you that naive to buy that?

Mr. CUMMINGS. Well, yes, I believe what they said because Patterson is in our bank fairly often; Michigan National had asked as I understand it, the officers of our bank who handled the Michigan National Bank correspondent relationship about the possibility of participating in loans.

They were in our bank and met a banker from whom we had been purchasing loans. I don't think that indicates being naive. I think it is an entirely possible scenario.

The CHAIRMAN. You just think it was happenstance? They just happened to meet and they got married? You know, nobody tried to—it wasn't like that one in "Fiddler on the Roof," the matchmaker. There was no matchmaker, it just happened?

Excuse me, but I was going to excuse you people and say we will go to the next witnesses but in view of the answers I am getting here, I am going to ask you to please stay around a while. I am going to vote and I shall return and we will pursue a few other little items here because I can't understand the answers.

We will be in recess subject to the call of the Chair.

[Recess.]

The CHAIRMAN. The committee will come to order.

I would ask the two counsel if they would be gracious enough to sort of sit behind their clients, because we need a little more room at the witness table.

At this time, I would ask Mr. Perry Driggs, Jr., president of Michigan National Bank; Mr. Herbert K. Peterson, executive vice president, Michigan National Bank, to approach the witness table.

Please approach the witness table. Just bring another chair up.

Mr. Driggs and Mr. Peterson, would you kindly stand and raise your right hands?

[Witnesses sworn.]

The CHAIRMAN. Thank you, gentlemen. Please be seated.

I want the two of them for a few moments.

Mr. Driggs, pull the microphone over to you a little bit. We are going to allow you to read your entire statement a little later.

Were you here when I read a quote from page 2 of your statement, the one about the Continental Bank was contacted?

Mr. DRIGGS. Yes, I was here.

The CHAIRMAN. Is that a truthful statement?

Mr. DRIGGS. Yes, it was.

The CHAIRMAN. Do you know who indeed discussed participations at Continental from your institution?

Mr. DRIGGS. Initially our vice chairman, Mr. Paul Sauder.

The CHAIRMAN. Is he here this afternoon?

Mr. DRIGGS. No, he is not.

The CHAIRMAN. Did he describe his conversation to you?

Mr. DRIGGS. He was not in the conversation. He sent representatives.

The CHAIRMAN. Whom?

Mr. DRIGGS. Mr. Herb Peterson, Mr. Arnold Middeldorf, and Mr. Melvin Buser, from our Battle Creek office.

The CHAIRMAN. With whom did he have contact prior to sending the people from your Battle Creek office to Continental Illinois?

Mr. DRIGGS. I don't know of the individuals who he had contact with. He met with some after the American Bankers Association convention in Chicago in 1980.

One of the ones I do know he had contact with was Mr. John Lytle, but he might have had contact with other people.

The CHAIRMAN. Is it your understanding that the contact that was made with Penn Square and Mr. Patterson was just a casual thing that might have happened at the coffee machine, or was there an appointment arranged for the three people from Battle Creek to meet with the people from Penn Square by Mr. Lytle?

Mr. DRIGGS. All I know is that they went over to meet with Mr. Lytle to discuss participation with the Continental Illinois.

The CHAIRMAN. OK, and what type of participations, primarily energy-oriented?

Mr. DRIGGS. Primarily energy-oriented.

The CHAIRMAN. All right, and, as a result of that meeting, Michigan National began engaging in participations with Penn Square. Is that correct?

Mr. DRIGGS. After that meeting; yes.

The CHAIRMAN. And which other institutions were recommended by Continental and Mr. Lytle for energy participation loans?

Mr. DRIGGS. To the best of my knowledge, no other institution.

The CHAIRMAN. No other institution?

Mr. DRIGGS. Yes.

The CHAIRMAN. And so, do you think that the relationship that developed between Michigan National and Penn Square was just a casual thing that happened, like I stated earlier, or do you think there was a matchmaker involved?

Mr. DRIGGS. Well, from my understanding of the conversations that went on at that first meeting, it was more than just casual.

The CHAIRMAN. It was more than just casual. In other words, Mr. Lytle put the parties together and said to you people at Michigan National, these people at Penn Square, Patterson, a tremendous fellow, a great salesman? You heard Mr. Lytle describe Patterson this morning, did you not?

Mr. DRIGGS. I met Mr. Patterson; he certainly was a great salesman.

The CHAIRMAN. Oh, you met him, too?

Mr. DRIGGS. Yes, I did.

The CHAIRMAN. OK. Let me get back to my friends at Continental.

Mr. Baker, do you think that that arrangement was a very casual one that happened at the coffee machine, or do you think that Mr. Lytle, indeed, as an officer at Continental, arranged an appointment, encouraged Penn Square and Michigan National—

Michigan National, rather—to purchase participations from Penn Square?

Mr. BAKER. I really don't know, not having been there, and I don't know the circumstances under which Mr. Patterson either happened to be there or was there by arrangement, but obviously we frequently are in the position of putting buyers and sellers together.

Michigan National, like ourselves, and many other banks in the northern tier of the country, were not experiencing the loan demand that some other parts were. In 1980, there was a tremendous demand by banks and lending institutions for energy loans, and I am confident, no matter what the circumstances, we were not trying to be harmful to Michigan National.

The CHAIRMAN. No one has contended that you were, sir.

Mr. BAKER. I understand.

The CHAIRMAN. You know I am getting a little waltz here that I think is ridiculous.

Mr. PERKINS. Could I comment, Mr. Chairman? You and I are like ships passing in the night, because I don't think we have all this disagreement.

The CHAIRMAN. It was Mr. Cummings, your expert from the British Isles, who said he thought it was very casual.

Mr. PERKINS. Mr. Chairman, I am not trying to give a little waltz or dance at all. We are trying to answer you forthrightly on what we know. Mr. Cummings suggested that all he had heard was Mr. Lytle's version, and it was as described. We brought the two parties together—a limited thing.

The CHAIRMAN. He said Mr. Patterson happened to be at Continental.

Mr. PERKINS. That is correct.

The CHAIRMAN. Let me interrupt you for a second. I understand we have Mr. Peterson here.

Were you at that initial meeting, Mr. Peterson?

Mr. PETERSON. Yes, I was.

The CHAIRMAN. All right. Now, in your opinion, did Mr. Patterson just happen to be there when you went to Continental, or was there a prearranged meeting?

Mr. PETERSON. We have no knowledge that any meeting with Mr. Patterson was prearranged.

The CHAIRMAN. You went to discuss participations?

Mr. PETERSON. With Mr. Lytle.

The CHAIRMAN. Anyone else?

Mr. PETERSON. Only several members of his staff that were introduced to us during the time we were there.

The CHAIRMAN. They introduced you to whom as a result of that for the purpose of entering into participation loans?

Mr. PETERSON. I am sorry, Mr. Chairman. From the Continental, persons from the Continental Bank?

The CHAIRMAN. No—from which institutions? In other words, Continental did not have any participations to sell you at the time?

Mr. PETERSON. We had no participations with Continental at that time.

The CHAIRMAN. Right. You met with Mr. Lytle and members of his staff or his division.

Mr. PETERSON. That is correct.

The CHAIRMAN. You discussed what you were seeking to persons for participations?

Mr. PETERSON. Yes, sir.

The CHAIRMAN. Did they make any recommendations?

Mr. PETERSON. They indicated that one of their major correspondents was in the bank, and that they would be happy to introduce them to us.

The CHAIRMAN. Let me ask you this, Mr. Peterson.

The meeting with Mr. Lytle, did you happen to just be driving by Continental from Battle Creek and decide to drop in and say, "Hi, Mr. Lytle," or had that been an arranged meeting?

Mr. PETERSON. That was an arranged meeting.

The CHAIRMAN. You had an appointment?

Mr. PETERSON. Yes, sir.

The CHAIRMAN. Right, and then Mr. Patterson happened to be in the bank?

Mr. PETERSON. Yes, sir.

The CHAIRMAN. Was any other individual from any other institution, that had some participations in energy-related loans for sale, in the bank that day?

Mr. PETERSON. Not to my knowledge.

The CHAIRMAN. So the only casual individual who happened to be there casually was Mr. Patterson?

Mr. PETERSON. He had several members of his staff with him, but that is correct.

The CHAIRMAN. Hanging around the coffee machine?

Mr. PETERSON. No, sir.

The CHAIRMAN. You did not think that that might have been an arranged meeting by Mr. Lytle? You don't think he might have said, hey, Bill, Patterson, that is? Why don't you get some of your honchos here, because the people from Michigan National are coming in, and I want to put you people together?

Mr. PETERSON. At the time of the meeting, I certainly didn't, because I was told of the substantial relationship that had been developed over the last few years between the two banks.

The CHAIRMAN. What do you think happened?

Mr. PETERSON. It could have been—

The CHAIRMAN. OK.

Mr. PERKINS. I honestly don't know what happened at that time, and I certainly have no reason to doubt the statements that are in the Michigan National's testimony. I believe that what was said was based on what we had got just from the version that we have from Mr. Lytle.

As Mr. Baker said, we do bring parties together. That is a normal thing to do, and I think can be done quite properly.

On the other hand, if your question is to the extent that one of our people or Mr. Lytle are out and actively touting and pushing and trying to develop a lot of business or move a lot of loans, or something on behalf of other banks, clearly that is—clearly, I would be critical of that.

The CHAIRMAN. It could happen without your knowledge?

Mr. PERKINS. That is right.

So I don't think—I really don't think we have a disagreement at all.

The CHAIRMAN. All right.

I have one more question for this group hopefully, and then Mr. Barnard does, and then we will excuse you, and we will get to the genial gentleman from Michigan.

Mr. Cummings.

Mr. CUMMINGS. During this interview process that we conducted in this management review, we talked to many, many people, and I should say that there were other officers of our oil and gas department besides Mr. Lytle in separate interviews who had confirmed the circumstances of the Michigan National people and the Penn Square people being in the bank at the same time.

The CHAIRMAN. No one denies they were there at the same time?

Mr. CUMMINGS. Not by prearrangement, and it was not unusual for Bill Patterson and some of his people to be in our bank presenting loans, discussing loans, or presenting loan documentation. That was what was going on at that time.

Mr. PERKINS. Again, we are just talking different views.

The CHAIRMAN. Which of you gentlemen was interviewed by Goldman-Sachs with respect to loan participations?

Mr. BAKER. I was.

The CHAIRMAN. Mr. Baker, tell me if this is correct:

GOLDMAN-SACHS. Did you have any written policies regarding guidelines for purchaser of loan participations?

Continental Officer: No.

That was you, Mr. Baker?

Mr. BAKER. Yes.

The CHAIRMAN [reading].

GOLDMAN-SACHS. Were there specific controls of concentration of loan participations?

The Continental officer answered "No."

Is that accurate?

Mr. BAKER. That is correct.

The CHAIRMAN. How do you square that with what Mr. Perkins told Mr. Leach from Iowa about the guidelines that are in effect and that were not implemented in the Penn Square situation?

Mr. BAKER. I think the reference that Mr. Perkins was making was to our procedures and policies relative to collateral, and participation in loans on a basis that is consistent with our direct lending, which is the intention of participations that we look at them in the same way that we look at a direct loan that we are making; so I don't think there is any inconsistency between what I was saying there and what Mr. Perkins said.

The CHAIRMAN. Mr. Perkins, didn't I understand you to say to Mr. Leach when he asked you about the very thorough questions that people in the agricultural area have to answer prior to receiving a loan, that you said that is true, and we do the same in all other areas as well, but unfortunately not in the Penn Square case? I am a little confused here.

Do you have guidelines for your lending officers, and for people applying for loans and participations or don't you?

Mr. PERKINS. Well, we have certain standards and procedures and requirements on any loan that we make, and when we take participations we are, when we take participations the policy, or the procedures are supposed to be the same procedures to be followed as if we were doing it directly ourselves.

Mr. BAKER. The question in the Goldman-Sachs interview as I interpreted it at the time, Mr. Chairman, had to do specifically with participations, do you have specific procedures and policies loaning-wise relative to participations and my answer was no, they are the same as they are relative all other loans.

The CHAIRMAN. Or you could have answered yes, we do have.

Mr. BAKER. They are the same ones we have for all loans.

The CHAIRMAN. Thank you, Mr. Baker, Mr. Perkins, Mr. Cummings, Mr. Cordell.

Mr. PERKINS. Thank you, Mr. Chairman.

The CHAIRMAN. I am sorry. Excuse me, Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Actually my question was going to be to Mr. Driggs and Mr. Peterson. If you want to excuse the others.

The CHAIRMAN. I am going to have them give their statements and we will go with them next.

Mr. BARNARD. Let me ask a question.

The CHAIRMAN. Why not?

Mr. BARNARD. Mr. Driggs, I have a feeling that possibly the Michigan National had to be sold this arrangement a little bit. The reason I have that impression is that because of the letter that Mr. Lytle wrote Mr. Patterson on January 28, 1981, and in your testimony you said that we proceeded in November 1980, just 2 months before then, to participate in approximately \$12 million of Penn Square's loans.

Then on January 28, 1981, Mr. Lytle writes Mr. Patterson, did you hear the composition of that letter when it was read?

Mr. DRIGGS. Yes, I heard it when it was read.

Mr. BARNARD. The thing that concerns us is that he says that they have met with Arnold Middeldorf. Is he with your bank?

Mr. DRIGGS. Yes, he is. He is here today.

Mr. BARNARD. It says: "They are pleased with the package of credits that you had put together. They are grateful. It looks like they," meaning you, "are growing both in confidence and understanding." Do I understand from that that very possibly your staff had some questions about all of this arrangement?

Mr. DRIGGS. I am sure they went into detail with the engineers of Continental, the information that they had, and they went into the relationships they had with Penn Square and their expertise in oil and gas and we respected Continental very highly.

Mr. BARNARD. But you still had some questions about it?

Mr. DRIGGS. That is correct.

Mr. BARNARD. And then the other question is, does your bank normally require a takeout for participation loans? "I assured them that we would take the credits out at maturity and whenever they feel unconfident."

If you got that arrangement from everyone, you would be in very good shape?

Mr. DRIGGS. Very good shape.

Mr. BARNARD. Is that your understanding all of the time?

Mr. DRIGGS. Not all the time.

We have takeouts when we have construction mortgages and there would be an in-mortgage at the time with a takeout from a savings and loan or life insurance company, so there are arrangements when they are at maturity takeouts under many different situations.

Mr. BARNARD. But not at any time?

Mr. DRIGGS. Not at any time.

Mr. BARNARD. I have no further questions.

The CHAIRMAN. Gentlemen, again we thank you for your participation, your assistance, your cooperation.

There may be some questions in writing subsequently that might arise once we have heard from other witnesses and we will submit them to you, Mr. Perkins, as you know, in the usual manner.

Mr. PERKINS. We will be delighted to follow through on that and we will follow through on the comments this afternoon with your staff.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you kindly, gentlemen.

I understand we have Mr. Middeldorf here as well.

Mr. Driggs, yourself, Mr. Peterson, and Mr. Middeldorf are going to testify.

Mr. DRIGGS. Yes.

[Mr. Middeldorf sworn.]

The CHAIRMAN. You may proceed, Mr. Driggs.

TESTIMONY OF H. PERRY DRIGGS, JR., PRESIDENT, MICHIGAN NATIONAL BANK

Mr. DRIGGS. Thank you, Mr. Chairman.

I am Perry Driggs, the president of Michigan National Bank of Lansing, Mich. I would like to briefly describe our bank before commenting upon our involvement with the Penn Square Bank.

Michigan National Bank, headquartered in Lansing, Mich., with assets of \$2 billion, is the flagship bank of the Michigan National Corp., a registered bank holding company with \$6.6 billion in assets and having 27 subsidiaries.

Michigan National Bank is unique in Michigan in operating offices in five cities located beyond the 25-mile branch restrictions applicable to other Michigan banks.

The Battle Creek office of Michigan National Bank is one such office which, while technically a branch of Michigan National Bank, operates as a separate subsidiary of the bank. Thus it maintains a separate advisory board of directors and is headed by a senior vice president who is the functional equivalent of a bank president.

Michigan National Bank, in essence, operates a small bank holding company, and is itself a subsidiary of a bank holding company, Michigan National Corp.

The Battle Creek office, with assets of approximately \$480 million, would be the fourth largest subsidiary of the Michigan National Corp. if separately chartered.

It functioned, in part, as the energy division of Michigan National Bank.

Michigan National's involvement with Penn Square Bank stemmed from pressures created when the cost of our funds exceeded the Michigan interest rate ceilings on many loans. In an effort to maintain and improve profitability, it was determined that the bank should expand further its floating interest rate commercial loan portfolio.

Such loans were difficult to obtain due to Michigan's depressed economic environment, so we turned to our correspondent banks for assistance.

One of our correspondent banks, Continental Bank, was contacted to discuss loan participations with them. They discussed with representatives of our Battle Creek office the field of energy lending, in which, compared to Continental, we had relatively little experience.

A representative of Continental introduced us to officers of Penn Square Bank, which Continental indicated was a source of high quality, secured, floating rate loans. We were pleased initially, as well as later, to have been accepted into what we perceived was a fraternity of reliable energy lenders including Continental, Chase Manhattan, Seattle-First, and Northern Trust.

Relying initially upon assurances of Penn Square's expertise, we proceeded in November 1980 to participate in approximately \$12 million of Penn Square's loans. These participations were purchased based upon our independent analysis of the loans, and Continental's assurances and offers of assistance.

The CHAIRMAN. Mr. Driggs, you say Continental's assurance, and so forth. Would you be a little more specific?

I mean, Continental is a building.

Mr. DRIGGS. John Lytle and his staff indicated that they would help us in understanding the credits, in looking at the borrowers and indicating whether they had good relationships with them, and so forth.

They introduced these two gentlemen to several engineers and told them, I understand the quality of the engineers' reports coming from Penn Square, but you can—I will defer that to these gentlemen later. They were at the specific meeting.

Relying initially upon assurances of Penn Square's expertise, we proceeded in November 1980 to participate in approximately \$12 million of Penn Square's loans. These participations were purchased based upon our independent analysis of the loans, and Continental's assurances and offers of assistance.

Initially we were interested in smaller secured loans of under \$1 million bearing a floating interest rate. This arrangement complemented Continental's position since it did not wish to be involved in participations of less than \$1 million.

Satisfied with the initial participations, we later participated in larger loans having become familiar with the performance of the loans and having gained a greater awareness of Penn Square's operation.

This occurred, however, only after we had demonstrated our willingness and ability to process the smaller loans, and become eligible for consideration of larger participation positions.

The relationship grew until June 1982 at which time Michigan National Bank was involved in loan participations totaling in excess of \$190 million. These Penn Square participations continued to perform in an extremely satisfactory manner until the bank was closed.

The CHAIRMAN. Excuse me. On that point, you are aware of the fact that now, I would assume from the reports and so forth and the hearings that we held in Oklahoma City, that these loans were performing well, many of them, because Penn Square was paying the interest to the upstream banks on nonperforming loans?

Have you become aware of that?

Mr. DRIGGS. We have become aware of that since the bank was closed.

The CHAIRMAN. Do you know if any of your loans were nonperforming loans at the time Penn Square was paying interest?

I mean at this point do you have any loans on which they were doing that?

Mr. PETERSON. Yes, I believe that we probably do, Mr. Chairman.

The CHAIRMAN. Don't feel bad because, as I said in Oklahoma City, gentlemen, and you are small compared to the big city slickers that got took, and the Federal Reserve Board, and the comptroller of the regional office got took. These people, they outslicked the slickers.

Excuse me. Proceed.

Mr. DRIGGS. Certainly.

Michigan National was asked early in 1982 to extend a fully secured line of credit to First Penn Corp., the parent of Penn Square. Based upon our analysis of the creditworthiness of First Penn, its apparent healthy financial condition and our experience with the Penn Square Bank loan participations, the requested line of credit was approved for \$5 million.

This line of credit was used infrequently, only for short periods of time and all advances made prior to June 25, 1982, were promptly repaid.

In late June 1982, the Michigan National Battle Creek office was informed that sizeable chargeoffs of the Penn Square loans had been requested by the Comptroller of the Currency.

It was our understanding that in connection with examination of Penn Square, the Comptroller was requesting an infusion of \$30 million of equity capital into the bank. Representatives of Penn Square Bank asked Michigan National to extend secured loans to substantial customers of Penn Square for approximately \$16 million.

While Michigan National was aware of the importance of this capital infusion, insufficient information was provided to Michigan National by June 30, 1982, to permit us to act upon the request.

Upon learning of this request, and due to its nature, I immediately made efforts to contact officials of the Comptroller of the Currency on June 30 to determine the seriousness of Penn Square's condition.

I was unable to obtain any specific information.

As the committee is aware, the Comptroller closed Penn Square Bank shortly thereafter.

The tragic consequences of the Penn Square closure are well known. Our bank, along with numerous other banks, credit unions, other financial institutions and individuals, now faces substantial losses.

With 20-20 hindsight, we now recognize that greater reliance was placed upon our associations with other institutions, our own analysis of the Penn Square Bank and the overall record of satisfactory performance by the Penn Square Bank than should have been the case.

However, it must be remembered that there was nothing significant in our bank's relationship with Penn Square which—

The CHAIRMAN. Excuse me. Could I interrupt one more time?

You just said with 20-20 hindsight we now recognize that greater reliance was placed upon our associations with other institutions. Which other institutions do you refer to?

Mr. DRIGGS. We were involved with many leading banks who also placed reliance and had a very fine energy division; they too were caught.

The CHAIRMAN. You say here that you now recognize that greater reliance was placed upon our associations with other institutions.

Now, which other institutions other than Continental or more specifically John Lytle recommended Penn Square, passed on to you?

Mr. DRIGGS. As we got into the Penn Square situation, I called an individual at the Chase Manhattan that I knew.

The CHAIRMAN. Who was that individual?

Mr. DRIGGS. Mr. Richard Piney.

The CHAIRMAN. P-i-n-e-y?

Mr. DRIGGS. Yes.

The CHAIRMAN. What is his capacity with Chase?

Mr. DRIGGS. He is no longer with Chase, but at that time he was the vice president in charge of the correspondents relationship.

The CHAIRMAN. Is he the one that dealt with Penn Square?

Mr. DRIGGS. That is correct.

The CHAIRMAN. At Chase they didn't purchase through the energy division, did they? These participations?

Mr. DRIGGS. We learned that later.

The CHAIRMAN. You learned later, rather than go through the energy division to have it analyzed properly by energy, what they did was go through Mr. Piney?

Mr. DRIGGS. In the correspondents division.

The CHAIRMAN. He generated a lot of business that way?

Mr. DRIGGS. It is my understanding, on occasion they did refer some of the loans to the energy division. I do not know of Chase's working—

The CHAIRMAN. Which other institutions?

Mr. DRIGGS. Basically Continental and Chase.

The CHAIRMAN. One phone call to Piney, was that it?

Mr. DRIGGS. And a conversation with him later.

The CHAIRMAN. Phone call to Mr. Piney and other than that the introduction by Mr. Lytle of Mr. Peterson and Mr. Middeldorf to Mr. Patterson; no, no, to Mr. Patterson and his coterie, who happened to casually be at Continental Bank that particular day?

Mr. DRIGGS. That is correct.

The CHAIRMAN. OK., proceed, please.

Mr. DRIGGS. That was on my part. However, there were other individuals who made checks in addition to the ones that I did.

The CHAIRMAN. You are at page 5.

Mr. DRIGGS. OK.

However, it must be remembered that there was nothing significant in our bank's relationship with Penn Square which would have prompted a greater investigation into the creditworthiness of Penn Square than was performed.

We had confidence in Continental Bank and its experience in the energy field.

The CHAIRMAN. Continental and its experience in the energy field were saying John Lytle and his staff?

Mr. DRIGGS. The entire energy division of Continental Illinois. They were well known to be expert in the field in the United States.

The CHAIRMAN. All right.

Mr. DRIGGS. Whenever we found the documentation of a loan participation upon which we had made advances was inadequate under the loan policies of our bank, the loan was promptly repurchased by Penn Square in accordance with the assurances we had been given. Even with respect to the line of credit we extended to the First Penn Corp., advances made on that line of credit were promptly repaid until the very end.

In short, there was nothing evident from our associations with other institutions or our transactions with the Penn Square Bank that raised a warning flag regarding our involvement with that bank and its portfolio.

It is now apparent that the reliance we placed on these matters was misplaced and we at Michigan National are currently assessing our internal controls and credit approval procedures and will modify these controls and procedures in an effort to avoid a similar experience wherever and to whatever extent is dictated by our assessment.

Michigan National Bank continues to be a strong financial institution and shares the committee's desire to prevent any similar misfortune from recurring.

Notwithstanding any losses that might be incurred, we are confident that Michigan National can continue its history of prudent, professional, and successful lending practices that have exemplified it in the State of Michigan.

I would like to introduce to the committee Mr. Herbert K. Peterson, our executive vice president responsible for overall lending, and Mr. Arnold J. Middeldorf, our senior vice president responsible for the operations of our Battle Creek office, which managed the Penn Square relations.

We will be glad to respond to the best of our ability to any questions the committee may have.

Thank you.

The CHAIRMAN. Thank you, Mr. Driggs.

On page 5 you say, "Even with respect to the line of credit we extended to the First Penn Corp. advances made on that line of credit were promptly repaid until the very end."

Mr. DRIGGS. That is correct.

The CHAIRMAN. Then what?

Mr. DRIGGS. At the very end two advances were made.

The CHAIRMAN. In what amounts, sir?

Mr. DRIGGS. \$2 million and \$3 million.

The CHAIRMAN. To the First Penn Corp. For what purpose, do you recall?

Mr. DRIGGS. We did not know at the time it was used in and out to repurchase or when their commercial paper was terminated and they needed a brief line until the commercial paper was reissued, we assumed it was for that purpose.

The CHAIRMAN. That is the paper that they were selling down there to some of their customers? Remember that?

Mr. BARNARD. Yes.

The CHAIRMAN. That had been highly recommended to some of the customers of the Penn Square Bank?

Mr. DRIGGS. That was the purpose that they used it for.

The CHAIRMAN. Right. I may ask competent staff to help me with some initials here, but I am looking at an "Assets Subject to Criticism."

This is from the Comptroller examiner's reports:

\$1 million Lockridge, William; Guarantor, Hefner, Robert A., III; Doctor and horse man residing in Kentucky. A consolidation loan to pay off previous debts and provide operating capital.

Collateral presented is second to real estate mortgage on 900-acre farm with substantial improvements in Kentucky.

Assessed value, \$5,580,000, prior lien \$3,250,000.

Financial statement on maker reflects heavy total liabilities, \$5,963,000 against net worth of \$1,727,000 vested in the farm \$5.5 and thoroughbreds, \$1.403 million.

Financial statement on Guarantor Hefner reveals debts of \$2,397,000 and net worth of \$25,780,000 centered in oil and gas, \$24,665,000.

The servicing officer admits the loan was booked as an accommodation to guarantor Hefner who is also a bank customer. Although the guarantor provides ample support, above normal supervision of this out-of-territory credit is indicated in view of maker's financial conditions.

The CHAIRMAN. Examiner was Mr. Hooks, officer was good old Bill Patterson. Now, reading from a Penn Square document entitled "Interest Advance to Participating Banks on Commercial Loans as of November 30, 1981: Lockridge, William To Cover Non-payment."

Mr. DRIGGS. That is where they were paying the interest, loans that were not performing?

The CHAIRMAN. Correct. It says William Lockridge, he is the doctor and horse man who resides in Kentucky, and the note number is 24399, participating bank is Michigan National, prepaid \$16,273.96. Do you remember that one at all?

Mr. DRIGGS. Are you saying that the interest was paid by Penn Square Bank, and are we familiar with that?

The CHAIRMAN. This is one on which interest was prepaid by Penn Square Bank. Were you still holding this one when the cards came tumbling down?

Mr. DRIGGS. We were not aware of any interest being paid by the bank.

The CHAIRMAN. I didn't imply that you did. Unfortunately you should have known but you didn't know because you were not informed.

This was an internal Penn Square document which was reviewed by Peat, Marwick & Mitchell, but they kept it a secret. Did you know Mr. Lockridge at all who was the borrower in this instance from Kentucky?

Mr. MIDDELDORF. I did not know him personally, no.

The CHAIRMAN. OK.

Mr. Middeldorf, we have not had the pleasure of asking you about your impression of that first meeting to discuss energy loans, whether you thought it was just happenstance that Mr. Patterson was at Continental or whether upon reflection, you think that maybe it was a little more than a casual situation.

Mr. MIDDELDORF. At the meeting at that time, I didn't think about it being anything but happenstance.

Now, there is a question in my mind as to whether or not it was.

The CHAIRMAN. Let me ask you this. Mr. Peterson, Mr. Middeldorf, you were assigned by Mr. Driggs to look into purchasing participations in energy loans, is that correct?

Mr. DRIGGS. No, our vice chairman, Mr. Sauder, asked Mr. Peterson and Mr. Middeldorf to follow the lead that he had started.

The CHAIRMAN. OK.

Did you purchase participations in energy loans from institutions other than Penn Square?

Mr. PETERSON. We did not.

The CHAIRMAN. Now, you have heard about this delightful letter that has been quoted from within; it says "I reassured them that we would take the credits out at maturity or whenever they felt unconfident."

That is referring to Arnold Middeldorf and his people at Michigan National, a letter from Mr. Lytle to Mr. Patterson dated January 28, 1981. Was there indeed a reassurance given to you by Mr. Lytle that if there were any problems they would repurchase the loans from Mr. Lytle, Mr. Middeldorf?

Mr. MIDDELDORF. Yes, there was, in the original package of loans that we eventually purchased the \$13 or \$12 million, I definitely had the, came away from that meeting that I had the assurance from Mr. Lytle that if we had any difficulties with those loans, they would be taken out.

The CHAIRMAN. Continental would repurchase them from you or Penn Square?

Mr. MIDDELDORF. Right.

The CHAIRMAN. Doug, why don't you proceed for a while.

Mr. BARNARD. One of the things that concerns the committee considerably is that how much attention and really credit analysis was given the loans that were sold up from Penn Square to Continental and also to Michigan National.

In one group of loans that they sold up, to Michigan National there were three loans, and two of these loans we happen to know were loans that had been criticized by the bank examiners but they later satisfied the bank examiners because they sold them to you. I would like to ask you, for the sake of the record, although I don't want the specifics in the record, Mr. Chairman, because I think classifications by the Comptroller are somewhat confidential, but I would like for you to read the comments of the Comptroller about

two of these loans and for you to tell me about the credit analysis when you bought them.

The point I am getting at, Mr. Driggs, is that the bank shouldn't buy loans *carte blanche*. Just because they came up in a cash letter, you were not supposed to just give credit and forget about it.

Mr. DRIGGS. That is true.

Mr. BARNARD. It appears, though, in some instances that might have been done but Mr. Peterson and Mr. Middeldorf would just, it is at the bottom of page 1 called Old Dominion Oil Corp.

Just read that. That is where you bought \$557,672 out of a \$1 million transaction.

Mr. PETERSON. Mr. Barnard, I have the Old Dominion Oil Corp. report.

I have not seen this, nor am I personally familiar with the details of this credit. It is very hard for me to answer your question based on that.

Mr. BARNARD. If I just walked in off the street and provided you my financial statement, and it showed a deficit net worth of \$144,000, and I asked you for a loan of \$1,930,000, and actually you didn't advance that much, but here is a negative net worth and yet Michigan National participated in that loan.

I was incorrect to begin with, to the tune of \$383,672. I am sure after you got into it you sold it back to them but in the meantime, that had taken place. They had gotten it out of their portfolio up to you and maybe you got it back.

Before you gave them credit for participations, was there an analysis of the quality of the loans?

Mr. PETERSON. Yes, sir.

Mr. BARNARD. Look at the next one, the item on the long sheet. I rather not call out the name of the account.

Mr. PETERSON. Mr. Barnard, although this name is familiar with, or familiar to me, I just cannot discuss the credit in any detail. We could perhaps address that in questions that you may have in writing at a later time.

Mr. BARNARD. Well, we have to get these documents back because of the nature of them.

I just cannot see how, with the information that the Comptroller has furnished us here about these particular credits, how in the world anybody could have made a proper credit evaluation of the situation, just based upon the outstandings and the net worth and the documentation, and in one instance, it says that the bank was taking a blank assignment on oil and gas leases, but nothing has been filed:

The servicing officer states that no filings on the O&G leases, because the borrower turns the leases so quickly that another filing would cloud title and delay the sale of the leases.

You couldn't possibly know where you stood from the standpoint of taking a place in the credit.

Mr. DRIGGS. I think the thing we will have to supply the committee with was our analysis of those credits, what the leases were, and the procedures that we went through to approve them.

Mr. BARNARD. And whether or not you asked them to buy it back?

Mr. DRIGGS. That is correct.

Mr. BARNARD. Could we do that, Mr. Chairman?

The CHAIRMAN. Why, of course.

Mr. DRIGGS. We will supply you with that information.

Mr. BARNARD. How does all of this jell with your statement on page 5 where it says

It must be remembered that there was nothing significant in our bank's relationship with Penn Square which would have prompted a greater investigation into the creditworthiness into the Penn Square than was performed.

In other words, you do not remember, probably, Mr. Middeldorf, enough activity of request to repurchase loans that you had any further questions?

Of course, I believe you did have some questions when the arrangements began in January 1981—right?

Mr. MIDDELDORF. Regarding what?

Mr. BARNARD. Well, as we read in the letter from Mr. Lytle to Mr. Patterson, he says that there had been a meeting with Arnold Middeldorf and his people at Michigan National and it determined that they are pleased with the package of credits that was put together last November—this was written in January.

In other words, they were talking to you in January about loans that they had sent to you in November, and I am just reading from the letter.

It says that, "It looks like they are growing both in confidence and understanding of oil-related lending, but as we did previously, I assured them that we would take the credits out at maturity."

I am trying to get an answer, yes or no. Were you concerned about the quality of the loans?

Mr. MIDDELDORF. No, I was not.

Mr. BARNARD. Mr. Lytle thought you were.

Mr. MIDDELDORF. I was not familiar with that letter at that time and I do not know what prompted him to write that letter.

Mr. BARNARD. On reflection, though, you think you possibly should have had some caution?

Mr. MIDDELDORF. No. At the time we were dealing with Penn Square, no.

Now—yes.

Mr. BARNARD. I hope so.

The CHAIRMAN. I will address the questions to you initially, Mr. Driggs, and if you feel someone else should answer, that is perfectly acceptable, because I realize that you cannot know everything about what is going on.

Did you indeed make, or did Michigan National make, personal loans to Bill Patterson and others at Penn Square, apart from the participations?

Mr. DRIGGS. Just one moment, Mr. Chairman.

The CHAIRMAN. If you have someone who can answer that, I would be happy to swear them in for you.

Mr. DRIGGS. Yes, we did.

Mr. BROWN. May I address the Chair?

The CHAIRMAN. Unusual, but in view of the circumstances, yes.

Mr. BROWN. Thank you, Mr. Chairman.

The problem we have is about accounts and names of people.

The CHAIRMAN. I am sorry, but what?

Mr. BROWN. Accounts under the Right to Financial Privacy Act passed by this committee in 1978.

The CHAIRMAN. We are amending it tomorrow.

Mr. BROWN. We have no reluctance whatsoever to providing the committee with it.

The CHAIRMAN. Let me try something else.

Mr. BROWN. Provide us the procedure; we will be glad to do what we can.

The CHAIRMAN. Well, we do know that there was a loan to the marina in Florida, and that is the one we discussed earlier today wherein Mr. Patterson is a player.

Would you check with counsel to see if you can discuss that loan?

Mr. DRIGGS. Yes, I will, Mr. Chairman.

Mr. Chairman, we made loans to some officers and directors of Penn Square. We will be glad to supply you with information in accordance with the Privacy Act, and in compliance with whatever law there is, so that you can see what was done.

The CHAIRMAN. All right, I think I can ask this question without causing a problem.

Were there indeed loans made, and I am not asking to whom the loans were made, but with the collateral being for the marina in Florida that has been discussed earlier today, or participations?

Mr. DRIGGS. Participations, yes.

The CHAIRMAN. And are you at liberty to tell us what the status of that participation in the Florida Marina loan would be today?

Mr. DRIGGS. I think either Mr. Peterson or Mr. Middeldorf would be in a better position to tell you.

Mr. MIDDELDORF. Right now, the loan is in the process of being foreclosed on.

We have not proceeded simply because there is, as we understand it, some investigation work going on by the FDIC.

The CHAIRMAN. As well as others?

Mr. MIDDELDORF. As well as others.

The CHAIRMAN. There was a loan to Bill Jennings, chairman of the board of Penn Square, we understand, in the amount of \$1.5 million that was secured by a stock of TOS, an oil supply company that has filed for bankruptcy.

Do you recall how this loan found its way into your portfolio and what the status of that loan is at this time?

Mr. DRIGGS. I will refer to Mr. Peterson.

Mr. PETERSON. The initial contact for the request for that loan was made by Mr. Patterson to me.

The CHAIRMAN. On behalf of?

Mr. PETERSON. On behalf of Mr. Jennings.

The CHAIRMAN. And do you know the status of that loan at this point in time?

Mr. PETERSON. That loan was never fully disbursed.

It is delinquent and, excuse me, Mr. Chairman, I have run into the same problem, I guess, on the Financial Privacy Act, in being careful about—

The CHAIRMAN. The status of a loan?

We are aware, and we have made public—

Mr. PETERSON. Mr. Chairman, as I have indicated, it is delinquent.

The CHAIRMAN. Fine.

Mr. Driggs, if you at Michigan National had been cognizant of the fact that a cease-and-desist agreement with the Office of the Comptroller of the Currency had been entered into, and that Penn Square was under constant surveillance by the Office of the Comptroller of Currency, do you feel that you would have participated in the energy-related loans or the other loans that you participated in with Penn Square?

Mr. DRIGGS. No, we would not have. I spoke with a representative of the Comptroller regarding that and said we would have put more pressure on Penn Square and the other banks involved and perhaps their office. In that light, perhaps the whole situation would have been corrected quickly, and the bank would not have been closed.

The CHAIRMAN. When did you first learn of the problems with Penn Square?

Mr. DRIGGS. The morning of June 30.

The CHAIRMAN. The morning of June 30?

Mr. DRIGGS. Yes.

The CHAIRMAN. Did you learn that from the Chicago Office of the Comptroller? Were you called, or did you have to seek information? How did the information come to you, sir?

Mr. DRIGGS. Mr. Patterson had met with people in our bank to raise loans for the bank. I was not aware of the purpose of the loans, and we had called a meeting to discuss them on Wednesday, and Wednesday morning, they came to my office and said: "We do not have sufficient information. There appears to be some problems with Penn Square Bank because of the chargeoffs."

At that point, I inquired of the Office of the Comptroller of the Currency in Chicago and talked to Mr. Bob Burns, asked him if he could give me any light on what was happening at Penn Square.

He said he had been informed of the situation—

The CHAIRMAN. By the Dallas Office of the Comptroller?

Mr. DRIGGS. I don't know where his information came from, but I got no definitive information as to how serious the problem was from the perspective of the Comptroller at that time.

I asked if I could call the Dallas office myself and they said they preferred to have me work through them and we would be getting back in touch.

Mr. Patterson came down to the office. He was in the bank. We discussed with him what was going on. He reassured us that they had need for capital, that there were many wealthy individuals who were interested in buying the bank or putting up capital, and we had tried to ascertain through a long discussion just what was going on.

Eventually, we discovered that there was going to be a special meeting with his board and the Comptroller in Oklahoma City the next morning.

The CHAIRMAN. How did you discover that?

Mr. DRIGGS. He indicated that to us.

The CHAIRMAN. Mr. Patterson, not the Comptroller's Office?

Mr. DRIGGS. I asked if we could send Mr. Middeldorf down there to find out what was happening. He said, yes. Mr. Middeldorf flew down with them that evening, and was unable to get into the meeting because the Comptroller's Office, rightfully so, wanted it for just the inside directors and officers who are managing that bank.

We did learn after that meeting that Mr. Patterson was dismissed and that they did offer a cease-and-desist order.

The CHAIRMAN. You learned when after that?

Mr. DRIGGS. The next morning.

The CHAIRMAN. From whom did you learn that?

Mr. DRIGGS. Mr. Middeldorf learned that from either Mr. Jennings or Mr. Patterson.

The CHAIRMAN. Excuse me, but do you recall, Mr. Middeldorf, from whom you learned that or how you came about that information, the dismissal and the cease-and-desist?

Mr. MIDDELDORF. Yes; I was there Thursday morning, the board of Penn Square met at 8 o'clock and the meeting with the Comptroller was to be at 9 o'clock.

I talked to Mr. Jennings about attending the meeting with the Comptroller. He said it was all right with him if it was all right with the Comptroller.

I came up to his office at 9 o'clock and he informed me that the board had just suspended Bill Patterson.

I asked him then to attend the meeting he was going to have with the Comptroller in an effort to determine what was going on and he went back in and came out and said, "They do not want you there. However, after the meeting is over, I will tell you what happened."

I came back up to his office close to noon, and the meeting had broken up and he had said that the Comptroller had issued a temporary cease-and-desist order and that they were required to set up a compliance committee and he was very shaken and that was the end of the conversation.

The CHAIRMAN. Again, that information came to you, not from the Comptroller's Office?

Mr. MIDDELDORF. No.

The CHAIRMAN. But not from the Comptroller, but from Mr. Jennings.

Mr. MIDDELDORF. That is right.

The CHAIRMAN. When did you hear from the Comptroller's Office, you called the office in Chicago, they said, don't call us, we will call you.

When did they call you?

Mr. DRIGGS. As I recall, Mr. Jerry Bergman of Continental Illinois called me Thursday afternoon or Thursday during the day and said there would be a meeting in the old board room of the Continental Illinois with representatives of the major banks that were participating with Penn Square to discuss the situation.

We flew to Chicago and representatives from all the major banks that you are going to be hearing from were there. We met most of the day, eventually a representative—

The CHAIRMAN. Which day was that?

Mr. DRIGGS. Friday. Eventually a representative from the Federal Reserve came to discuss their involvement and what they would like to try to see done.

And during the day, I called Mr. Burns——

The CHAIRMAN. Do you recall what the Federal Reserve representative, who he was, which office he was from?

Mr. DRIGGS. From Washington, D.C.

The CHAIRMAN. Washington, D.C.

Mr. DRIGGS. Yes.

The CHAIRMAN. Did he happen to tell you what they were prepared to do?

Mr. DRIGGS. They wanted to know——

The CHAIRMAN. I just wanted your version. We have had them talking already.

Mr. DRIGGS. They wanted to know what we, as banks, would do, and discussion of the problem.

During the long day that we were at Continental Illinois, I went out and called Mr. Burns again and spoke with him about the Penn Square matter and got the—did not get a definitive answer.

The CHAIRMAN. This is Mr. Burns. What is his first name?

Mr. DRIGGS. Bob.

The CHAIRMAN. Is it B-y-r-n-e-s?

Mr. DRIGGS. Burns. B-u-r-n-s.

The CHAIRMAN. B-u-r-n-s, OK.

Mr. DRIGGS. Rufus O. Burns is his name.

The CHAIRMAN. R-u-f-u-s?

Mr. DRIGGS. I don't know how. He indicated——

The CHAIRMAN. He said don't call me, don't call Dallas?

Mr. DRIGGS. Not at that time. He was very—he wanted to be kept apprised of everything that we learned and also——

The CHAIRMAN. He wanted you to tell him?

Mr. DRIGGS. I told him we were in meetings.

The CHAIRMAN. He is in the Comptroller's Office and he is asking you for information, right?

Mr. DRIGGS. He wanted to be apprised of what we learned and he indicated to me that he would tell us information that he had gathered.

The CHAIRMAN. So what did he tell you?

Mr. DRIGGS. At that point, I did not get any further information.

The CHAIRMAN. When did you hear from him again?

Mr. DRIGGS. Frankly, the bank was closed on the day after the Fourth holiday and I do not recall when I heard from their office again.

The CHAIRMAN. Rufus and you have been friends for a long time?

Mr. DRIGGS. We had known each other, dealt with each other and their staffs for some time, yes.

The CHAIRMAN. You going to send him a Christmas card again this year after the way he treated you? Don't answer that one.

Gentleman, our staff have noted in going over the documentation that in many of the Longhorn-named limited partnerships with the name Longhorn, I understand there is a plethora of them that are on file in Oklahoma and in these either Carl Swan or J. D. Allen are participants, usually as general partners.

There were a number of Michigan residents listed as limited partners. Are any Michigan National directors, officers, or employees limited or general partners in any limited partnerships in which Carl Swan or J. D. Allen were involved, these Longhorn partnerships?

Have you been able to determine that?

Mr. DRIGGS. Have we been able to determine that?

The CHAIRMAN. Yes; I understand the staff discussed that with you a few days ago.

Mr. DRIGGS. Yes.

The CHAIRMAN. At the time, you did not know. I wonder if you would be able to find anything else in the interim?

Mr. DRIGGS. Just within the last 2 days, I have learned that one of our directors of our—one of our affiliate banks and our chairman was involved in one of the limited partnerships.

The CHAIRMAN. All right.

Mr. DRIGGS. Yes.

The CHAIRMAN. John Doe lives in Peoria, Ill. I like that because that is Bob Michel's hometown, Peoria. And all of a sudden Carl Swan and J. D. Allen, and a resident of Peoria who is a little prominent becomes involved in a limited partnership. So John Doe in Peoria tells his friends about having gone into the limited partnership in energy and things, particularly toward the end of the tax year. It is a shelter, people are all looking for shelters.

Would you think perhaps if we were to look at the addresses of the individuals who were, did participate from Michigan National you might have some of their friends and neighbors and associates in the communities also amongst Michigan residents in these limited partnerships in Longhorn? I am not saying there is anything wrong, but isn't that how it usually happens? I am trying to explain to my staff how it happens. Would you confirm that or not?

Mr. DRIGGS. Sometimes it occurs through a broker who works the partnership, other times word of mouth.

The CHAIRMAN. That can happen at cocktail parties?

Mr. DRIGGS. Yes; certainly could.

The CHAIRMAN. Or by the coffee machine?

Mr. DRIGGS. It certainly could.

The CHAIRMAN. Really. Would it be any problem for you to identify for us specifically the names of these individuals that you are aware of now who were a part of Michigan National that participated in these partnerships as well as their home addresses and work addresses?

Mr. DRIGGS. We will be glad to take the list and we will identify everyone that we can.

The CHAIRMAN. We could then just look at the pattern.

Mr. DRIGGS. All right, be happy to supply the committee with that information.

[The information submitted by Mr. Driggs follows:]

In response to the committee's request for the names, home addresses and work addresses of directors, officers and employees of Michigan National Bank who are investors in Longhorn Limited partnerships, please be advised that the following are investors in Longhorn related limited partnerships:

Name	Position	Home address	Business address
S. C. Stoddard	Chairman of the board.....	Birmingham, Mich. 48010	1700 Woodward, Bloomfield Hills, Mich. 48010.
Herbert H. Jacob.....	Director, MNB-Oakland, MNB- Bloomfield Hills, Mich. 48013.... W. Metro (affiliates of MNB).		1 Ajax Drive, Madison Heights, Mich. 48091.

The CHAIRMAN. Mr. Barnard.

Mr. BARNARD. Mr. Driggs, at any time on examination of your bank by the Office of the Comptroller of the Currency, I believe it is the Battle Creek office that maintained most of these participation loans.

Mr. DRIGGS. Yes.

Mr. BARNARD. Was it examined by the Comptroller of the Currency?

Mr. DRIGGS. Yes; we are examined approximately every year.

Mr. BARNARD. On any occasion were any of these loans that you purchased from Penn Square criticized by the bank examiners?

Mr. DRIGGS. In examination during May 1981 there were four or five loans that were criticized by the Office of the Comptroller; yes.

Mr. BARNARD. Following that did the bank continue their participation arrangement with the Penn Square Bank?

Mr. DRIGGS. As I understand it, our Battle Creek office looked to each one of those loans and prior to the final wrap-up of the examination of the Comptroller's Office in September, all of the loans were brought current to or paid in full, and I am not—I don't recollect all the facts but an investigation was made into each one of those loans by our officers.

When the Comptroller performs an examination of our bank we ask each area to look at the loans or the criticized assets or any suggestions and write a detailed report to the Comptroller's Office. That was done, and evidently every condition was satisfied prior to the conclusion of the examination.

Mr. BARNARD. And you were not sufficiently concerned at that point to discontinue your participation arrangement with Penn Square?

Mr. DRIGGS. We were not.

Mr. BARNARD. You still maintained the confidence?

Mr. DRIGGS. That is correct.

Mr. BARNARD. In Mr. Patterson?

Mr. DRIGGS. Yes.

Mr. BARNARD. I have no further questions, Mr. Chairman.

The CHAIRMAN. I know that you will be sorry to hear this, Mr. Driggs, Mr. Peterson, Mr. Middeldorf, but I don't have any further questions at this time, either.

So we want to thank you for your assistance, your cooperation with staff, that of your personnel. You have been very helpful. There may be further questions in writing, already you have one that you will fill the blanks in for us on.

Mr. DRIGGS. We will be happy to respond to any questions. Thank you very much.

The CHAIRMAN. You have very competent advisers, I know, so that should make it easier.

Mr. DRIGGS. We appreciate that.

The CHAIRMAN. Thank you very much.

The CHAIRMAN. At this time I ask Mr. Richard Jaehning and Arland Hatfield be kind enough to approach the witness table.

Thank you, Mr. Hatfield and Mr. Jaehning have been sworn. I understand you have a prepared statement.

Mr. JAEHNING. Yes.

The CHAIRMAN. Would you be kind enough to proceed?

TESTIMONY OF RICHARD G. JAEHNING, PRESIDENT, SEATTLE-FIRST NATIONAL BANK; ACCOMPANIED BY ARLAND D. HATFIELD, SENIOR VICE PRESIDENT AND MANAGER, ENERGY DIVISION

Mr. JAEHNING. Mr. Chairman, distinguished members of the committee, I am Richard Jaehning, president of the Seattle-First National Bank, and this is Mr. Arland Hatfield, senior vice president and manager of the Energy Division at Seafirst.

We are here today to cooperate fully with the committee in its continuing inquiry into the failure of Penn Square Bank. We share this panel's interest in the complex set of relationships which arose not only between Penn Square, its customers and participating banks, but with Federal Government's regulatory agencies as well.

With the chairman's permission, we will spare the committee's time and not detail here the minute-to-minute chronology of Seafirst's dealings with Penn Square. We will, however, be glad to address any questions the committee may have on that progression. We would prefer to get right down to the how and why of the matter, because quite frankly those questions have caused a great deal of very painful corporate soul-searching at Seafirst during the past several months.

Seafirst has always prided itself on being a conservative bank with an earned reputation for sound management. Over the past couple of decades, we have enjoyed steady growth and a position as the regional financial leader in the Pacific Northwest.

We became interested in energy lending in the mid-1970's when our strategic analysis predicted a strong and ongoing demand for credit services in that field. We had already been doing business in Alaska in connection with the pipeline; and it seemed a natural progression to begin looking into oil and gas lending in the Southwest.

Our interest in energy was sparked in the late 1970's when, along with many other financial institutions across the Nation, we began to feel mounting pressures from high, volatile interest rates, partial deregulation, increased competition from unregulated near-banks, and a general worsening of the economy. Particularly in our own Pacific Northwest, where economic health is tied to the timber and aerospace industries, the recession began early, and is as severe as any place in the Nation today.

By 1979, we were looking at the potential opportunities Penn Square was beginning to offer.

We were looking at the large, successful banks who were already dealing with that institution. We were looking at our own short but successful history in energy lending. We were looking at the

clean bill of health the Comptroller of the Currency's examiners continued to give Penn Square loans. And it all looked good to us.

In retrospect, we wish we had looked a little longer and a little deeper. We wish the Comptroller or Penn Square officers had shared with us the serious inadequacies in the lending, credit, and documentation policies of that institution.

Although we believe that adequate credit review policies did exist within our bank, it is clear that in some instances, documentation lagged far behind loan volume and collateral was not verified. Credit work was slow, and more importantly, it was based upon industry assumptions about the future of oil prices. At this point, Seafirst is a little bruised and more than a little embarrassed, but we hope and expect a vital recovery.

Steps have been taken in that direction. We have opened an office in Oklahoma City and have staffed it with some of our best credit people. They have contacted all the customers involved in the Penn Square participations and are working with the FDIC to purchase those loans.

We have thoroughly reviewed our credit policies and procedures and have made certain they will be adhered to. Our Energy Division is headed by a seasoned credit administrator and is staffed by bank officers with proven abilities to work within our established credit review framework.

Mr. Chairman, members of the committee, we have had to say some hard things today. We will not soon forget Penn Square, but we are not going to let it haunt us either. Seafirst is, and will continue to be a conservative, well-managed institution that has earned the confidence of its customers, its peers, and its community.

We will be pleased to answer the committee's questions.

The CHAIRMAN. Thank you, Mr. Jaehning.

No. 1, oftentimes a brief statement and a straight out statement is a very clear statement, and I congratulate you on it.

On page 2, "by 1979 we are looking at the potential opportunities Penn Square was beginning to offer. We were looking at the large successful banks who were already dealing with that institution."

Where did you get that information, that Penn Square had potential opportunities, that it was offering and that the large successful banks were already, a lot of successful banks already were dealing with that institution?

Mr. JAEHNING. I didn't have direct contact at that time so it is a little difficult for me to give you a specific answer on that.

But reflection would indicate that our energy department which had been formed by then, had received a contact from Bill Patterson, and we were aware that both Chase and Continental had been doing business in the Southwest—

The CHAIRMAN. In other words, and Mr. Hatfield could help you on this if you would like.

Was it an ABA meeting, an IBA meeting or did Mr. Patterson come up to Seattle and say, hey, I am selling, you buying?

Don't get me wrong, that is the way he operated.

Mr. HATFIELD. I was named as energy manager at Seafirst in July. Mr. Boyd was the manager who met and was in contact with Mr. Patterson of Penn Square at the initial contact time.

The CHAIRMAN. So are we to assume—we will hear from Mr. Boyd after we hear from you.

When you made that statement, Mr. Jaehning, at page 2, what you are saying is that Mr. Patterson who somehow or other met Mr. Boyd who was at that time heading up the energy department division?

Mr. JAEHNING. That is right.

The CHAIRMAN. And said here I am, Wild Bill Patterson, I am selling if you are buying and by-cracky, I have sold to Continental and to Chase and to Who's Who all over the place? Is that an accurate description?

As I said to others, don't feel bad, that is the way he operated.

Mr. JAEHNING. I cannot tell you if that is an accurate description or not, but I certainly wouldn't refute it.

The CHAIRMAN. All right.

Then you say, "we were looking at the clean bill of health, the Comptroller of the Currency's examiners continued to give Penn Square loans," and then at the end of your statement you say, had you known what the real facts were things would have gone a little differently, correct?

Mr. JAEHNING. That is right.

The CHAIRMAN. As you probably have heard, the one thing that bothers me here that I think perhaps we have to look at, I am not one of the members who feels we need a whole lot of legislation, I think perhaps we need more application of the prudent man rule and better judgment and of course judgment is one of those things, that is why we have the erasers on pencils, we all make mistakes.

But in this area I happen to feel that we may be at a point where the time has come to disclose a little more about the facts in this situation of the financial institution when there needs to be some corrective actions taken, and that this idea of keeping it a grand secret, you know, perhaps we ought to revisit this because after all, if you are running a good—incidentally, everything we have heard to date is that your institution up there in the State of Washington is a first class institution, has been for many years, you have served the area well, nothing we have heard except complimentary remarks and evaluations.

So what problem would you have with disclosure when the Comptroller comes in or one of the other regulators comes in and finds that an institution is not being properly managed and that unless they clean up their act, they will be facing public scrutiny.

Would you have any trouble with looking at a little more disclosure than we have had to date? Piercing that veil of secrecy slightly?

Mr. JAEHNING. There is a way today to do partially what you are talking about. It is called the shared national credits. That would be where a bank would have a credit and we would not be a participant, but a direct lender in a credit to that particular customer. Thus, if there is an examination that takes place in Minneapolis, for example, that information would then be passed on to us.

I really can see no reason why this particular rule that the Comptroller has could also apply in the Penn Square situation. We are participants, we had a right to know, I think, when they came

in and looked at the documentation and found it to be inadequate. We had a right to know that.

As a shared participant in that particular loan, no matter who it was, I think we should have had that information.

The CHAIRMAN. You feel the Comptroller's office was delinquent in not providing that information?

Mr. JAEHNING. I am not absolutely sure how that rule applies across the board. I do know that in a national credit such as one with International Harvester, for example, and with many other credits, that the examination takes place at the lead bank and the classification at the lead bank is then distributed to the other participating banks.

All I am saying is I cannot understand why something of that type couldn't work in a case like this.

The CHAIRMAN. That is all right for you. You are a participating bank in a loan.

Mr. JAEHNING. That is right.

The CHAIRMAN. How about the S&L next door to you or the credit union next door to you who deposited funds in excess of \$100,000 in Penn Square? How were they helped by that?

Mr. JAEHNING. Well, you are here getting into an extremely sensitive area on how much information you are going to divulge.

The CHAIRMAN. Mr. Jaehning, we have in the past seen very few instances like Penn Square where the whole thing is shut down and people take the loss. To date we have been able to—we have been looking at mergers and what have you and even though some have had to wait a long period of time, in most instances they have been made whole after a long period of time.

In this instance, there is very little probability that many of those people, that anyone who had deposits over \$100,000 will be made whole.

And, just as I say, I think that it is important that we take a careful look at this secrecy and see whether we have not worshipped at that shrine too long a period of time, and that perhaps maybe we should look at a few other idols and deities.

Unfortunately we will have to ask your indulgence to run over and cast a vote. We will be back momentarily.

Mr. JAEHNING. Yes, sir.

[Recess.]

The CHAIRMAN. The committee will be in order.

Mr. Jaehning, have you taken any trips to Oklahoma, to Oklahoma City, to visit Penn Square and the people there?

Mr. JAEHNING. I did.

The CHAIRMAN. Recently?

Mr. JAEHNING. Not recently.

The CHAIRMAN. When was that? When were you last there?

Mr. JAEHNING. I have been to Oklahoma City within the last 6 weeks to visit our people there.

The CHAIRMAN. Prior to that?

Mr. JAEHNING. I visited our people there twice in the last 2 months.

The CHAIRMAN. And prior to that?

Mr. JAEHNING. I made a trip to Oklahoma City at the end of January 1982.

The CHAIRMAN. And what was the purpose of that trip, Mr. Jaehning?

Mr. JAEHNING. I had taken over the world banking area. It started reporting to me in August 1981, along with some other duties I had in the bank. I had set out a schedule to travel to certain areas around the world, including Oklahoma City, to become more familiar with the different areas that reported to me.

This was just a scheduled trip to Oklahoma City to better understand what the situation was there.

The CHAIRMAN. And while there, you met with whom from Penn Square?

Mr. JAEHNING. I met Mr. Patterson and Mr. Jennings from the Penn Square Bank.

The CHAIRMAN. How about Mr. Beller?

Mr. JAEHNING. Yes, I met Mr. Beller.

The CHAIRMAN. Did you spend much time with Mr. Beller?

Mr. JAEHNING. I spent about 2 hours, one breakfast with him.

The CHAIRMAN. And with Mr. Jennings?

Mr. JAEHNING. He was at the same breakfast.

The CHAIRMAN. Did you see Mr. Jennings subsequently?

Mr. JAEHNING. Very briefly.

The CHAIRMAN. Mr. Patterson.

Mr. JAEHNING. Again—

The CHAIRMAN. Just a breakfast?

Mr. JAEHNING. No.

The CHAIRMAN. Did he take you to the Cowboy Club?

Mr. JAEHNING. No, no; I saw Mr. Patterson. I was there for 2 days. Off and on we made some calls, and we would come back and I had a dinner at Mr. Jennings' house, for example, with about 20-some people, and Mr. Patterson—

The CHAIRMAN. Was Mr. Beller at that dinner?

Mr. JAEHNING. I think he was; yes.

The CHAIRMAN. Our information was poor Mr. Beller—you know, there was a song, poor Mr. Chisholm—strummed on his mandolin; our impression was he just about spent a lot of time strumming his mandolin, not that he is not a wonderful gentlemen, he is, but Mr. Jennings and Mr. Patterson used him as a—to placate the Comptroller. That was why I am wondering: When you were there, who did you feel was running the operation?

Mr. JAEHNING. Well, I had a long conversation with Mr. Beller and Mr. Jennings together, because I had some concerns about documentation problems that we had been having and—

The CHAIRMAN. Mr. Beller couldn't have been very helpful there?

Mr. JAEHNING. Well, he was.

The CHAIRMAN. That is not—

Mr. JAEHNING. Whether he was giving me a song and dance, you know; hindsight would say he probably was.

The CHAIRMAN. You know, we had a nice discussion with him in Oklahoma City. He admitted that he was, you know; he was told that that area, energy, was out of his—out of bounds for him.

Mr. JAEHNING. He did not tell me that, nor did Mr. Jennings tell me that.

The CHAIRMAN. Now, Mr. Jaehning, how often did you review the credits of Penn Square, and did you participate in any discussions on the Penn Square loans with your management committee?

Mr. JAEHNING. I was not on the credit committee. There were two committees that reviewed credit from Penn Square, and I will ask Arland to go over that briefly with you because he was on those committees.

One was in the world banking area and the other was the general credit review committee for the bank.

I did not serve in those committees. I am on the management committee and have been and was, but credits of the size of Penn Square basically were not management committee credits. In other words, we reviewed credits at the management committee that were at our house limit or above.

Our house limit was about \$30 million. Most of these credits were in the area of \$3 million to \$10 million, and they were reviewed at the world banking committee and at the general credit committee of the bank.

The CHAIRMAN. Was it just Mr. Boyd who had responsibility for Penn Square loans, or was it somebody higher up the ladder?

Mr. JAEHNING. He reported to John Nelson, the executive vice president, and John Nelson was for a period of time the chairman of the world banking credit committee and also served on the bank's credit committee.

Late in 1981, or early 1982, probably about January—

Mr. HATFIELD. Yes, February.

Mr. JAEHNING. Then Arland Hatfield, at my request, was made chairman of the World Banking credit committee.

The CHAIRMAN. To replace?

Mr. JAEHNING. John Nelson.

The CHAIRMAN. When did Mr. Nelson retire?

Mr. JAEHNING. John retired from the bank; he is still on the payroll, but he retired from the bank in July.

The CHAIRMAN. Could we say, was he a Penn Square casualty?

Mr. JAEHNING. Yes, I would say he is a Penn Square casualty.

The CHAIRMAN. Now, you say that—did you get involved in looking into the Penn Square participations, Mr. Jaehning?

Mr. JAEHNING. I did not.

The CHAIRMAN. Yet you took the trip to Oklahoma City, and while there, you took the opportunity to discuss documentation on these loans?

Mr. JAEHNING. Well, we had a—

The CHAIRMAN. Did you have somebody with you?

Mr. JAEHNING. John Boyd, from our bank, was with me.

The CHAIRMAN. On that trip to Oklahoma City?

Mr. JAEHNING. Yes; but we had had some concern about inadequate documentation; we felt that we needed some reassurance, and in my conversations, as I say, with Messrs. Jennings and Beller, I was given all kinds of assurance to the effect that: "Believe me, that documentation was improving; that documentation was in good shape; that, yes, they had had some problems with documentation, but that is why Mr. Beller was there because he was a credit person, and don't worry about these things."

I still had some concerns after my visit, and I asked Arland to go down and just take a look around, look at a few files and see what he thought about the progress at the bank.

The CHAIRMAN. Arland is Mr. Hatfield?

Mr. JAEHNING. Yes.

The CHAIRMAN. Tell us about your going down and looking around.

Mr. HATFIELD. I went down in the latter part of February. I spent 2 days at Penn Square. The purpose of my visit was to look at the procedures that the bank used in evaluating their credits, and then the review process that they used in—after the credit had been made or approved by the various committees that approved it.

I also wanted to meet with—

The CHAIRMAN. What did you find?

Mr. HATFIELD. I wanted to meet with the people and get my own personal evaluation of their quality.

The CHAIRMAN. Tell us about who you met and who was approving these loans?

Mr. HATFIELD. My initial meeting was with Mr. Beller. I visited with Mr. Beller and went through the people he hired mainly from First Oklahoma and had brought over as key people to work with him on the review process and the approval process.

I spent about two hours with him and then left him and went with Mr. Richard Dunn, who was their loan review officer and spent about 2 hours with him.

Later on in the day, I asked if I could start looking at some credits. I had some specific credits I wanted to look at; those that we had significant exposure in—some large loans. I looked through those credits. The people I visited with said they had just been in the process of upgrading and cleaning up the credit files.

I wanted to look at some they had not cleaned up. I went through and checked documentation on four very large credits and found them to be OK.

I went back to Mr. Beller and asked him if I could look at their loan policy statement, if they had such a thing. I also would like to look at the minutes of their meeting of their loan committee to see what kinds of loans they were reviewing and approving.

I did that.

The CHAIRMAN. What kinds of loans were they looking at and approving?

Mr. HATFIELD. They were approving all the loans made within the bank.

The CHAIRMAN. Including all energy loans?

Mr. HATFIELD. All energy loans. I asked him who is the chairperson of the loan committee, and he said, "I am."

The CHAIRMAN. Who was that now?

Mr. HATFIELD. Mr. Beller.

He said I would invite you to come in in the morning; we are going to have a loan committee meeting to go over various loans. Mr. Joe Semler, deputy manager of the energy division, was with me. We went to that meeting.

They reviewed two energy credits that morning. I asked him questions about the collateral, how they determined the collateral, the basis of the reserves, and we went through the geology and

who the geologist reported to. He told me he was totally independent. This was Mr. Beller, and I saw them approve these two loans and the committee broke up. I spent the rest of the day visiting with a geologist in the geology department.

The CHAIRMAN. What we are hearing is—Mr. Barnard and I are hearing—a story we did not hear in Oklahoma City. Mr. Barnard, why don't you relieve me a few minutes, and I will be back.

Mr. BARNARD. Thank you, Mr. Chairman.

Gentlemen, we certainly do appreciate your coming the long distance that you have to be with us all day long. Maybe we have gained a little empathy from you about all the challenges we have on this committee.

Mr. Jaehning, how do you recognize credit, a credit manager or officer, in any commercial bank? Do you recognize him as a very skilled individual, someone who is highly experienced, highly knowledgeable, and so on? What is your general characterization of a credit officer? What would you expect out of a credit officer?

Mr. JAEHNING. I have a great deal of respect for credit officers in any bank, and the credit officers in our bank are normally a person that has been in credit for a long period of time. Credit is not something that you learn in a year or two. Most of our people that are senior credit officers today have been with the bank anywhere from 15 to 30 years, and they are very disciplined people. They are also very patient people and have very good judgment. They believe that you have to have all the facts. They believe that you have to have good documentation. They believe that you never have the chance to ever get any documentation once you advance funds.

Mr. BARNARD. Wouldn't you expect that same qualification from an officer of a bank from whom you were buying a substantial amount of loans?

Mr. JAEHNING. I would, yes.

Mr. BARNARD. Did the Seattle First, as far as Mr. Patterson was concerned?

Mr. JAEHNING. My association with Mr. Patterson was maybe an hour or so in a 2-day period. Really, I would have a hard time evaluating that period of time whether Mr. Patterson was a supersalesman or a super credit officer.

Mr. BARNARD. Well, then, you mean that you were relying upon your own credit department for the creditworthiness of those loans as opposed to Penn Square?

Mr. JAEHNING. Well, yes, and remember that we were buying participations, that we were given great assurances that these credits had been checked, that they were good credits, and that the documentation was proper. But yes, we share some of that responsibility.

Mr. BARNARD. Of course, you know Monday-morning quarterbacking is always very, very easy when you are judging the Seattle Sea Hawks, but—

Mr. JAEHNING. Please.

Mr. BARNARD. You said in your statement that you were looking at the clean bill of health the Comptroller of the Currency examiners continued to give Penn Square loans.

I would say about the Penn Square Bank, that here is a \$400 million bank in a shopping center, in Oklahoma City, that, is generating 80 percent of its loans in one particular field.

I thought that banks were very much concerned about concentration and overconcentration.

That is one aspect.

No. 2 is that it was very active in the field of brokered funds. That is the big one. We have a schedule of all the credit unions in this country that were depositing money down there at unusually high interest rates, another red flag.

It just appears to me that a bank the quality of Seattle First and the Continental and the Michigan National and others would have noticed some of these characteristics and really identified it as a go-go bank—like one of these go-go nightclubs, it is not there for too long. Did you ever question any of these unusual characteristics of this institution?

Mr. JAEHNING. Yes. We questioned it in the fall of 1981. We had a concentration policy within our bank at about 150 percent of capital.

We went beyond that in January 1982 and the Energy Department was told very loudly to get back within those limits as soon as possible. There were many attempts to do this.

We did not purchase any new energy loans after about February or March 1982. We made advances on commitments we had but we effectively cut off the Energy Department and that was in February or March 1982.

Mr. BARNARD. In cutting off the Energy Department, were you also cutting off the Penn Square Bank?

Mr. JAEHNING. Yes.

Mr. BARNARD. Was that because of your own evaluations of those credits and the operations of Penn Square?

Mr. JAEHNING. It was more in the area of concentration and the fact that we were exceeding our rules as far as concentration was concerned.

The CHAIRMAN. What was the date now, February 1982?

Mr. JAEHNING. February or March 1982.

The CHAIRMAN. You decided that it was energy loans or Penn Square energy and Penn Square loans?

Mr. JAEHNING. The Energy Department had exceeded its concentration limits at that point.

The CHAIRMAN. Did the Energy Department lend money to some of the big swingers at Penn Square?

Mr. JAEHNING. Well, we had some 120 customers that were participating in at Penn Square Bank and, you know, we have now—

The CHAIRMAN. Excuse me, I am not talking about participation. I will get specific.

A chap named Ron Burks. I don't know if he had a \$2 million line of credit or \$2 million plus \$205,000 but as of February 1982 your institution approved a \$2 million line of credit to him, on which he drew down about \$1,689,000.

Then there was Mr. Patterson, December 1981, \$1.4 million. They were signed by John Boyd. It doesn't say what it was for.

Then we have \$2.5 million, at least, to Jennings, and the last, \$1.5 million was drawn down in May.

Were you familiar with those loans, Mr. Jaehning?

Mr. JAEHNING. I was not at that time, no. I am familiar with the Jennings loan today, yes.

The CHAIRMAN. But the February 1982, after you told the Energy Department to slow down they still proceeded with another \$2 million to Mr. Burks, were you aware of that?

Mr. JAEHNING. I was not, and I qualify that by saying that we had commitments out that we did honor after that date.

The CHAIRMAN. I am sorry.

Mr. BARNARD. Go right ahead.

The CHAIRMAN. Want me to go for a while?

Mr. BARNARD. I want to ask him one thing.

I know we will hear the testimony of Mr. John Boyd, former senior vice president and general manager, but was his dismissal because he violated bank policies and procedures, and practices in the administration of these loans?

Mr. JAEHNING. Well, basically, yes, John did violate some of our policies and practices and we felt that in July that he probably didn't have confidence in us and we didn't have confidence in him at that point.

Mr. BARNARD. Did he have any other problems with other credits other than with Penn Square?

Mr. JAEHNING. There were credits in the energy area we were having problems with at that time, yes.

Mr. BARNARD. Was this because of documentation?

Mr. JAEHNING. No.

Mr. HATFIELD. No, they were just—

Mr. BARNARD. Just not creditworthiness.

Mr. HATFIELD. Problems with economy or lack of drilling capacity or need for drilling.

Mr. BARNARD. Had these loans been approved by your credit committee?

Mr. HATFIELD. Most of them had, yes.

Mr. BARNARD. In other words, they were processed by Mr. Boyd but, on the other hand, they were approved by the loan committee then?

Mr. HATFIELD. Mr. Boyd at that time had a \$10 million lending limit so he could approve loans up to that amount. Over a certain dollar amount, if it were a new credit, the credit committee would review that. So many of the loans were on review, there were quite a few that were approved.

Mr. BARNARD. Since the Penn Square have you had to tighten up your procedures and policies?

Mr. JAEHNING. Yes. As I mentioned in my statement, we have had a full review of our procedures, policies, lending limits, and the authority of the different committee levels, and so forth.

We have tightened up considerably.

Mr. BARNARD. One final question which I asked the others.

How much importance or significance did you give the statement by the auditors, the old auditors as well as the new auditors?

Mr. JAEHNING. I was not aware of the original statement until just recently. The statement that came out in March of this year

that everything was fine and everything was clean—I was aware of shortly after it was issued.

Arland, do you want to address this?

Mr. HATFIELD. I was aware in 1980 of the qualification. We questioned Penn Square. At the time I was there I questioned them about it. They said it was mainly the fact that they didn't have the qualified people to handle the paper work, that they had corrected those things and that the Comptroller had given them a clean bill of health as of that date.

Mr. BARNARD. Mr. Jaehning, I know the chairman is going to follow up on this but I want to ask it also.

On your visit to Oklahoma City and your breakfast with the management team of Penn Square, you left there with every satisfaction that Mr. Beller—

The CHAIRMAN. Eldon Beller.

Mr. BARNARD [continuing]. He was the chief executive officer with the authority and supervision of the credit function of the bank?

Mr. JAEHNING. I left there with the idea he was the chief credit officer. I don't think there was any doubt that Mr. Jennings was the chief executive officer but I was given every reason to believe that Eldon was the chief credit officer of that bank.

Mr. BARNARD. And you gained no indication that he was supposed to stay out of Mr. Patterson's bailiwick?

Mr. JAEHNING. I did not.

Mr. BARNARD. Thank you, Mr. Chairman.

I have no further questions.

The CHAIRMAN. Did you have any indication he was supposed to stay out of Mr. Patterson's bailiwick, Mr. Hatfield, to wit, energy loans?

Mr. HATFIELD. No. Contrarily, I was told he was this senior credit person and in charge of the credit committee.

The CHAIRMAN. One of these days when we have the transcript ready I would commend to you as interesting reading the hearing in Oklahoma City and the testimony of Mr. Beller himself, that he was there, it was SOP [standard operating procedure] an understanding about his employment that stated it was understood he would not get involved in those areas because those were sacrosanct and belonged to Mr. Patterson and Mr. Jennings.

Does Seafirst have correspondent relationships with Chase and Continental and Michigan National?

Mr. JAEHNING. Yes, it would be like any other bank.

The CHAIRMAN. Did you discuss with those institutions, Penn Square, at any point in time, Mr. Jaehning?

Mr. JAEHNING. I did not.

The CHAIRMAN. Mr. Hatfield.

Mr. HATFIELD. I did not.

The CHAIRMAN. To refresh my memory because of the vote that intervened, as I recall, to the best of your knowledge, the relationships that developed between Seafirst and Penn Square was primarily as a result of Mr. Patterson calling upon Mr. Boyd in some way, shape, manner or fashion and going from there?

Mr. JAEHNING. That would be my understanding, yes.

The CHAIRMAN. Did either of you ever verify with Chase, Continental or Michigan National the fact that they were purchasing participations from Penn Square?

Mr. JAEHNING. I did not.

Mr. HATFIELD. I did.

The CHAIRMAN. You did?

Mr. HATFIELD. I did.

The CHAIRMAN. At what period of time, Mr. Hatfield?

Mr. HATFIELD. In the fall of 1981, I was down in the energy division visiting with some of the officers about particular loans and I met Mr. Pat Goye, the correspondent from Continental Bank, who serviced our bank on the west coast. I asked him at that time about the Penn Square relationship and he said that they had an excellent relationship with them.

The CHAIRMAN. What was his name again?

Mr. HATFIELD. Pat Goye.

The CHAIRMAN. Goye?

Mr. HATFIELD. Goye. G-o-y-e.

The CHAIRMAN. Pat Goye. I am curious. You said that the reason Mr. Boyd was dismissed, pinkslipped, was that not only Penn Square but there were other credits that you had problems with that he had approved?

Mr. JAEHNING. As I indicated earlier, there were some other problems in our energy department.

The CHAIRMAN. When did those surface?

Mr. JAEHNING. Most of the problems in energy have surfaced this last spring, and this last summer.

The CHAIRMAN. And in July? When Penn Square—

Mr. JAEHNING. Actually, prior to July.

The CHAIRMAN. But Mr. Boyd was with you prior to July.

Mr. JAEHNING. That is right.

The CHAIRMAN. Had he been given notice prior to July 4 that his services were no longer required?

Mr. JAEHNING. No.

The CHAIRMAN. When did he get that notice?

Mr. JAEHNING. Probably around the middle of July.

The CHAIRMAN. Subsequent to the demise of Penn Square?

Mr. JAEHNING. Yes, sir.

The CHAIRMAN. So, is it fair to assume that in reality his departure was primarily due to the problems with the Penn Square loans?

Mr. JAEHNING. Primarily, yes.

The CHAIRMAN. Thank you.

Mr. Nelson's retirement was for that same reason? Early retirement?

Mr. JAEHNING. Yes, although there are some other circumstances involved. John had been moved out of the world banking area back in the end of March or first part of April, and a new manager had been put in that area. So there were other situations involved in that particular retirement.

The CHAIRMAN. Other than those two were there any other casualties?

Mr. JAEHNING. Not at this time; no.

The CHAIRMAN. OK.

Did you hear from the Comptroller's Office at any point in time about the problems of Penn Square?

Mr. JAEHNING. Prior to what date?

The CHAIRMAN. Prior to the shutting of it down.

Mr. JAEHNING. Our chairman received a call, I believe around the 29th of June.

The CHAIRMAN. Of June?

Mr. JAEHNING. Of June.

The CHAIRMAN. OK. From whom did he receive that call, sir?

Mr. JAEHNING. Somebody in the Comptroller's Office.

The CHAIRMAN. You don't know who?

Mr. JAEHNING. I don't know who it was.

The CHAIRMAN. Do you know what he was told?

Mr. JAEHNING. We were asked, along with Continental and Chase, if we wished to come to Washington, D.C., and to go over some problems at Penn Square with the Comptroller.

The CHAIRMAN. Do you know who attended that meeting?

Mr. JAEHNING. I did, and Arland Hatfield did.

The CHAIRMAN. At that time what were you told?

Mr. JAEHNING. We were told that an ongoing exam that started back in April was showing some very serious problems with the Penn Square Bank. We were told that there were a number of chargeoffs that would be listed and that the Penn Square Bank at that time was trying to raise additional capital. We were asked whether we felt there was anything that we or other banks might be able to do to try and support Penn Square Bank.

The CHAIRMAN. To assist in raising additional capital?

Mr. JAEHNING. That was one of the questions presented; yes.

The CHAIRMAN. That was the first you knew that the situation had been—had become so dire?

Mr. JAEHNING. Yes.

The CHAIRMAN. D-i-r-e?

Mr. JAEHNING. Yes.

The CHAIRMAN. All right.

Does Seattle First have its own energy analysis department? In other words, do you have engineers, geologists in your energy department?

Mr. HATFIELD. We have an engineer.

The CHAIRMAN. An engineer?

Mr. HATFIELD. We have an engineer.

The CHAIRMAN. An engineer?

Mr. HATFIELD. And we use outside consultants.

The CHAIRMAN. Did you send the outside consultants or your engineer to Oklahoma City?

Mr. HATFIELD. Our engineer had gone down to Penn Square and reviewed with their geologists and their engineering department their system.

The CHAIRMAN. Their system. How much time did your engineer spend there?

Mr. HATFIELD. I can't answer that.

The CHAIRMAN. Roughly.

Mr. HATFIELD. I would say 2 days, but I cannot say for sure.

The CHAIRMAN. When was that?

Mr. HATFIELD. In the fall.

The CHAIRMAN. Of 1981?

Mr. HATFIELD. 1981. Yes.

The CHAIRMAN. And subsequent to that did any of your technicians go to Oklahoma City to look at any of Penn Square's loans?

Mr. HATFIELD. Mr. Boyd can respond more to that because he was the manager at that time. I am only aware of the one visit.

The CHAIRMAN. Who else do you have technically qualified at Seattle First on energy loans? You have one engineer, and you use outside private consultants.

Mr. HATFIELD. Yes.

The CHAIRMAN. Is that the sum total of it?

Mr. HATFIELD. That is the sum total of it.

The CHAIRMAN. As compared to Continental which seems to have—

Mr. HATFIELD. Yes. That is right.

The CHAIRMAN. Which seems to have a greater number of individuals involved?

Mr. HATFIELD. Yes.

The CHAIRMAN. Mr. Barnard.

Mr. BARNARD. I have no questions, Mr. Chairman.

The CHAIRMAN. Gentlemen, we want to thank you. Were you with me in Seattle?

Mr. BARNARD. No.

The CHAIRMAN. You didn't come?

Mr. BARNARD. Oklahoma City was my only trip.

The CHAIRMAN. You missed a wonderful trip.

Mr. JAEHNING. You didn't have to mention the Seahawks, though.

The CHAIRMAN. I didn't mention them. OK. Really, as you know, we were there in the fall; the full committee was there for hearings on the economy and I understand it has not improved since we were there. I am sure that you didn't—I hope you didn't mind too much coming to Washington to visit with us.

Mr. JAEHNING. This time of the year it is beautiful.

The CHAIRMAN. We want to thank you for your cooperation, your assistance to the staff, and there might be additional questions we might be submitting in writing and that is it.

Mr. JAEHNING. Thank you very much.

The CHAIRMAN. Thank you, gentlemen.

Now we hear from Mr. John R. Boyd, who has been, until recently, senior vice president of the energy division of Seattle-First National Bank.

[Witness sworn.]

Proceed, sir.

**TESTIMONY OF JOHN R. BOYD, FORMER SENIOR VICE PRESIDENT
AND MANAGER, ENERGY DIVISION, SEATTLE-FIRST NATIONAL
BANK**

Mr. BOYD. Until July 15, 1982, I was senior vice president and manager of the energy division of Seattle-First National Bank. I am pleased to appear before the committee to answer questions related to the Penn Square Bank operations. I hope that the facts that I am able to give will be helpful in your deliberations.

For background, Seafirst has been involved in making energy-related loans since the mid-1970's. In March 1978, the bank established an energy department which later became a division of Seafirst's World Banking Group.

The division was given a global responsibility. We sought and made energy loans in the areas of drilling equipment, refining, service companies, and production payment financing. Our primary geographic areas of lending were the Southwest, Alaska, Canada, and South America.

By the end of 1980 our average outstanding energy loans exceeded \$200 million.

During the 1980-81 period, the level of oil and gas prices moved sharply upward, which increased the level of drilling for oil and gas. Our energy loan portfolio grew accordingly.

By December 31, 1981, the energy division had average outstanding energy loans of \$846 million. Seafirst's relationship with Penn Square began in early 1979. At that time, we were advised that Penn Square was using Continental Illinois and Chase Manhattan as its principal upstream correspondents.

Seafirst's relationship with Penn Square began slowly. By the end of 1979, Penn Square-related loans amounted to \$4 million of the energy division's then outstanding \$79 million in loans.

By the end of 1981, Penn Square-related loans accounted for approximately \$300 million of the energy division's \$1 billion loan portfolio. All Penn Square energy loans in which Seafirst participated during 1980, 1981, and 1982 were covered by written master participation agreements executed by both banks in each of the 3 years. These agreements required Penn Square to properly collateralize and to evaluate the creditworthiness of each loan.

During our 3-year involvement with Penn Square, the Office of the Comptroller of the Currency had regularly examined Seafirst, and had raised no questions concerning our Penn Square-related loan participations. Further, we were aware that the Comptroller had regularly examined Penn Square, and we had no indication from the Office of the Comptroller or from Penn Square's management of any problem.

In fact, sometime after a visitation of Penn Square Bank by the Office of the Comptroller, which I believe occurred in September 1981, several members of Penn Square's management advised me that the Comptroller's Office had commented favorably on additions to the bank's personnel, and improvements made in its systems.

The first time I can recall the Comptroller's Office commenting to us regarding Penn Square was following the Comptroller's April 1982 examination of Seafirst's energy division. At that time, I was advised that examiners of the Comptroller's Office might wish to come back and examine certain Penn Square loans.

So far as I am aware, we, at Seafirst, heard nothing further from the Comptroller until the last week in June. I understand at that time our senior management received a call from the Office of the Comptroller in Washington, D.C. As you know, a few days later, Penn Square was closed by the Comptroller's Office.

I will be pleased to answer the committee's questions.

The CHAIRMAN. Thank you, Mr. Boyd. At page 2, you say, Sea-first's relationship with Penn Square began in early 1979. "At that time, we were advised Penn Square was using Continental Illinois and Chase Manhattan and as its principal upstream correspondents."

You say "we." Who are "we"? "At that time we were advised * * *"

Mr. BOYD. I was advised of that.

The CHAIRMAN. Is that the editorial "we"?

Mr. BOYD. I didn't mean it—an associate of mine, Y. C. Chao, we were together.

The CHAIRMAN. Who is Y. C. Chao?

Mr. BOYD. He is a vice president of Seattle-First National Bank.

The CHAIRMAN. He is still there?

Mr. BOYD. Yes, sir.

The CHAIRMAN. Y. C.?

Mr. BOYD. C-h-a-o.

The CHAIRMAN. Y. C. Chao. And his position at Seafirst?

Mr. BOYD. At that time he worked under me in the energy department.

The CHAIRMAN. And now he does what?

Mr. BOYD. I believe he is still in the energy department.

The CHAIRMAN. About the same level is he? Did Mr. Hatfield replace you in the energy department?

Mr. BOYD. Yes.

The CHAIRMAN. The man?

Mr. BOYD. No; he did not replace me. No.

The CHAIRMAN. Who replaced?

Mr. BOYD. He replaced me, yes, as manager of the energy department, and Mr. Chao is in the same position.

The CHAIRMAN. That he was in relation to Mr. Hatfield as he was in relation to you?

Mr. BOYD. I believe that is true, yes.

The CHAIRMAN. So let's start over again. The "we" refers to you and Mr. Chao?

Mr. BOYD. Yes.

The CHAIRMAN. How did Penn Square come to your attention and the fact that it had, that it was selling participations to Chase and Continental?

Mr. BOYD. Bill Patterson called Seattle-First some time in March or April 1979 inquiring about a letter of credit that the bank had issued in relationship to one of the loans that he was working with in Oklahoma. That particular technical question was straightened out and he asked the individual whom he was speaking to if Sea-first had an oil and gas department.

And they said, yes, they did. And I spoke with him on the phone. He introduced himself, told me what they were doing at Penn Square, and asked if he could come by and visit with us—which he did.

The CHAIRMAN. Go ahead.

Mr. BOYD. Which he did probably 30 days later. We visited and from the standpoint of what Penn Square was doing, what they were hoping to do and so forth, and I made a trip to Oklahoma probably in May 1979, or thereabouts.

The CHAIRMAN. You made the trip to Oklahoma at his invitation?

Mr. BOYD. It was mutual. He invited me to come and I accepted.

The CHAIRMAN. Who picked up the tab, the air fare?

Mr. BOYD. I paid my own, yes, sir.

The CHAIRMAN. Seattle-First paid it?

Mr. BOYD. Yes, sir.

The CHAIRMAN. Did Mr. Chao go with you?

Mr. BOYD. No, sir, I went by myself.

The CHAIRMAN. Did Mr. Patterson give you any references, any people that you should contact to verify the accuracy and the veracity of his statements to you about participations that Chase and Continental had with Penn Square?

Mr. BOYD. Yes, sir, he did. He gave us a Continental Illinois Bank person.

The CHAIRMAN. Anyone in particular at Continental Illinois?

Mr. BOYD. I cannot recall.

The CHAIRMAN. Could it have been John Lytle?

Mr. BOYD. No; I knew John Lytle.

The CHAIRMAN. You knew John Lytle from before?

Mr. BOYD. Yes, sir.

The CHAIRMAN. Did you at any point check out Penn Square with John Lytle?

Mr. BOYD. By our working together on a number of large credits from 19—mid-1981, I would say probably from February 1981 when we started to look at the larger credits that were offered by Penn Square, John Lytle and I had an opportunity to work together.

The CHAIRMAN. You knew already at this point in time you had become involved with Penn Square? You were already in the pool?

Mr. BOYD. Yes, sir.

The CHAIRMAN. Swimming away.

Did you talk to anyone at Chase about their participations?

Mr. BOYD. I don't recall, Mr. Chairman.

The CHAIRMAN. You do say in your statement, as did the gentleman who testified earlier, that "at the time we were advised Penn Square was using Continental and Chase Manhattan as its principal upstream correspondents?"

Mr. BOYD. Yes, sir.

The CHAIRMAN. You didn't follow up on that?

Mr. BOYD. I can't tell you for sure.

The CHAIRMAN. To the best of your recollection?

Mr. BOYD. To the best of my recollection, I did.

The CHAIRMAN. You said on page 3: "Further, we were aware that the Comptroller had regularly examined Penn Square, and we had no indication from the Office of the Comptroller or from Penn Square management of any problem."

Did you really expect the Comptroller, in view of the secrecy that prevails in all of these areas, would have informed you of any problems that Penn Square was having?

Mr. BOYD. No, sir, I made an assumption that if Penn Square credits were passed by the Comptroller in Seattle, and passed at Penn Square that those credits must be creditworthy.

The CHAIRMAN. You are a young man and I anticipate you would like to stay in the business in the future.

You might be informed of the fact that we have found the Comptroller's Office with one region doesn't talk to the Comptroller's Office in the other region, and you shouldn't in the future assume that they do that much conversationalizing. It is too bad, but that is the case.

Mr. BOYD. Unfortunately.

The CHAIRMAN. Next paragraph, "Several members of Penn Square's management advised me that the Comptroller's Office had commented favorably on additions to the bank's personnel, and improvements made in its systems."

That is a self-serving statement by people from Penn Square itself, correct?

Mr. BOYD. At the time I thought it was a statement of fact.

The CHAIRMAN. Now you realize it was self-serving?

Do you recall who the members of Penn Square's management team were that gave you that advice?

Mr. BOYD. Mr. Patterson, Mr. Beller, and Mr. Jennings.

The CHAIRMAN. Was that on a visitation that you made to Penn Square in Oklahoma City?

Mr. BOYD. Yes, sir, and also on the telephone.

The CHAIRMAN. Did you talk with Mr. Beller very frequently on the telephone?

Mr. BOYD. Probably five or six times.

The CHAIRMAN. With Mr. Beller?

Mr. BOYD. Yes, sir.

The CHAIRMAN. And the subject of the conversations, do you recall?

Mr. BOYD. General things, Mr. Chairman. No, I cannot recall.

The CHAIRMAN. You know those of us who were in Oklahoma City and spoke to Mr. Beller found out he wasn't allowed to be involved in energy loans?

Mr. BOYD. Well, I did not speak with him on energy loans.

The CHAIRMAN. Well, what did you discuss with him?

Mr. BOYD. I—

The CHAIRMAN. Did he go on the fishing trip?

Mr. BOYD. No, sir.

The CHAIRMAN. That was to invite him on the fishing trip?

Mr. BOYD. No, sir.

The CHAIRMAN. Can you tell us who went on the fishing trip?

Mr. BOYD. Yes, sir, Mr. Jennings, Mr. Patterson, just officers or directors.

The CHAIRMAN. Some of the big participants, Hefner, Swan?

Mr. BOYD. Mr. Hefner IV, went on the fishing trip; Mr. Swan.

I believe those were the only ones at Penn Square.

The CHAIRMAN. From your institution, who was along?

Mr. BOYD. Mr. William Jenkins, Mr. Gillis, Mr. Jay Langhurst, who is the vice president responsible for Oklahoma, Mr. David Jenkins, Mr. Al Eerkes, and Mr. Robert Schultz.

The CHAIRMAN. How about Mr. Nelson?

Mr. BOYD. No, sir, I went, of course.

The CHAIRMAN. Mr. Chao?

Mr. BOYD. He had responsibility for Texas. As a regional manager, Mr. Langhurst had responsibility for Oklahoma.

The CHAIRMAN. Mr. Jaehning said that they didn't become too involved with any of the Penn Square loans. I wonder how come he went on the fishing trip?

Mr. BOYD. Mr. Jaehning did not go on the fishing trip. Mr. Jenkins.

The CHAIRMAN. Oh, I am sorry.

I asked—who did you say went from Seattle?

Mr. BOYD. William M. Jenkins.

The CHAIRMAN. OK.

Let me ask you this, Mr. Boyd: Did you have total control? Were you the last word in purchasing participations from Penn Square, or did you report to anyone above you?

Mr. BOYD. Well, there were two types of participations which we purchased from Penn Square.

The larger credits which were above my \$10 million lending authority had to receive a previous approval before those credits, before we could book those credits.

The credits which were under \$10 million, I had the authority to commit and to make those commitments.

The CHAIRMAN. You went up to \$846 million from Penn Square?

Mr. BOYD. No, sir, we went into the \$350 million or in that area.

The CHAIRMAN. OK. In that \$350 million would you say the majority of the credits were above or under the \$10 million mark?

Mr. BOYD. The majority would be under.

The CHAIRMAN. So that indeed you indeed were—

Mr. BOYD. I had a substantial responsibility in regard to those credits.

The CHAIRMAN. So that, is it fair to assume that you had a substantial responsibility and you made the judgments and unfortunately unbeknownst to you Penn Square was not doing as well as people thought they were?

Mr. BOYD. Yes, sir, that is a fair assessment.

The CHAIRMAN. Were you, or when did you become aware, if you did, of the fact that on some of these participations that were nonperforming, that Penn Square was paying the interest on them to the upstream banks like Seattle and Chase and Continental?

Mr. BOYD. I wasn't aware of that until after the June situation.

I don't know whether I read it or was told or whatever the case may be.

The CHAIRMAN. How soon after the shutdown of Penn Square—you left in mid-July?

Mr. BOYD. Yes, sir, July 15.

The CHAIRMAN. Would you be aware whether or not on any of those loans that Penn Square, that were nonperforming where Penn Square was paying the interest, would you be aware of the fact that any of those were held by Seattle First?

Mr. BOYD. No, sir.

The CHAIRMAN. You did not have enough time between the shutting down and the time you left?

Mr. BOYD. No, sir.

The CHAIRMAN. Mr. Barnard?

Mr. BARNARD. Mr. Boyd, how long had you been with the Seattle First?

Mr. BOYD. Fourteen years.

Mr. BARNARD. What is your background in the bank? What had been your progress in the bank?

Mr. BOYD. I began as a trainee in September 1968 and in the trust department.

I was a portfolio manager and a security analyst receiving a designation of charter financial analyst and in 1975 I moved across from the trust department into corporate banking. I was elected a vice president, I believe, in 1975.

I worked in the corporate banking section, which was involved in the world banking area, and the U.S. department for 8 months, and in 1976 I began working in the South, what we call our South-west market, and went into, we specialized in energy in 1978, and worked in that capacity until the present.

Mr. BARNARD. With you as the senior vice president?

Mr. BOYD. Yes.

Mr. BARNARD. When were you promoted to that position?

Mr. BOYD. That would have been about 1981, I believe. The middle of 1981, in there.

Mr. BARNARD. Were you ever at any time for your own reasons concerned about the volume of loans being generated by Penn Square?

Mr. BOYD. That was definitely one of the things that I had my attention drawn to. I spent a great deal of time with Mr. Jennings going over the philosophy of the merchant banking concept. One of the things that he had always talked about in that situation is upstream; the key to success is an upstream correspondent must learn to respect and must have respect for the work that is done; and, therefore, the quality of their participations, the quality of their paperwork was the foundation upon which to move the bank further on.

Mr. BARNARD. Did you develop a confidence in their expertise to document loans?

Mr. BOYD. I believe that they were doing an adequate job at the time; yes. I won't say it too strong.

Mr. BARNARD. You had no problems with them then from the standpoint of insufficient documentation or collateral evaluation?

Mr. BOYD. We did have from time to time, and we would have to call them and have to spur them to give us information; yes.

Mr. BARNARD. Why would you tolerate a situation like that?

Mr. BOYD. Two things. One was the—what I thought was the competence of the people; and the second thing is they were an emerging organization.

Mr. BARNARD. You didn't think they were competent?

Mr. BOYD. The competence of their people.

Mr. BARNARD. But they couldn't document loans.

Mr. BOYD. I think their workload was heavy.

Mr. BARNARD. Too heavy?

Mr. BOYD. At times, yes, sir.

Mr. BARNARD. That wasn't a red flag, as far as you were concerned?

Mr. BOYD. It depends on when in the relationship. In 1979 and 1980, I don't believe it was a red flag. It was not a red flag. When they brought on 35 or 40 of the new people that were in the bank, I

believe when Mr. Patterson resigned, there was something like 80 people in the energy department.

Mr. BARNARD. He ran the department, though, didn't he?

Mr. BOYD. Yes, sir.

Mr. BARNARD. And what was your evaluation of his background as compared to yours in making oil and gas loans?

Mr. BOYD. I looked at Bill Patterson in the context of the people that worked for him, of the senior management in the bank, of the directors of the bank. I thought Bill functioned very well as a generator of business, and the people that he had working for them showed a great deal of independence and many of them were very skilled. So, from the standpoint of his background, I guess I looked at him as a business developer and as a manager of that area.

Mr. BARNARD. In appraising just general operations of Penn Square, did you think it was overconcentrated considering its size and its capital and the volume of business, as well as some of the arrangements it was making with its participating banks?

Mr. BOYD. In hindsight that is obviously true.

Mr. BARNARD. Isn't it a general rule in banking that concentration is something you have to be aware of?

Mr. BOYD. As a manager, yes, sir.

Mr. BARNARD. It seems like everybody, including Seattle First and Continental, Chase and others just absolutely were oblivious or did not consider the overconcentration. I just don't quite understand that.

I realize it was at a go-go period when you needed profits, but on the other hand didn't it violate every cardinal principle of good bank management as far as concentration was concerned?

Mr. BOYD. The only expression that I can say is that the merchant bank concept, as Mr. Jennings had proposed, I was—I thought was—a sound one, and that—

Mr. BARNARD. He was primarily nothing but a loan broker, right?

Mr. BOYD. I looked at it as much more than that.

We in our arrangement worked a number of this master participation agreement which I referenced earlier in my statement, which essentially I thought had in it the requirements that were necessary for them to fulfill the commitments that they had made to us.

The second thing is that we looked at the deep Anadarko Basin, and the activity that was involved in Oklahoma was not a price sensitive business, but a much longer economic development, which would allow the companies involved in it to receive adequate financial returns.

I did not look at it as speculation but rather as an orderly development of a large gas field in a very prolific area.

Mr. BARNARD. Did you find that the overlarge banks in that area, and also in the Texas area, were as involved in oil and gas leases as Penn Square was percentagewise?

Mr. BOYD. No; not percentagewise. They were involved. I can't comment on the extent of their activity. I don't know.

Mr. BARNARD. They were cautious of their concentration, though, weren't they?

Mr. BOYD. Yes, sir. One thing is because of their age.

Mr. BARNARD. How many of those loans were front-end loans where you actually went in at the very beginning as far as financing the equipment, and so forth, rather than based upon production?

Mr. BOYD. Most of our loans, I believe, in the early part of the relationship were equipment loans. So, therefore, you had equity by the borrower to buy a certain piece of equipment and you lent against that.

Mr. BARNARD. What ratio?

Mr. BOYD. About 70-percent debt, 30-percent equity.

As far as, and as we got into production financing, no, I would say the majority of the loans had proved producing reserves behind them.

Mr. BARNARD. Well, the real question is do you think that Seattle-First National was fair in removing you from their employment?

Mr. BOYD. Well, I was the person that initiated this relationship. I was the person that was primarily responsible for it. I represented to management that I had given due diligence, that I had known the people, and so forth.

Of course, it was a large concentration within our banking corporation, particularly larger credits when you make a serious commercial mistake, then yes, it is normally expected that you will resign.

Fair, I don't know about it. But in any event, this is what happened.

Mr. BARNARD. One of the gentlemen that testified here today said he was a scapegoat for his particular organization. Do you feel that you were the scapegoat of Seattle-First National?

Do you think that others would be responsible?

Mr. BOYD. I take the primary responsibility for this situation. I don't think I have the sole responsibility. I don't think you are saying that, but it is a hard situation to face, no question about it, because from the amount of work and the diligence that I tried to put into the situation and to have it arrive at this conclusion is—

Mr. BARNARD. I am not familiar with all the relationships with Penn Square, but did you make any loans to officers or directors of Penn Square?

Mr. BOYD. Yes, sir.

Mr. BARNARD. Did they, in turn, make any loans to officers and directors of Seattle-First?

Mr. BOYD. Yes, sir, and I was the recipient of that loan. I had a \$10,000 car loan there, which was made in April 1980.

I pay \$234 a month, I believe, at 14-percent rate. It was \$10,000. I pay \$234.31 a month.

Mr. BARNARD. It must be about a 6- or 7-year loan?

Mr. BOYD. Four-year loan.

Mr. BARNARD. There is nothing in the bylaws or policies or practices of Seattle-First that would not condone loans of this kind with correspondents?

Mr. BOYD. I can't comment on that. Not so far as I know, Mr. Barnard.

Mr. BARNARD. It has been suggested today that some banks have, I think they call it a code of ethics, or something of that kind, which probably would have frowned upon this type of relationship.

Your bank, of course, did not have that, I presume?

Mr. BOYD. We do have a code of conduct, and we, as officers, are required to sign it on an annual basis.

Mr. BARNARD. What was your rate of interest on this loan?

Mr. BOYD. Fourteen percent.

Mr. BARNARD. That was 7-percent add-on?

Mr. BOYD. How do you mean, sir?

Mr. BARNARD. OK; 14-percent APR; was that a preferential rate?

Mr. BOYD. No, sir.

In my own bank I could have gotten an employee loan that was equal to or better than what I had at Penn Square.

Mr. BARNARD. Why did you go to Penn Square?

Mr. BOYD. It was totally a convenient thing. I was in Seattle and was leaving on an airplane, and Bill Patterson was there, and I said, "Well, I have got to leave because I have to fill out my situation downstairs," and he said, "No, I will be glad to do it for you," and did it and set it up on the basis that I explained to you.

Mr. BARNARD. Was this before he had made a loan with you?

Mr. BOYD. Well, yes, this was made in April 1980, April 7.

Mr. BARNARD. Did you subsequently loan him money?

Mr. BOYD. Yes, sir, I did.

Mr. BARNARD. What kind of loan was that?

Mr. BOYD. I will be pleased to share it with you. My problem is that—

Mr. BARNARD. Confidentiality.

Mr. BOYD. Yes, sir.

Mr. BARNARD. I have no further questions, Mr. Chairman.

The CHAIRMAN. Mr. Barnard, the loan was to Mr. Bill Patterson. Mr. Patterson reported to the board of directors of Penn Square Bank; the date of the report was December 10, 1981. He reported to the board of directors of Penn Square that he had borrowed \$1,400,000, \$1,200,000, now to purchase First Penn Corp. stock, and he borrowed that from Seattle-First National Bank, and the collateral pledged to secure the credit—another handshake deal—none.

Mr. BARNARD. Did you make that loan to him?

Mr. BOYD. Yes, sir, I did.

The CHAIRMAN. Just a handshake; no collateral?

Mr. BOYD. It was an unsecured loan substantiated by a balance sheet; yes, sir.

The CHAIRMAN. Rather substantial, wasn't it, \$1,400,000 on just a signature?

Mr. BOYD. Mr. Chairman, in a secured or unsecured situation, the balance sheet and the income-producing characteristics of the borrower are enough, but it is a rather substantial loan unsecured.

The CHAIRMAN. Of course it is.

Mr. Lowery.

Mr. LOWERY. Thank You, Mr. Chairman.

Mr. Boyd, thank you for staying to this hour.

In addition to the \$10,000 consumer loan which I consider well within the parameters of guidance laws and so on, were there

other loans to officers, personal loans to officers of Seattle from Penn Square?

Mr. BOYD. Not to my knowledge.

Mr. LOWERY. Thank you.

As I understand it most of the loans from banks to their own directors, \$10,000 consumer loans, \$20,000 education loans, mortgage loans are not beyond that.

What is the total participation in loans of Seattle First and Penn Square acquired loans?

Total amount of money?

Mr. BOYD. \$400 million is what the bank has reported.

Mr. LOWERY. Of that \$400 million, how much was acquired after July 1981?

Mr. BOYD. Sir?

Mr. LOWERY. I used July 1981 because in previous testimony today we had people state that at that time the banking examiners of Penn Square had stated considerable concern about the situation, the loans at Penn Square.

Mr. BOYD. That date I don't have, Mr Lowery, but I would say probably half of the loans were funded, more than half, from July 1981 to February or March 1982.

Mr. LOWERY. So more than half, at least \$200 million?

Mr. BOYD. Yes, sir.

Mr. LOWERY. I am interested—and this question was asked previously—in understanding the existing and necessary confidentiality requirements, not being exactly sure what the law says on that, I am endeavoring to find out what the law says on that, if there is a procedure or if it would be advisable for information that was available to bank examiners in Oklahoma, available to bank examiners in Seattle or in Chicago. If so, should those examiners have been using that information when they looked at the loan portfolio within their examination of Seattle First National Bank?

I think this is one of the main areas this committee really wants to look at to see if there are some improvements that can be made either through oversight or legislation.

What would your opinion be, if that would be important, if that would have been important in this case, and if as a banker that would be desirable?

Mr. BOYD. My opinion is that if the Dallas office of the Comptroller's Office had notified the Seattle office of the Comptroller's Office, to just make a visitation and only look at the Penn Square Bank loans, there would be no need to communicate any information. Their very presence of examining loans and asking questions on a certain segment of loans would alert, I believe, the management or at the very least, the lending officer's attention to not only was the documentation probably not as it should be, you would go back to the source, to that originating bank.

This does not help the many people that are affected, of course, on the deposit side of Penn Square Bank.

This would only be speaking to the loan participations, but hindsight is perfect, if we had had that information, or whenever we got the information, we would not have continued on the pattern of involvement with Penn Square that we did.

Mr. LOWERY. This is not to say that Seattle First or Continental should have picked this up as their own procedures, but we all know that they should have done so.

Mr. BOYD. Yes, sir, that is correct. You can never be too diligent. I know about that.

Mr. LOWERY. I am glad you mentioned the depositors.

This is not directly related to this hearing, but I think it emphasizes the point that it is important that the citizens of this country understand those depositors were covered by FDIC and they have received \$253 million in deposits, and deposits have been taken care of by FDIC in Penn Square. I only mention that because of the importance of the confidence within the banking system that the consumers and depositors in this nation must have.

Among other things, it proves that the FDIC, the bank protection of depositors, does work; but we are, of course, very concerned about the financial viability of institutions. That is also very important to the public, because we know what the results of the lack of that confidence would be. What I am interested in, and I know the chairman and other members of the committee share the interest from their questions, is looking at additional procedures or additional oversight by this committee to calm the fears of the public.

I thank you.

Mr. BOYD. Yes, sir.

Mr. LOWERY. Thank you, Mr. Chairman.

The CHAIRMAN. A few more questions, Mr. Boyd.

You mentioned in answer to a question by Mr. Barnard that you looked at the competence of the people at Penn Square.

Tell us about the people that you felt were competent in Penn Square. Who were they?

Mr. BOYD. I thought their engineering department was particularly skillful, Mr. Gilbert and his associate who were very knowledgeable petroleum reserve engineers.

Mr. Gordon Spears who is the vice president. Our engineer who has 30 years in evaluating the economic prospects for a large petroleum company came with the bank, and he went and made a personal review and interviewed these people.

I had worked with them but he came away saying that they had one of the finest engineering departments and systems that he had seen anywhere.

The general level of people that Mr. Patterson had working for him directly, and you asked for specific names.

The CHAIRMAN. Yes, and their functions.

Mr. BOYD. May I refer to the annual report of Penn Square Bank?

The CHAIRMAN. Of course.

Mr. BOYD. In general, Mr. Chairman, most of the people that were in Penn Square Bank had had previous banking experience, I would say in some of the finest financial institutions in the country, and they were proven as experienced lenders.

When you start in 1979, it is very small. There were less than 10 or 12 people. You can see the gradual additions of competent and capable people being added to that staff.

The CHAIRMAN. If they are all so competent and capable, what happened?

Mr. BOYD. I don't have the facts. It is very difficult. I have given a great deal of thought to this. I don't know the answer, sir.

The CHAIRMAN. If you had an engineer, Gordon Spears?

Mr. BOYD. Gordon Spears.

The CHAIRMAN. That worked at Seattle once and he was brought on board when?

Mr. BOYD. Brought on board in February 1982.

The CHAIRMAN. February 1982?

Mr. BOYD. Yes, sir.

The CHAIRMAN. Prior to that did you have an engineer?

Mr. BOYD. No, we did not.

The CHAIRMAN. But you stopped making loans in February 1982 except for commitments that had been made, purchasing participations, I mean?

Mr. BOYD. Yes, but most of our loans were not production loans, most of our loans were equipment loans.

The CHAIRMAN. My point is this, sir, equipment loans are for equipment to produce, right?

Mr. BOYD. Yes, sir.

The CHAIRMAN. And the collateral that you were getting or looking at, was it just equipment or was it also the reserves?

Mr. BOYD. No, we had some reserve loans in our portfolio. I see that I was not clear is what I am trying to correct here.

The CHAIRMAN. I tell you what is not clear to me, you gave us a nice dissertation on Mr. Gordon Spears' evaluating the Energy Department or the technical personnel at Penn Square. That man didn't come on board until February 1982.

We were told that you were told in January and February 1982, hey, we have got too much participation with Penn Square. Cease and desist. Is that not the way it happened?

Mr. BOYD. Yes, sir.

The CHAIRMAN. So who evaluated the engineering department at Penn Square prior to February 1982?

Mr. BOYD. It was not evaluated in a technical sense, sir. In the judgment—what made us feel so comfortable was when Mr. Spears completed his examination we assumed—

The CHAIRMAN. Your Monday morning quarterbacking, man.

Mr. BOYD. To the extent of the system.

The CHAIRMAN. Let's go back.

Mr. BOYD. OK.

The CHAIRMAN. You have decided in 1980—when did you start participations?

Mr. BOYD. In 1979.

The CHAIRMAN. 1979. Who evaluated the engineering department of Penn Square in 1979?

Mr. BOYD. There was not one at that time.

The CHAIRMAN. When was an evaluation made and when was the engineering department at Penn Square coming into existence?

Mr. BOYD. In 1980.

The CHAIRMAN. Who evaluated it for you in 1980?

Mr. BOYD. No one.

The CHAIRMAN. Who evaluated it for you in 1981?

Mr. BOYD. No one.

But my point is, Mr. Chairman, that we had a number of production payment financings that we had taken as participations. Mr. Spears went down and verified those systems and verified the way in which they conducted their engineering.

I made the assumption that they had conducted their engineering previous to that review subject to the systems that he was shown.

The CHAIRMAN. Sir, you purchased the participations prior to Mr. Gordon Spears coming on the scene?

Mr. BOYD. Yes, sir.

The CHAIRMAN. And making his evaluation. That means that you had no evaluation prior to that time when you were purchasing the participations.

Mr. BOYD. That is right.

The CHAIRMAN. Is that not correct?

Mr. BOYD. Yes, sir; that is correct.

The CHAIRMAN. All right.

So to say they had a competent engineering department, you didn't know that while you were buying all the participation, you didn't find that out until after you stopped purchasing.

Mr. BOYD. That is correct.

The CHAIRMAN. Whom did you have as technical personnel within your energy department at Seattle First prior to February 1982 at which time Mr. Gordon Spears came on the scene?

Mr. BOYD. We had no one.

The CHAIRMAN. It was you and Mr. Chao?

Mr. BOYD. At that time of February 1982, there were—

The CHAIRMAN. Prior to 1982, February 1982, 1979, 1980, 1981.

Mr. BOYD. We had no technical people on our staff at that time.

The CHAIRMAN. I got bedazzled by your former officers here, excuse me, not you, they did it. They said they had an energy man, they didn't have an engineer until after they stopped, told you to stop purchasing participations.

Mr. BOYD. But we had consultants from the outside that reviewed our production but they did not review Penn Square's energy department.

The CHAIRMAN. Correct. I don't doubt that. We understand that.

Mr. BOYD. Yes, sir.

The CHAIRMAN. That is clear on the record.

Now, you told me about these competent people. Are these in people Mr. Eldon Beller brought in?

Mr. BOYD. Many of them were, came into the energy—came directly into the energy division—

The CHAIRMAN. When Mr. Eldon Beller was made president?

Mr. BOYD. Yes.

The CHAIRMAN. That wasn't until 1981 or August 1981, I believe.

Mr. BOYD. 1981, yes, sir.

The CHAIRMAN. Prior to that, what kind of competent people did Bill Patterson have and who were they?

Mr. BOYD. I am sorry, Mr. Chairman, I cannot—the names escape me.

The CHAIRMAN. I would imagine so. I think the whole kit and caboodle was Patterson and Jennings.

Now, on the fishing trip.

Mr. BOYD. Yes, sir.

The CHAIRMAN. What was the purpose of the fishing trip?

Mr. BOYD. The purpose of the fishing trip was to introduce the senior management of Penn Square Bank and a number of our customers which we had met through Penn Square to the senior management of our bank.

The CHAIRMAN. Customers of—

Mr. BOYD. The Penn Square that we had participations in.

The CHAIRMAN. Were they from the Oklahoma area?

Mr. BOYD. Yes.

The CHAIRMAN. Mr. Hefner.

Mr. BOYD. The Fourth, yes, sir.

The CHAIRMAN. Who else?

Mr. BOYD. Mr. Swan.

The CHAIRMAN. Mr. Swan. He is on the board at Penn Square. Both a board member and a borrower and a customer of yours as a result of your having met Bill Patterson.

Mr. BOYD. Yes, sir. Mr. Allen.

The CHAIRMAN. Mr. Allen, all right.

Mr. BOYD. Mr. Gray, Gary Gray.

The CHAIRMAN. Is he a customer?

Mr. BOYD. Customer of Sea-First.

The CHAIRMAN. And Penn Square, and is he from—which area is he from? Oklahoma?

Mr. BOYD. Oklahoma City, yes. These were all Oklahoma people.

The CHAIRMAN. All right. These were customers?

Mr. BOYD. Yes, sir.

The CHAIRMAN. And you were buying participations from these customers actually, that is what they were as customers, right?

Mr. BOYD. Buying participations—we were introduced to—

The CHAIRMAN. From Penn Square?

Mr. BOYD. Yes, sir.

The CHAIRMAN. All right.

Mr. BOYD. OK.

The CHAIRMAN. What was the date of the fishing trip?

Mr. BOYD. In early June.

The CHAIRMAN. 1982.

Mr. BOYD. June 10, 11, or 12.

The CHAIRMAN. At that time you had already been told by your management at Seattle-First to cease and desist further purchases of participations. In other words, cool it.

Mr. BOYD. Yes, sir.

The CHAIRMAN. Did you disobey those instructions?

Mr. BOYD. I tried not to. The fishing trip was established in February 1982 that we were going to have it in early June so the actual trip took place during this time period. I should say the trip actually took place in the early part of June, but we had made the invitation in February or March, in that area.

I still felt because of the size of the participations and the relationship that we had with Penn Square Bank, that it was important that our management have an opportunity to visit with them on a firsthand basis.

The CHAIRMAN. Usually when you are trying to—when you want to romance a customer you romance the customer because you want to have more business with that customer.

Mr. BOYD. Yes, sir.

The CHAIRMAN. Once you have decided you don't want more business with that customer, isn't it a waste of money, time and effort to romance the customer?

Mr. BOYD. Well, we wanted to maintain the position that we had with those individuals and to allow our senior management to visit with them.

The CHAIRMAN. It was mentioned to us that these chaps would know because of their involvement with Penn Square, that Penn Square was having problems. On that fishing trip was there any discussion of the problems that Penn Square was facing?

Mr. BOYD. No, sir.

The CHAIRMAN. None whatsoever?

Mr. BOYD. No, sir.

The CHAIRMAN. All right.

Mr. BOYD. To my knowledge, no. No, sir.

The CHAIRMAN. So how long was the fishing trip?

Mr. BOYD. We had a dinner in Seattle, Wash., on Thursday night and we left Friday morning for British Columbia.

The CHAIRMAN. By plane.

Mr. BOYD. Yes, sir, by seaplane.

The CHAIRMAN. Was it one plane?

Mr. BOYD. No, it was several planes.

The CHAIRMAN. Several planes.

Mr. BOYD. Yes, sir. And landed at Big Bay and the planes left approximately 10 o'clock the following Sunday morning.

The CHAIRMAN. So you were there how many days?

Mr. BOYD. It would have been Friday morning to Sunday morning, 2 days.

The CHAIRMAN. Did you stay in the same facility?

Mr. BOYD. No, sir. There were cabins that were—

The CHAIRMAN. But everybody didn't do their own cooking?

Mr. BOYD. No, no, the lodge—

The CHAIRMAN. You had a lodge where you could cook the meals, and so on?

Mr. BOYD. Yes, sir.

The CHAIRMAN. A little conversation?

Mr. BOYD. Yes, sir.

The CHAIRMAN. No TV up there, was there?

Mr. BOYD. No, sir.

The CHAIRMAN. No radio?

Mr. BOYD. No—well, yes, there was radio.

The CHAIRMAN. So you did a lot of talking?

Mr. BOYD. Yes.

The CHAIRMAN. And at no time during that conversation did Mr. Swan, Mr. Patterson, Mr. Jennings, Mr. Hefner, mention the fact that Penn Square needed some capital, additional capital?

Mr. BOYD. No, sir. The conversation was general about the United States, about inflation, about unemployment, what was going on in Oklahoma.

It was a very general and convivial—

The CHAIRMAN. What was it that was going on in Oklahoma that was discussed?

Mr. BOYD. The level of drilling, what the results were from some Anadarko wells. It was general energy and general economic discussions and held in small groups.

The CHAIRMAN. That was it?

Mr. BOYD. Yes, sir.

The CHAIRMAN. Did you get to be friendly with any of the officers at Penn Square during your relationship in purchasing participations from Penn Square?

Mr. BOYD. Yes, I knew Mr. Patterson very well, I knew Mr. Jennings fairly well.

The CHAIRMAN. Were your principal contacts with those two?

Mr. BOYD. On a day-to-day basis, probably more with Bill Patterson and then his staff.

The CHAIRMAN. Did you take any trips with Mr. Patterson? Any vacation trips, sojourns?

Mr. BOYD. No, sir, well, the fishing trip.

The CHAIRMAN. Other than the fishing trip?

Mr. BOYD. No, I never traveled with him.

The CHAIRMAN. When in Oklahoma City, did you ever go out and have dinner with him after a long hard day's work?

Mr. BOYD. I probably had dinner with Mr. Patterson in Oklahoma twice in the 3 years that I knew him.

The CHAIRMAN. Did he ever take you out to the Cowboy Club?

Mr. BOYD. Not that I recall.

The CHAIRMAN. You did not see the performance?

Mr. BOYD. No, sir.

The CHAIRMAN. Did he ever perform for you? You were here earlier when we discussed some of his performances.

Mr. BOYD. Yes, sir, I read—

The CHAIRMAN. Chicken legs and all.

Mr. BOYD. I never saw that. I read the Fortune article, yes.

The CHAIRMAN. Did he ever demonstrate to you his capacity, wooden leg? Hollow leg?

Mr. BOYD. Yes, we have had a drink together, yes, sir.

The CHAIRMAN. And how about in Seattle?

Mr. BOYD. Normally we would eat dinner in the bank dining room or at a local restaurant.

The CHAIRMAN. Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman. I have no questions at this time, thank you.

The CHAIRMAN. Mr. Boyd, we want to express our deep appreciation to you for bearing with us. It has been a long day but I hope you will understand that some of it was beyond our control, that we had no alternative on.

Frankly, I will be honest with you, it is 8:15, is that what it is? Yes. I would like to have allowed you to have left earlier, but by the same token, we did not want to inconvenience you by having to wait another day.

We wanted to get the witnesses in today that we scheduled for today. So we thank you.

Incidentally, I want to express my personal appreciation to you for your assistance, your cooperation with the staff throughout and your presence here. I would just say I wish you well.

Mr. BOYD. Thank you, sir.

The CHAIRMAN. The committee will now recess until tomorrow morning at what, 6:30?

We will recess to 9:30, and we will have William Goldsmith, and Mr. Mario Renda as our leadoff witnesses.

I Thank Mr. Patman, Mr. Lowery, and Mr. Leach, for joining us.

[Whereupon, at 8:17 p.m., the committee was adjourned, to reconvene at 9:30 a.m., Thursday, September 30, 1982.]

1981
Annual Report
and Form 10-K



Continental
Illinois
Corporation
Continental
Illinois
National Bank
and Trust
Company of
Chicago

*The combined
diversity of
Continental's
people—
Building on
basic strengths
for 125 years*

About the Cover

From Le Touquet, France, and Fairmont, Minnesota, senior vice presidents Jean-Louis F. L. Recoussine (left) and Garry J. Scheuring came by different paths to help typify the combined diversity of Continental's people on this year's Report cover.

At work "behind that quiet facade," Recoussine oversees international activities in Europe from London. Scheuring is responsible for multinational relationships worldwide from offices in Chicago and Toronto.

Together, they signify a basic strength that daily amplifies the others featured in recent years' cover photos of ironworkers at work on the new Continental Illinois Center offices now nearing completion in New York and of longtime stockholder Rell Small, who bought his shares a few weeks after the crash in 1929.

That was years before Recoussine and Scheuring and many others began gathering education and experience, to join Continental and become part of an organization that unites and integrates an increasingly diverse staff worldwide—to make the coming years outshine the 125 we celebrate in this one, building on basic strengths.

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Performance in Review

Some key measures of Continental's performance in 1981, as well as a perspective on the Corporation's growth over the past five years, are presented in the charts and graphs on this and the following page. This section prefaces the more detailed financial discussion and statements beginning on page 16 of this combined Annual Report and Form 10-K.

A Review of 1981

Income before security transactions was \$260.3 million in 1981, a gain of \$36.2 million or 16.1 per cent from 1980. Strong advances in both net interest and non-interest income contributed to the increase. These gains were partly offset by a moderate 11.7 per cent increase in non-interest expenses, reflecting the continuing, selective investment for growth in Continental's businesses, and by a \$24 million larger provision for credit losses in line with general business conditions and a growing loan portfolio.

The year's results were achieved in the face of market volatility, slowing economic growth, and changing regulation—and reflect more than one year's success. They also reflect basic market strengths built over decades, and translate into a five-year compound average annual earnings growth rate of more than 15 per cent, one of the best among major money-center banks.

Year-to-Year Comparisons

Net interest income continued to be the major source of revenue in 1981, but declined as a percentage of total revenues due to a 32.3 per cent increase in other operating income. A 12.4 per cent increase in average earning assets added \$101.9 million to net interest income, while

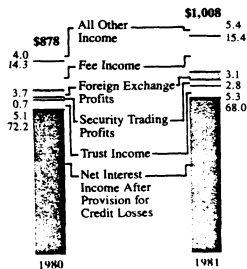
a nine-basis-point narrower margin reduced the figure by \$29.3 million. Security trading profits reached a record \$27.9 million, despite exceptionally adverse market conditions. Both domestic and foreign fee income increased, while foreign exchange results were strong, but declined overall due to translation losses.

Non-interest expense amounted to 61.8 per cent of net interest and other operating revenues in 1981, compared with 63.5 per cent in 1980. Staff expense, which includes salaries, wages, and benefits, and is the largest category of operating expense, increased as a percentage of total non-interest expense from 51 per cent in 1980 to 54 per cent.

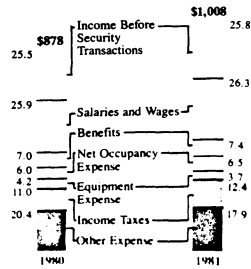
Five-Year Comparisons

Over the past five years, income before security transactions has grown by 76.8 per cent to \$6.58 per share, exceeding the five-year inflation rate of 59.7 per cent, as measured by the Consumer Price Index (CPI). Cash dividends per share have increased 61 per cent to \$1.90, which also exceeds the CPI rate of inflation. The relationship of dividend pay-outs to income before security transactions has been maintained in the 30 per cent range in each of the past five years, and was 28.88 per cent in 1981. In other words, 29 cents of every dollar of 1981 earnings were returned to stockholders, while 71 cents were reinvested in the Corporation. Stockholders' equity grew to more than \$1.7 billion in 1981, and has grown by more than 87 per cent over the last five years. Return on stockholders' equity improved to 16.1 per cent, from the 15 per cent range achieved in each of the previous five years, while return on total assets was 0.59 per cent, equaling the five-year average.

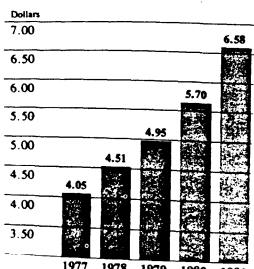
Sources of Net Interest and Other Operating Income



Distribution of Net Interest and Other Operating Income



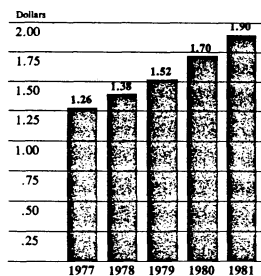
Per-Share Income Before Security Transactions



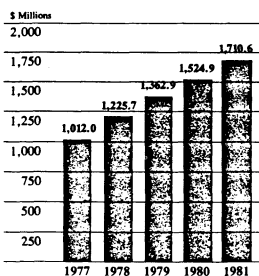
Financial Highlights

	1981	1980	Per cent change
Operating Results (\$ in thousands)			
Net interest income (taxable equivalent basis)	\$ 910,406	\$ 837,874	8.6%
Income before security transactions	260,315	224,143	16.1
Net income	254,623	225,941	12.7
Return on equity	16.10%	15.53%	—
Return on total assets	0.59%	0.56%	—
Per-Share Data			
Income before security transactions	\$ 6.58	\$ 5.70	15.4%
Net income	6.44	5.75	12.0
Dividends declared	1.90	1.70	11.7
Book value—December 31	43.19	38.76	11.4
Closing price—December 31	33¼	31¼	6.0
Price-earnings ratio—December 31	5.0x	5.5x	(9.0)
Year-End Totals (\$ in thousands)			
Assets	\$46,971,755	\$42,089,408	11.5%
Deposits	29,594,005	27,313,667	8.3
Loans and lease receivables	33,299,226	27,629,701	20.5
Reserve for credit losses	289,169	246,413	17.3
Stockholders' equity	1,710,692	1,524,942	12.1
Average common shares outstanding	39,537,500	39,256,231	—
Number of common stockholders of record at year-end	17,094	18,428	—
Number of employees at year-end	12,713	12,257	—

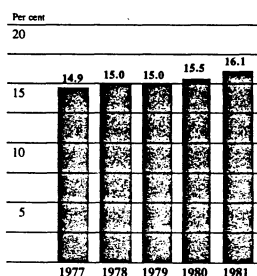
Dividends Declared Per Share



Stockholders' Equity at Year-End



Return on Average Stockholders' Equity



To the Stockholders

It is a pleasure to report another record year, although high and erratic interest rates made 1981 a trying time for the banking industry and our customers. Results advanced in line with our planned objectives and long-term strategy.

The 16.1 per cent gain in income before security transactions (to \$260.3 million or \$6.58 a share) provided another encouraging mark of consistently strong performance, in a year of uneven and often adverse business conditions. Major factors in the gain were increased interest income and other operating income, coupled with continued close attention to credit quality and expense control.

Both the 16.1 per cent gain in income before security transactions and the 12.7 per cent gain in net income (to \$6.44 a share) exceeded the rate of inflation, which declined by a commonly accepted measure from 12.4 per cent to 8.9 per cent during the year. Reduced inflation was 1981's best economic news and, with further progress on that front, can be good news for years to come. Despite the doubts and difficulties which accompany efforts to curb inflation and have cut short previous attempts, the Federal Reserve and the Reagan Administration seem prepared to stick with the priority they have given this one. In that case, persistence will prevail, where previous efforts have fallen short and failed. Present inflationary pressures are part of the price of previous short-lived efforts, and this one presents basic correctives.

High Interest Rates No Boon to Banks

Though it may be news to any who still harbor the notion that high or rising interest rates are a boon to the banks, bank earnings gains generally took an opposite path from interest rates throughout the year, rising as rates fell in the first and fourth quarters but declining when rates rose in between.

The notion that banks thrive on high rates rarely held true for the money centers, and was still less so in 1981. Strong fourth-quarter gains gave earnings a year-end glow, but came on the heels of nine successive prime rate decreases, three of them led by Continental.

Some spectacular gains in a few major banks' fourth-quarter earnings made headlines, but generally reflected special conditions. Some were turnaround situations and several were aided by unusually high bond-trading profits. Others showed sharp declines. For all eight of the other major money-center bank holding companies with which we compare our performance, the combined gain in income before security transactions was less than 2.7 per cent for the year as a whole. Including our 16.1 per cent, the overall gain for the group was a little better, but still less than 3.8 per cent.

Progress in Important Performance Measures

Against this background, continued progress in other important performance measures was even more encouraging than continuing more than 20 years of steady annual earnings gains.

The return on average stockholders' equity increased to 16.1 per cent from 15.5 per cent in 1980, the previous high. The return on average total assets increased to 0.59 per cent, compared with 0.56 per cent in 1980. Both of these gains brought us closer to new long-term goals we have set in these important measures.

The dividend was increased by 11.1 per cent, to a new annual rate of \$2.00 a share, extending our record of annual increases to 13 years. Stockholders' equity also was increased by an additional 12.1 per cent, with \$179 million of retained earnings increasing the year-end total equity to more than \$1.7 billion, as we continued to build our capital base for further growth and future gains.

Emphasis on Resource Allocation

Continued emphasis on allocating greater resources to business areas with greater long-term potential, combined with careful management of expenses in every area throughout the organization, helped contain other operating expense. This grew by 11.7 per cent, well below the 20.1 per cent growth rate of 1980.

The basic corporate strengths and market developments behind that outstanding performance are dealt with in the body of this Annual Report, including our Report on Form 10-K. Two fundamental elements reflected throughout the additional data and discussion contained in this Report, however, deserve fuller treatment here. Those two fundamentals are people and planning. The integration and interaction of these two fundamentals in large part account for our exceptional record of steady earnings gains in each of the past 20 years, and particularly in the past decade. These are also fundamental strengths that can lead to further progress and higher goals in years to come.

Key Strategic Targets Raised

Our basic goal has been and continues to be increasing the value of the stockholders' investment. In the decade from 1970 to 1980, our annual return to investors averaged 10.5 per cent, the highest among major money-center bank holding companies.

As a concrete step toward further enhancing the attractiveness of our stock as an investment, long-range targets for two key performance measures were raised in 1981, and new higher goals were set, to be achieved over the strategic planning horizon. The return on equity goal was raised to 18 per cent, from 15 per cent over the past several years. Our target for return on total assets was raised to 0.65 per cent, or six basis points above our average return during the last five years.

Both of these higher goals are long-range strategic objectives, attainable only through sustained effort over a period of time. Both goals are now being incorporated into our planning, budgeting, and resource allocation processes, however, and we are already moving closer to both, as noted earlier in the 1981 results.

How soon we will achieve these goals, of course, depends in part on factors we cannot foresee. Fundamental problems in the U.S. economy have yet to be worked out and have indeed been heightened in recent years by rising political, social, and economic pressures around the world. At the same time, trends toward deregulation, increased competition, and consolidation in the financial services industry continue to mount.

These are subjects of continuing attention and concern. We recognize that our performance may be influenced in the short term by broad environmental forces, but we believe that it will ultimately continue to be determined by our own strategies and efforts. Success will depend on our ability to anticipate and assess those forces, and pilot our own course with skill and insight—in other words, on first-class people and effective planning.

Matching Strengths to Market Demands

The markets of 1981 were highly volatile, as interest rates reacted to inflation, changing expectations, and the sweeping tax, spending, and social programs introduced by the Reagan Administration to strengthen national security and deal with underlying structural problems in the U.S. economy.

The Federal Reserve Board attempted to exercise restraint on growth of the money supply over the course of the year. Although results from this difficult task were not constantly evident from week to week, and markets reacted nervously, and the Fed's role was not always appreciated, its policies helped produce a significant and long-sought decline in the rate of inflation.

Unsettled market conditions put a premium on such basic strengths as balance sheet management. Having long relied more heavily than most banks on market-priced funds rather than on fixed-rate consumer deposits, we had long since developed the broad experience and made the adjustments that others had to make when consumer deposits began to dwindle and become more costly. Combined with an organization-wide emphasis on pricing all services productively and appropriately, our funding capabilities helped advance our position in highly competitive corporate financial markets worldwide. Our interest rate sensitivity structure was carefully managed, with much of our loan growth in floating rate credits that could be favorably funded as market rates changed.

Emphasis on Credit Quality

As the economic downturn and prolonged high interest rates placed even some strong businesses in a weakened condition, cash-basis and renegotiated credits made up 1.9 per cent of the portfolio at year-end, compared with 1.6 per cent in 1980 and 1.9 per cent in 1979. Our long-standing emphasis on credit quality has become increasingly important, as high interest expense and low sales volume present unusual pressures in several industries, and appear

likely to be reflected in continued credit problems until conditions improve.

The specific mechanisms for monitoring and maintaining the quality of the lending portfolio are discussed on page 21. Considering the kinds of apprehensions that sometimes arise in times like these, however, at least two points deserve mention here.

One is that our position as a leading wholesale lender is the direct result of a commitment to meeting the legitimate credit needs of customers throughout the business cycle. The relationships and specialized industry and customer knowledge built up in that process are extremely valuable. Our credit losses during significant cyclical downturns over the past several years have compared favorably with those of other major money-center bank holding companies.

Another basic strength is our consistent earnings growth over many years. Our strong earnings stream creates a bulwark against the kind of business conditions that developed in 1981 and seem likely to continue into 1982, as we continue to serve and build our business base.

Developmental Factors

In addition to maintaining a leading position in traditional corporate lending markets, we also are well-positioned to take advantage of the growing business need for more comprehensive financial strategies.

Through the process of systematic resource allocation, we have been steadily building organizational and technological capabilities in corporate and commercial finance, leasing, cash management, investment banking, and mergers and acquisitions consulting over the past several years. In all of these areas, our people have earned a reputation for excellence. As these and related businesses continue to grow and develop, they should continue to play an increasingly important role in advancing our successful corporate banking effort, further augmenting our other major strengths in more traditional banking areas.

Regulatory Change Brings New Opportunities

At the same time that uncertain economic conditions are testing the strengths and resourcefulness of financial institutions, the dynamics of the nation's financial marketplace are also changing, and opening new opportunities. The past year brought some notable legislative and regulatory breakthroughs, and some equally notable disappointments.

Perhaps the most notable progress came in our headquarters state of Illinois, which has long lagged behind other states in banking law. Passage of landmark multi-bank holding company legislation allowed bank holding companies to acquire established banks in their headquarters region and one adjacent region among five regions of the state.

Two other bills passed by the Illinois legislature eliminated consumer credit usury ceilings and paved the way for specialized International Banking Facilities now in

place in the state, under changes in Federal Reserve regulations.

Progress on the Federal level was less evident and somewhat disappointing. While the magnitude and pace of evolutionary change transforming the financial services industry continue to mount, with non-regulated institutions further increasing their market share, generally unproductive debate continued over three key issues. One was interstate banking, which is already here in some respects for banks such as ours, and in other respects for all sorts of business concerns except banks. Another was the Glass-Steagall Act, which maintains an overdrawn distinction between commercial and investment banking in certain key areas of interest to us. The third was Regulation Q, which attempts to hold down the rates that banks and thrift institutions may pay on consumer deposits—an increasingly futile restriction that simply diverts deposits to other takers.

The ultimate broad outcome of all three issues seems fairly certain, for the financial markets have long since passed by Congress and the regulators. Corporate banking for years has been conducted on a national scale. Our business long ago progressed from basic lending to the development of comprehensive financial services and strategies. The resounding growth of money market funds has made government rate-setting on consumer savings largely moot. What remains is for the legislators and regulators—and perhaps more important at this point, several of the private sector contenders—to recognize that changes cannot be prevented by legislation, and that markets, rather than rules and regulations, will determine the outcome in the end.

As we have noted before, timely resolution of these issues is not critical to our own immediate prospects, but prompt and proper resolution of these questions can have a direct effect on the country's economic strength and our long-term future. Short-term temporizing by the Depository Institutions Deregulation Committee on the 1980 law to unwind Regulation Q rate ceilings, for example, only drives more deposits into funds outside the regulation, denies some consumers more attractive returns, and continues to weaken savings incentives.

Building on Basic Strengths

Trends shaping the global economy and changing the structure of its financial markets have been evident for years, and the issues that they raise have long been part of our planning considerations. For the past several years, groups throughout the organization have been examining

our long-term direction. These continuing efforts had a direct effect on our course in 1981, and will help to guide our future.

Some of the measures are discussed in "The Businesses of Continental," beginning on page 8, but developing broad strategies and specific business goals is a continuing, evolutionary process.

For the 1980s and the years immediately ahead, building on basic strengths is more than a slogan; it reflects an ongoing business strategy. We intend to capitalize on the strengths we have built, and continue to build on them year by year.

We will need to choose our markets to prosper in the years ahead. We will need to design and price our services productively, and deliver them with genuine value added. We must continue to improve productivity and pay close attention to our return to investors. We must continue to anticipate and foster change and progress in our own business and in those we serve.

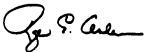
We feel that we have the basic strategies and proven strengths in place today to produce outstanding results.

Above all, however, we recognize that successful strategies depend on capable people. Thus when we speak of our basic strengths, we are speaking above all of talented people. To all who helped produce these results as Continental enters its 125th year, we wish to express our sincere appreciation.

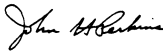
In the same vein, we want to express our thanks here for the long and devoted service of three of our directors, and welcome three new directors elected during the year.

In keeping with our Board's retirement policy, Michael Tenenbaum retired at our 1981 Annual Meeting last April, having served since 1973, and two of our most senior directors plan to retire at our forthcoming Annual Meeting. They are William A. Hewitt, a director since 1955, and Gordon R. Corey, a director since 1966. Mr. Hewitt's more than a quarter-century of service has been of outstanding length, and together with Mr. Tenenbaum's eight years and Mr. Corey's 16 years of dedicated attention to our affairs, helpful to the Corporation in every way. Their many contributions are greatly appreciated.

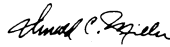
Three new directors elected during the year are: Weston R. Christopherson, chairman of the board and chief executive officer of Jewel Companies, Inc.; Robert A. Hanson, president and chief operating officer of Deere & Company; and William L. Weiss, president of Illinois Bell Telephone Company. We are pleased to have these outstanding business leaders on our Board.



Roger E. Anderson
Chairman of the Board of Directors
and Chief Executive Officer

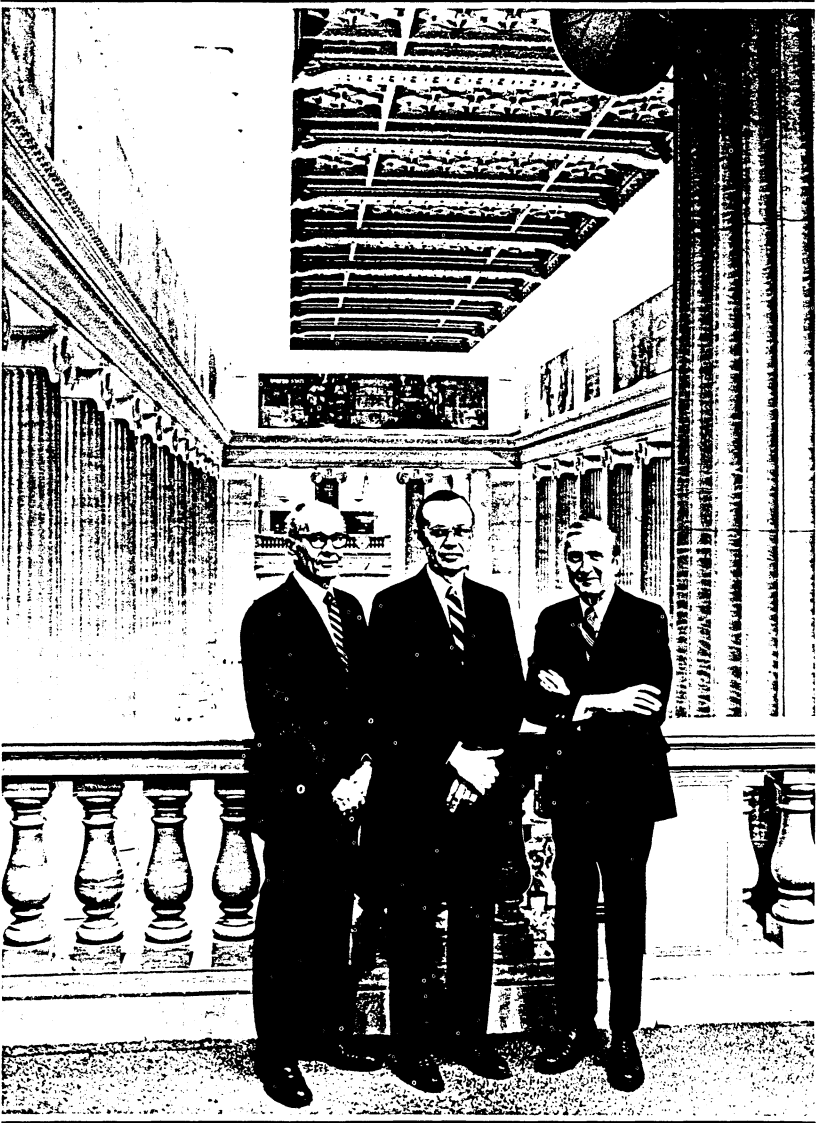


John H. Perkins
President



Donald C. Miller
Vice Chairman

Chicago, Illinois, February 22, 1982



Miller, Anderson,
Perkins

The Businesses of Continental

Continental's activities have expanded in many areas amid the changing opportunities of the past decade and remarkable evolution in the global marketplace.

To provide a clearer view of strengths and strategies and how the many business units tie together, this discussion looks at the basic functions that shape performance.

Credit Services

Credit services continue to be the core of our business, though other, related financial services are important and have become increasingly so in recent years. In 1981 interest income from lending accounted for 76.2 per cent of total revenues.

Commercial and Industrial Lending

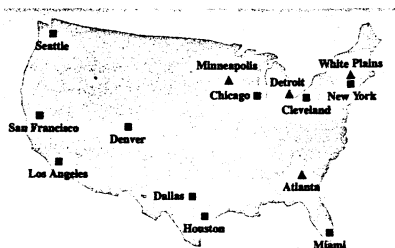
A primary commitment to wholesale banking, a leading position in key areas such as energy lending, and an aggressive push into attractive markets across the U.S. have made Continental one of the nation's top commercial and industrial lenders as well as the nation's sixth largest bank holding company. A similar emphasis worldwide continues to enhance Continental's market position as a key financial institution for U.S. and foreign-based multinational corporations, and guides continuing, selective international expansion keyed to changing opportunity in the global economy.

1981 Highlights

- Advancing leadership in corporate financial service markets worldwide, the commercial and industrial loan portfolio grew to \$12.8 billion at year-end.
- New regional offices in Atlanta, Detroit, Minneapolis, and White Plains, New York, further expanded the Bank's U.S. network to 13 locations. Construction of Continental Illinois Center neared completion on New York's Madison Avenue, for consolidation of Continental's extensive operations there.
- Under new Illinois law (and still subject to regulatory approval), agreements were reached to acquire two small and promising banks chosen for their commercial business potential in Chicago's north and west suburbs of Buffalo Grove and Oakbrook Terrace.
- One of the first four U.S. banks authorized to open banking facilities in Canada, Continental's Toronto-based subsidiary was converted to Continental Illinois Bank (Canada), and the Calgary office became a branch of the new bank.
- Following international expansion into Buenos Aires, Santiago, Madrid, and Lagos, Nigeria in 1980, Bank offices in Barcelona and Puerto Rico were formally opened in 1981. To make the best use of the Corporation's resources, peripheral Bank facilities in Düsseldorf, Edinburgh, Munich, and Rotterdam were closed, as was a Bank subsidiary in Vienna. Services to customers will be provided from Continental's larger European offices.

Real Estate Lending

One of the nation's leading real estate lenders, Continental specializes in commercial and residential construction



New representative offices in 1981 (▲) expand U.S. network.

lending and mortgage banking. Building on a premier position in the metropolitan Chicago market, plans are keyed to high-growth domestic markets and to greater participation in mortgage origination, sales, and servicing programs as economic conditions permit.

1981 Highlights

- The real estate portfolio grew selectively to more than \$3.9 billion, a 12 per cent gain from year-end 1980.

Consumer Lending

The Bank maintains a strong position in selected retail markets in the metropolitan Chicago area, and nationwide through its Town & Country Charge MasterCard and VISA network. Strategies center on markets where high-quality service can be delivered effectively and profitably.

1981 Highlights

- Changing competitive and market conditions led to a move away from indirect or secondary consumer lending, to concentrate resources on direct lending to customers.
- Legislation in Illinois and many other states lifted or eliminated interest ceilings, to improve retail credit profitability in a higher-rate environment. The annual percentage rate on MasterCard and VISA accounts nationwide was raised to 19.8 per cent from 18 per cent.

Related Services

An expanding network of subsidiaries and new, specialized divisions within the Bank steadily enhance finance capabilities. The earning power of these activities both contributes to and combines with strong and growing capital and asset bases, enabling the Corporation to take advantage of emerging opportunities while building market position in established areas.

Lease Financing

Continental Illinois Leasing Corporation

Energy Development Finance

Continental Illinois Energy Development Corporation

Commercial Finance

Continental Illinois Commercial Corporation

Merchant Banking

Continental Illinois Limited

Mortgage Banking

Republic Realty Mortgage Corporation

Edge Act Financing

Continental Bank International

1981 Highlights

- Net income from non-bank subsidiaries grew to \$41.2 million in 1981, from \$13.7 million in 1980.
- Continental Illinois Leasing Corporation's portfolio grew by almost 84 per cent to \$728.1 million, and revenues increased 44.2 per cent to \$54.4 million. Along with participation in the first leveraged financing of a preferred stock purchase, further expansion opened new opportunities, with the acquisition of a leasing company in Brazil and continued advances in the U.K. market, and additional leasing facilities in regional offices in the U.S.

- The energy development corporation, serving smaller producers who might not qualify for traditional bank financing, continued to augment Continental's premier position in the Houston energy market.
- Continental Illinois Commercial Corporation, adding specialized asset-based lending to customer financing alternatives, grew rapidly in both portfolio size and profitability.
- Investment banking activities in the Euromarket increased substantially in 1981, despite difficult market conditions; with effective planning and key personnel in place, Continental Illinois Limited managed or co-managed 27 issues worth \$1.6 billion, compared with seven issues worth \$600 million in 1980. The merchant bank also managed or co-managed 37 syndicated credits totaling more than \$8 billion, also a record for the unit.
- Continental Bank International, an Edge Act subsidiary specializing in international financial services, expanded to 11 U.S. locations with openings in Cleveland, Dallas, Minneapolis, Philadelphia, San Francisco, and Seattle.

Funding Operations

Maintaining and expanding the wide diversity of domestic and offshore sources developed over many years, funding operations have become an increasingly vital strength, as high and volatile market rates and regulatory ceilings siphoned low-cost consumer deposits.

Treasury Operations

Long-standing reliance on market-priced sources of funds positions Continental to respond to rapidly shifting market conditions. The Corporate Treasury group formally coordinates an established position in funding, interest rate sensitivity, and non-credit risk management.

Strategies vary with market conditions and trends in the economy, but the guiding aim is to manage interest rate sensitivity and the capital account so as to control the risk inherent in sudden interest rate swings, while maximizing potential funding profits.

1981 Highlights

- In line with the current objective of reducing the Corporation's rate sensitivity, several steps were taken to lengthen overall liability maturities, including reductions in both the taxable and tax-exempt investment portfolios and two innovative \$100-million note issues. These are discussed in greater detail on pages 26 and 39 of this Report.
- Taking advantage of new state and federal laws and regulations, an International Banking Facility was opened in Chicago, to take overseas commercial deposits free from domestic reserve requirements and interest rate ceilings, and to extend credit to foreign customers. The new unit strengthens competitiveness in international markets and



Treasury representatives coordinate risk management.

supplements similar funding capabilities provided by other Bank units in London, Singapore, Nassau, Bahrain, and a corporate subsidiary in the Netherlands Antilles.

- Improved systems and reporting mechanisms significantly aided worldwide management of non-credit risks.

Deposit-Gathering Activities

Maintaining consumer deposits in certain markets through selective approaches has proved a workable strategy, despite regulatory obstacles and rapidly changing conditions. Automatic banking, for example, has long been a particular strength. A positive response to Illinois' unit banking law, automatic banking also avoids the escalating costs of extensive retail branch systems common among competitors in other states. Resources continue to focus on advancing technology in funds gathering.

1981 Highlights

- In its first nine months of operation, the Money Network of shared automatic teller machines grew to 61 financial institutions.

■ In Chicago, plans were laid to remodel the Rookery banking facility to serve as an additional Personal Financial Service Center. Along with similar Bank centers at the 30 North LaSalle and Clark/Division facilities, the Center will offer a range of services geared to selected market segments.

■ Various regulatory and legislative developments, including the lifting of rate ceilings on certain time-deposit instruments and some provisions of the Economic Recovery Tax Act of 1981, opened significant new opportunities for the Bank to compete more equitably for consumer deposits.

Investment and Fiduciary, Trading, and Non-Credit Services

Strong emphasis on investment and fiduciary, trading, and non-credit services is geared to broader goals. These services play an increasingly important role not only in gaining and maintaining customer relationships, but in building earnings and the capital base for further growth.

Investment Management/Fiduciary Services

Building on long-standing strengths in corporate and personal investment management, account management, and financial advisory services, augmented by national leadership in merger and acquisition depository and bond trusteeship, strategies center on delivering innovative services to selected markets.

Recent initiatives include securities lending of employee benefit plan assets, self-insurance programs for hospitals and other institutional markets, and specialized financial services for high-net-worth individuals.

1981 Highlights

- Trust fee revenues rose 19.6 per cent to \$53.6 million.
- The Midwest's first complete securities lending program to brokerage firms introduced new opportunities for employee benefit plans to gain additional income from their securities portfolios.
- Continental Illinois International Investment Corporation (CIIC) strengthened its worldwide investment management capabilities, serving institutional markets from London and individual clients from Switzerland.
- Generating an annual return of 35.5 per cent over the past three years, the commingled high-growth fund for employee benefit plans more than doubled the return of the S&P 500 and ranked third among the 34 similar bank-managed funds measured by the Frank Russell consulting firm.
- Providing high-value-added services nationwide for corporate executives and other high-net-worth clients, Financial Advisory Services' activities expanded to include seminars on the effects of the 1981 Tax Act.
- Trust subsidiaries in Boca Raton and Sarasota received preliminary regulatory approval to offer full trust and investment services, further enhancing Continental's presence in this key market.

Bond and Currency Trading

One of the nation's leading bond dealers and underwriters, the Bank continues to advance in new directions, such as



Trust fee revenues rise 19.6 per cent.

financial futures consulting, to minimize interest rate risk for corporations and correspondent banks. On another front, foreign exchange trading operations built further presence in money markets worldwide.

1981 Highlights

- Security trading profits totaled a record \$27.9 million, reflecting comprehensive strengths under some of the most volatile taxable and tax-exempt market conditions seasoned traders could recall.
- Introducing the nation's first bank Financial Futures Advisory Service for corporations and correspondent banks put long experience in portfolio management to further use.
- Attuned to the ongoing internationalization of capital markets, the Bank began trading for its own account in precious metals, opened trading in selected foreign securities, and established direct security sales representation in London and Hong Kong.
- Foreign exchange trading revenues reached \$34.3 million, a gain of 10.6 per cent.

Non-Credit Services

In independent surveys, Continental ranks high among the leading firms in mergers and acquisitions consulting, private placements, corporate financial advice, and other strategic investment services. These services, combined with nationally-recognized leadership in cash management, check processing, and trade finance, are keys to further gains in major markets by helping customers develop creative, comprehensive capital strategies.

The productivity of these services can be gauged in profitability for customers and the Corporation.

1981 Highlights

- The Mergers and Acquisitions Division continued its rapid growth, participating in transactions valued at more than \$1 billion in the last two years of operation.
- Despite volatile capital markets, Private Placement continued its growth in volume and reputation, completing innovative transactions involving tax-exempt bonds and leveraged leases, taxable discount notes, and variable rate notes.
- Corporate Financial Advisory Services advanced client abilities to meet complex financial challenges, participating in several major leveraged buy-out, asset redeployment, and valuation projects.
- A new and more comprehensive cash disbursement service, "Complete Control Plus," advanced cash management services for the corporate market.
- While explicit Federal Reserve pricing of cash letter services had a major impact on the market, the Bank contin-

ued to advance toward the top among the nation's leading check processors.

- Innovative applications of Trade Finance products continued to produce a growing stream of fee income, while expanding capabilities in multi-country projects and equipment export finance broadened the range of worldwide customer service.

Equity Activities

Continental Illinois Venture Corporation and Continental Illinois Equity Corporation provide important financing alternatives for small to medium-sized companies, while generating a growing stream of income for the Corporation.

1981 Highlights

- Gains on the sale of equity investments, principally by Continental Illinois Venture Corporation, advanced sharply to \$42 million from \$8.2 million in 1980 and \$7.6 million in 1979.

Management Services

Recognizing the fundamental importance of first-rate professional management services in overall corporate performance, the following activities provide central support for earnings growth and competitive gains.

Planning and Information Services

Resource allocation coupled with close control of expenses continue to receive top priority. All key business areas have been analyzed for current realities and future growth prospects, in studies designed to match investments in manpower and other scarce resources with long-term profit potentials. Continued improvements in systems and support capabilities also enhance current productivity.

1981 Highlights

- Technological and reporting capabilities across the Corporation were brought together, with merging of systems and accounting functions in the Financial Information Services Division.
- Pioneering moves in electronic mail systems and office automation drew national attention—as did the development of important new tools that reduce the amount of time and money spent in performing labor-intensive activities and increase management's decision-making effectiveness.

Personnel, Legal, and Corporate Affairs

Superior performance depends on a staff attuned to competitive markets and aware of social responsibilities. Continuing training and development programs combine with a strong commitment to affirmative action to produce a challenging and supportive work environment which prepares all employees to meet high corporate objectives, expand their involvement in public affairs, and advance to their full potential. The Law Department, focusing resources on legal, regulatory, and public policy issues facing the



Improvements in systems and support capabilities enhance productivity.

Corporation, continues to play a major role in reducing the regulatory barriers facing banks on both the state and Federal levels.

1981 Highlights

- Women and minorities continued to advance throughout the organization. In 1981 minorities accounted for 17.9 per cent of officer, manager, and professional staff, compared with 5.3 per cent in 1971. Women advanced to make up 41.5 per cent of officers, managers, and professionals in 1981, compared with 17.7 per cent ten years ago.
- Quality of worklife programs, alternative work sites, and expanding training and development programs were introduced to meet changing employee needs and enhance productivity.
- Continued improvement in salary, benefit, and incentive compensation positions strengthened the ability to attract and retain top-caliber people.
- A Public Policy Committee was established to bring together concerned parties from all Continental units and address more effectively the issues that directly affect the Corporation's future, such as interstate banking, international trade, and urban revitalization.

Board of Directors

Continental Illinois Corporation
Continental Illinois National Bank and Trust Company of Chicago

Roger E. Anderson
*Chairman of the Board of Directors and
Chief Executive Officer*

John H. Perkins
President

Donald C. Miller
Vice Chairman

Raymond C. Baumhart, S. J.
President
Loyola University of Chicago

James F. Beré
Chairman and Chief Executive Officer
Borg-Warner Corporation
(chemical, plastic, air conditioning, building, industrial, and automotive products and equipment)

Weston R. Christopherson
Chairman of the Board and Chief Executive Officer
Jewel Companies, Inc.
(diversified retailer of food, drugs, and consumer products)

Gordon R. Corey
Financial Consultant; Retired Vice Chairman
Commonwealth Edison Company
(electric power company)

Robert A. Hanson
President and Chief Operating Officer
Deere & Company
(agricultural and industrial equipment)

William A. Hewitt
Chairman and Chief Executive Officer
Deere & Company
(agricultural and industrial equipment)

William B. Johnson
Chairman and Chief Executive Officer
IC Industries, Inc.
(holding company with major interests in commercial products, consumer products, and railroad activities)

Jewel S. Lafontant
Senior partner
in the law firm of Lafontant, Wilkins & Jones

Vernon R. Loucks, Jr.
President and Chief Executive Officer
Baxter Travenol Laboratories, Inc.
(medical care products)

Frank W. Luerssen
President
Inland Steel Company
(steel production)

Robert H. Malott
Chairman and Chief Executive Officer
FMC Corporation
(machinery and chemicals for industry and agriculture)

Marvin G. Mitchell
Retired; formerly Chairman of the Board and Chief Executive Officer
CBI Industries, Inc.
(holding company with major interests in metal plate fabricating and construction worldwide, oil and gas drilling, marine construction and repair work, water and wastewater treatment, real estate, and investments)

Keith R. Potter
Retired; formerly Vice Chairman
International Harvester Company
(farm equipment, motor trucks, and construction equipment)

John M. Richman
Chairman and Chief Executive Officer
Dart & Kraft, Inc.
(diversified manufacturer and marketer of food and consumer products and plastic/packaging products)

Paul J. Rizzo
Senior Vice President and Member of the Corporate Office
International Business Machines Corporation
(information processing systems and related services)

Thomas H. Roberts, Jr.
Chairman of the Board and Chief Executive Officer
DEKALB AgResearch, Inc.
(research and production of hybrids—corn, sorghum, poultry, and swine)

William L. Weiss
President
Illinois Bell Telephone Company
(telephone utility)

Blaine J. Yarrington
Executive Vice President
Standard Oil Company (Indiana)
(crude oil, chemicals, and petroleum products)



Committees of the Board**Audit**

R. H. Malott, Chairman
 F. W. Luerssen, Vice Chairman
 W. R. Christopherson

Compensation and Nominating

J. F. Beré, Chairman
 W. B. Johnson, Vice Chairman
 V. R. Loucks, Jr.
 M. G. Mitchell
 J. M. Richman

Loan

R. E. Anderson, Chairman
 J. H. Perkins, Vice Chairman
 D. C. Miller
 R. C. Baumhart, S.J.
 G. R. Corey
 R. A. Hanson
 W. A. Hewitt
 B. J. Yarrington

Trust and Investment Services

R. E. Anderson, Chairman
 J. H. Perkins, Vice Chairman
 D. C. Miller
 J. S. Lafontant
 K. R. Potter
 P. J. Rizzo
 T. H. Roberts, Jr.
 W. L. Weiss

February 22, 1982

Nominations

The Compensation and Nominating Committee of the Board of Directors will consider potential candidates for election as directors who are recommended in writing by stockholders of the Corporation. Recommendations should be sent to the Secretary, Mr. Ray F. Myers, 231 South LaSalle Street, Chicago, Illinois 60693, and should be received by December 15, 1982, to be considered for inclusion in the slate of nominees which will be proposed by the Board of Directors at the 1983 Annual Meeting. Such recommendations should include: a description of the candidate's business experience and other relevant background information during at least the past five years; company directorships and any other organizational affiliations of the candidate; amount of Common Stock of the Corporation beneficially owned by the candidate; any involvement of the candidate during at least the past five years in legal proceedings or other matters that would be material to an evaluation of ability and integrity.

February 22, 1982

Board of Directors (left to right) Beré; Roberts; Weiss; Malott; Corey; Mitchell; Johnson; Yarrington; Potter; Miller, Vice Chairman; Rizzo; Myers, General Counsel and Secretary; Anderson, Chairman of the Board of Directors and Chief Executive Officer; Perkins, President; Baumhart; Lafontant; Hanson; Loucks; Hewitt; Christopherson; Luerssen; Richman.



Corporate Management

Corporate Office

Roger E. Anderson (60)*
*Chairman of the Board of Directors
 and Chief Executive Officer
 Officer of the Corporation since 1969*

John H. Perkins (60)*
*President
 Officer of the Corporation since 1969*

Donald C. Miller (61)*
*Vice Chairman
 Officer of the Corporation since 1972*

Bond and Treasury Services

David G. Taylor (52)*
*Executive Vice President and Treasurer
 Officer of the Corporation since 1976*

Corporate Financial Services

Edwin J. Hlavka (44)
*Senior Vice President and Auditor
 Officer of the Corporation since 1972*

Corporate Personnel Services

Corporate Affairs
Eugene R. Croisant (44)*
*Executive Vice President
 Officer of the Corporation since 1974*

General Banking Services

George R. Baker (52)*
*Executive Vice President
 Officer of the Corporation since 1974*
Edward M. Cummings (60)*
*Executive Vice President and Area
 Corporate Officer—Europe
 Officer of the Corporation since 1971*

Eugene Holland, Jr. (59)*
*Executive Vice President and Chair-
 man, Credit Policy Committee
 Officer of the Corporation since 1973*

Alfred F. Miossi (59)*
*Executive Vice President and
 Director of International Affairs
 Officer of the Corporation since 1976*

Financial Services

Caren L. Reed (47)*
*Executive Vice President
 Officer of the Corporation since 1981*

International Banking Services

Leo C. deGrijs (55)*
*Executive Vice President
 Officer of the Corporation since 1981*

Multinational Banking Services

John E. Porta (50)*
*Executive Vice President
 Officer of the Corporation since 1977*

Special Industries Services

Gerald K. Bergman (47)*
*Executive Vice President
 Officer of the Corporation since 1980*

U.S. Banking Services

Hollis W. Rademacher (46)*
*Executive Vice President
 Officer of the Corporation since 1980*

Law Department

Ray F. Myers (61)*
*Executive Vice President,
 General Counsel and Secretary
 Officer of the Corporation since 1974*

Operations and

Management Services

Personal Banking Services

Gail M. Melick (53)*
*Executive Vice President
 Officer of the Corporation since 1974*

Financial Information Services

J. Joseph Anderson (43)*
*Executive Vice President and Controller
 Officer of the Corporation since 1972*

Personal Banking Services

William D. Plechaty (45)*
*Executive Vice President
 Officer of the Corporation or the Bank
 since 1970*

Real Estate Services

James D. Harper, Jr. (47)*
*Executive Vice President
 Officer of the Corporation since 1974*

Trust and Investment Services

Edward S. Bottum (48)*
*Executive Vice President
 Officer of the Corporation since 1980*

Investment Services

Richard W. Foss (55)
*Senior Vice President
 Officer of the Bank since 1980*

*Executive officer; ages in parentheses. The executive officers of the Corporation are elected by the Board of Directors to hold office until the first meeting of the Board after the Annual Meeting of stockholders next following election, and until a successor is qualified. The executive officers may be removed and replaced only by the Board of Directors, and may be removed, with or without cause, at any time by a majority vote of the Directors at the time in office.

All the executive officers have served in an executive capacity with the Corporation, the Bank, or an affiliate of the Corporation for more than five years.

February 22, 1982

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Management's Discussion and Analysis of Financial Condition and Results of Operations Financial Review

A New Approach

As the complexity of Continental Illinois Corporation in geographical scope, range of service, and internal structure has grown, providing a meaningful and understandable discussion of performance and progress has become more important.

This year, our Annual Report has been combined with the Report on Form 10-K filed annually with the Securities and Exchange Commission. The aim of the new format is to provide detailed, uniform financial data and discussion to all who are interested in Continental's performance.

The management discussion portion of this Report is divided into eight parts. The first section provides a capsule summary of the Corporation and its environment. The second section discusses the income statement, focusing on revenues, expenses, and profitability, while the third part explores the quality of the loan portfolio. The fourth section examines the Corporation's overall financial condition, and sets out the policies and approaches used in managing funding and capital positions. A fifth part looks at the performance of non-bank subsidiaries. A sixth section examines the results of operations during the fourth quarter of 1981, while a seventh part, in keeping with the Financial Accounting Standards Board Statement 33, attempts to suggest the impact of inflation on operations. The final section, the financial statements and their related footnotes, details the Corporation's financial position and results of operations.

We hope that this new format will be helpful in your understanding of Continental and its operations.

About Continental

Continental Illinois Corporation, a bank holding company, was incorporated under Delaware law in 1968. Originally founded as Conill Corporation, Continental took its present name in 1972. Except for qualifying shares held by directors, the Corporation is sole shareholder of Continental Illinois National Bank and Trust Company of Chicago, the sixth largest commercial bank chartered in the U.S. based on assets and the seventh largest in deposits at the end of 1981.

Providing commercial, personal, trust, and money market services across the country and around the world, Continental Bank comprises most of the Corporation's business, accounting for 95 per cent of total assets and 90 per cent of earnings in 1981.

As the needs of the financial marketplace in the United States and overseas evolve, however, the scope of activities is expanding continually. Building on a global network of branches, representative offices, subsidiaries, and affiliates staffed by more than 12,000 people, Continental consistently seeks to capitalize on opportunities for profitable growth in related financial fields.

To enhance performance in today's dynamic and highly competitive financial marketplace, business units are organized around strategic market segments. Staffed and structured to place the Corporation's full financial, technological, and human resources at the service of customers who share similar, specialized needs, each unit plays a specific role designed to deliver superior credit and non-credit services at competitive cost. Strategies in all areas are attuned to economic and regulatory conditions in the domestic and international markets served.

Supervision and Regulation

Two key factors in the performance of all bank holding companies are loan volume and the margin between lending rates and the interest rates paid to obtain lendable funds in worldwide money markets. Federal government policies, including those of the Board of Governors of the Federal Reserve System, can influence financial and credit market conditions at any given time, and in turn affect interest rate levels and the ability to lend. Thus changes in those policies also can influence Continental's performance.

The Federal Reserve Board (FRB) also is one of bank holding companies' principal regulators. The amended Bank Holding Company Act of 1956 generally limits holding companies to activities that the FRB determines are closely related to banking or managing or controlling banks. A bank holding company cannot acquire substantially all of the assets or control more than 5 per cent of the voting shares of any commercial bank of which it is not already the majority shareholder, without the FRB's approval. The FRB cannot approve any application to acquire voting shares in an additional commercial bank outside the state in which the holding company's existing bank subsidiaries are located unless specifically authorized by the laws of the additional bank's state.

Subject to FRB regulation, banks and their Edge Act corporation subsidiaries, which engage in international banking and finance, may establish foreign branches. Subject to FRB approval, Edge Act corporations also may establish branches in the United States and invest in the shares of financial companies whose transactions in the U.S. are solely and directly related to international business. With FRB consent, bank holding companies and any of their non-bank subsidiaries may own or control the voting shares of any company in which an Edge Act corporation may invest.

In addition to the FRB, national banks like Continental Bank are regulated by the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC), on matters including loan limits, borrowings, deposit reserves, interest rates, and dividends. Note 16 to the financial statements outlines limitations on the amount of dividends that Continental Bank may declare.

Federal law places restrictions on extensions of credit from banks to their parent bank holding companies and, with some exceptions, to other affiliates, on investments in stock or other securities thereof, and on the taking of such securities as collateral for loans. Banks and their affiliates

are subject to other restrictions on the issuance, flotation, underwriting, public sale, and distribution of securities. Operations in other countries are subject to various restrictions, and to the supervision of various regulatory authorities, under Federal law and the laws of those countries.

Selected Financial Data and Ratios (consolidated)

Year ended December 31	1981	1980	1979	1978	1977
(\$ in millions, except per-share data)					
Earnings					
Net interest and other operating income	\$ 1,008	\$ 878	\$ 712	\$ 611	\$ 526
Income before security gains or losses	260	224	194	169	144
Net income	254	226	196	168	143
Per-Share Data					
Income before security gains or losses	\$ 6.58	\$ 5.70	\$ 4.95	\$ 4.51	\$ 4.05
Net income	6.44	5.75	4.99	4.49	4.02
Cash dividends declared	1.90	1.70	1.52	1.38	1.26
Average Statement of Condition Items					
Earning assets	\$37,113	\$32,979	\$27,427	\$22,841	\$19,885
Total assets	44,004	39,565	33,252	26,965	23,044
Deposits	27,428	24,953	22,370	18,656	16,142
Bonds, mortgages, and similar debt	722	600	521	419	329
Stockholders' equity	1,616	1,443	1,294	1,122	965
Financial Ratios*					
Equity to total assets	3.67%	3.64%	3.89%	4.15%	4.18%
Return on earning assets	0.70	0.68	0.70	0.73	0.72
Return on total assets	0.59	0.56	0.58	0.62	0.62
Return on equity	16.10	15.53	15.00	15.04	14.94
Dividend pay-out	28.88	29.78	30.69	30.64	31.06

*Computed using income before security gains or losses and annual averages for statement of condition items.

Income Statement Analysis

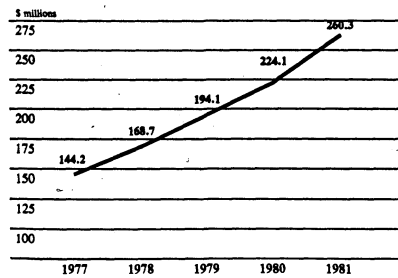
Summary

Throughout 1981, the forces of change were at work in the economy, both in the United States and internationally. These changes had significant effects on the banking

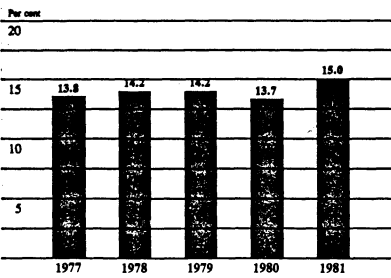
industry in general, and particularly on worldwide financial institutions like Continental.

Most important, financial markets in the U.S. and abroad reacted unpredictably to the economic initiatives of the Reagan Administration and the Federal Reserve Board's efforts to reduce inflation by controlling the

Income Before Security Transactions



Compound Five-Year Annual Earnings Growth Rate



growth of the money supply in a difficult and volatile world economy.

Operating results in 1981 reflect this challenging environment—and the basic strengths which enabled Continental to cope with the march of events. Careful attention to resource allocation, expense control, funding, and liquidity management all made important contributions to the following key results:

Income before security transactions of \$260.3 million, or \$6.58 a share in 1981 increased 16.1 per cent from the \$224.1 million or \$5.70 a share achieved in 1980. Net income rose 12.7 per cent to \$254.6 million or \$6.44 per share from \$225.9 million or \$5.75 a share a year ago.

Return on total assets of 0.59 per cent improved from last year's 0.56 per cent; the return on average stockholders' equity was 16.1 per cent, compared with 15.5 per cent a year ago.

Net interest income on a taxable equivalent basis increased by 8.6 per cent; 12.4 per cent growth in earning assets more than offset a nine-basis-point decline in the net interest margin.

Credit loss provisions of \$120 million exceeded net credit losses of \$71.1 million, raising the year-end reserve for credit losses to \$289.1 million. Net credit losses remained level at 0.24 per cent of average loans and leases outstanding.

Other operating income totaled \$322.4 million, up 32.3 per cent from \$243.6 million in 1980.

Other operating expense rose 11.7 per cent, a much slower growth rate than in recent years, with expanding services and business volumes continuing under lower inflation rates and careful management control.

Net Interest Income Rises

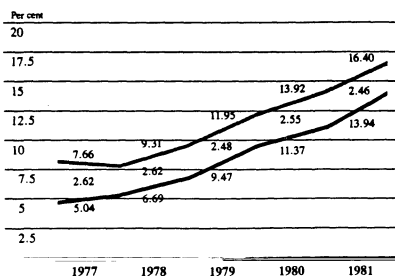
Net Interest Income (\$ in millions)			
	1981	1980	1979
Interest income	\$5,964.2	\$4,472.5	\$3,168.1
Taxable equivalent (TE) adjustment	104.6	107.5	103.5
Interest income (TE)	6,068.8	4,580.0	3,271.6
Interest expense	5,158.4	3,742.2	2,594.3
Net interest income (TE)	\$ 910.4	\$ 837.8	\$ 677.3

Net interest income (TE) was up 8.6 per cent in 1981, compared with gains of 23.6 per cent in 1980 and 13.3 per cent in 1979.

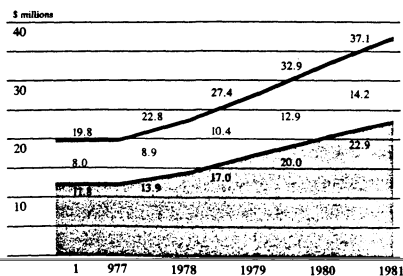
Changes in net interest income result from changes in both volume and the net interest margin. Volume refers to the dollar level of earning assets, while the net interest margin shows the relationship between interest yields on earning assets and the cost of funds required to support them.

As the following table shows, higher volumes have contributed to net interest income growth in each of the past three years. The effects of changes in the net interest margin have varied. The increase in net interest income in 1981 was due entirely to volume gains; and under volatile credit market conditions, funding costs generally rose faster than the average yield on earning assets, producing a nine-basis-point narrower net interest margin. Toward year-end, however, funding costs stabilized and margins rose, as an economic downturn curtailed private investment and lowered interest rate levels. During 1980 the margin rose seven basis points to 2.55 per cent amid unprecedented interest rate fluctuations. During 1979 the net interest margin declined 14 basis points to 2.48 per cent, as funding costs rose faster than asset yields throughout the year.

Interest Comparison
(As a Percentage of
Average Earning Assets)



Average Domestic and Foreign Earning Assets



Increase in Net Interest Income (TE) (\$ in millions)	1981 vs 1980	1980 vs 1979	1979 vs 1978
Change due to increase in earning assets	\$101.9	\$140.0	\$114.6
Change due to increase (decrease) in net margin	(29.3)	20.5	(34.7)
Net increase	\$ 72.6	\$160.5	\$ 79.9

Domestic and Foreign Volumes Advance

During 1981 earning assets increased worldwide, with domestic volumes growing faster than foreign volumes. Average domestic earning assets increased 14.3 per cent from 1980 to \$22.9 billion, while foreign earning assets averaged \$14.2 billion, up 9.7 per cent from 1980.

Total loans rose 17.7 per cent to average \$28.6 billion and were the major source of earning asset growth. Domestic loans accounted for \$2.9 billion of total loan growth, while foreign loans, which include those made from the head office to customers overseas, as well as credits extended by overseas branches and subsidiaries, rose by \$1.4 billion. The foreign portion of the total loan portfolio remained at about 30 per cent.

Domestic earning asset growth was accompanied by a redistribution of funds among investment alternatives. Reflecting a continuing emphasis on strengthening market position, average domestic loans rose to 85.1 per cent of average domestic earning assets, up from 82.7 per cent last year.

Due to domestic market conditions, the volume of investment and trading securities and other short-term investments decreased, and these assets declined as a percentage of total domestic earning assets.

Foreign earning assets also were reallocated. Average loans accounted for 64.0 per cent of average earning assets, compared with 59.4 per cent in 1980. Average investment and trading account securities and other short-term investments increased a combined 8.3 per cent in reaction to favorable international market conditions, but declined as a percentage of earning assets as other investments increased at greater rates.

A large share of average foreign earning assets traditionally has been held in the form of short-term money market investments (placements), which offer higher liquidity but lower yields than loans. During 1981 these investments were reduced both in dollar terms and as a percentage of average earning assets. Placements accounted for 31.7 per cent of foreign earning assets during 1981, compared with 36.5 per cent in 1980.

As in previous years, foreign interest margins were below domestic margins, partly because of the lower yields on foreign placements and partly because most foreign earning assets are financed by funds on which interest is paid.

Domestic and Foreign Operations	1981	1980	1979
	Average earning assets (\$ in billions):		
Domestic	\$22.9	\$20.0	\$17.0
Foreign	14.2	12.9	10.4
Net interest income (TE) (\$ in millions):			
Domestic	\$ 708	\$ 696	\$ 566
Foreign	202	142	111
Net interest margin (TE):			
Domestic	3.09%	3.48%	3.33%
Foreign	1.43	1.10	1.07
Income before security transactions (\$ in millions):			
Domestic	\$ 186	\$ 161	\$ 162
Foreign	74	63	32

The division of income and expense into domestic and foreign components is based in part on internal allocations, which may differ from those used by other bank holding companies. Condensed financial statements pertaining to domestic and foreign operations appear in Note 15 to the financial statements, where the same allocation considerations apply.

Approximately 41 per cent of average total assets was attributable to foreign operations in 1980 and 1981, compared with 40 per cent in 1979.

Other Operating Income Rises Significantly

With continuing efforts to build non-credit services to support and supplement lending activities, total other operating, or non-interest, income was up 32.3 per cent from 1980, which in turn rose 17.2 per cent from 1979, bringing the five-year average growth rate to 21.0 per cent.

Among the major components of this increase, domestic and foreign fee income rose \$29.8 million or 23.7 per cent over last year.

A substantial portion of the \$16.7 million rise in domestic fee income was generated by charge card membership fees, instituted in September 1980. These fees totaled \$17 million in 1981, up \$12 million from last year. In addition, fees for credit facilities, commissions, and service charges increased significantly, while merchant discounts related to charge card business decreased.

Foreign fee income rose 24.5 per cent from 1980, due primarily to expanded bankers acceptance and letter of credit business.

Recently, securities trading and foreign exchange have been less stable income sources than other non-interest income items, reflecting the volatility of interest and exchange rates brought about by inflation and efforts to control it.

Securities trading profits and commissions fluctuated widely during 1981; fourth quarter activity produced \$22.4 million of the annual \$27.9 million total. Profits from foreign exchange activities declined 3.4 per cent to \$31.1 million in 1981.

Other operating income growth was helped significantly by gains on sales of equity investments in 1981. Such sales are recurring, normal transactions, although the amounts may vary from year to year. More than 94 per cent of the gains on the sales of equity investments during 1981 was generated by the venture capital subsidiary, compared with approximately 82 per cent in 1980 and 60 per cent in 1979.

All other income in 1981 decreased 53.9 per cent to \$12.3 million. In 1981 all other income included only \$1 million in foreign withholding taxes paid by borrowers on Continental's behalf, compared with \$14.3 million in 1980 and \$4.2 million in 1979.

Other Operating Income (\$ in millions)	1981	1980	1979
Trust income	\$ 53.6	\$ 44.8	\$ 37.4
Security trading profits and commissions	27.9	6.1	15.7
Foreign exchange profits:			
Trading operations	34.3	31.0	11.3
Translation gains (losses) net	(3.2)	1.3	1.3
Fee income:			
Domestic	88.9	72.2	57.4
Foreign	66.6	53.5	43.2
Gains on sales of equity investments	42.0	8.2	7.6
All other income	12.3	26.5	33.8
Total	\$322.4	\$243.6	\$207.7

Expense Growth Rate Slows

During 1979 and 1980, non-interest expense (excluding the provision for credit losses) increased at an annual rate of more than 20 per cent. Careful monitoring of expense growth along with easing inflationary pressures reduced the rate of growth to only 11.7 per cent in 1981.

As shown in the following table, growth in many other operating expense categories moderated significantly. Management is committed to managing expense growth at levels in keeping with high quality service, business growth, and corporate profitability goals.

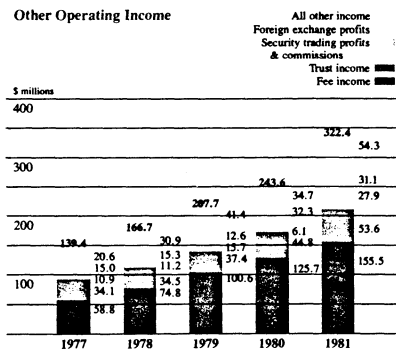
Other Operating Expense— Per Cent Increase	1981	1980	1979
Staff expense			
Salaries and wages	16.6%	14.1%	19.9%
Benefits	21.8	20.0	15.1
Total staff expense	17.7	15.3	18.9
Net occupancy expense	23.3	28.7	22.3
Equipment expense	0.1	33.5	31.8
Other expense	1.0	23.4	22.3
Total	11.7%	20.1%	20.9%

Staff expense growth in 1981 resulted from a 3.7 per cent increase in staff size to 12,713 full-time equivalent employees at year-end, and from increases in merit, promotional, and incentive pay, and in various benefit programs.

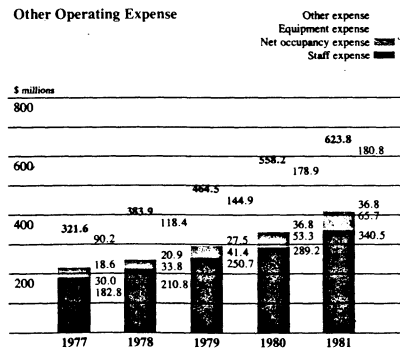
The stabilization of equipment expense in 1981 was due primarily to a decline in rental expense. The purchase of certain equipment which previously had been leased contributed to a substantial decrease in equipment rental expense. Equipment expense for 1981 reflects an expanded system of automatic teller machines.

The following table lists some of the key other expense items and the percentage changes during the last three years.

Other Operating Income



Other Operating Expense



Other Expense— Per Cent Increase (Decrease)	1981	1980	1979
	Advertising and public affairs	(3.1)%	(5.2)%
Insurance (primarily FDIC)	23.1	2.5	15.1
Legal, audit, and other purchased services	(8.5)	18.8	36.0
Stationery, postage, and supplies	5.9	11.3	22.7
Telephone	9.7	22.4	21.2
Travel and business promotion	20.5	23.5	33.8
All other	(4.3)	38.3	25.8
Total	1.0 %	23.4 %	22.3 %

Income Taxes Up on Higher Earnings

Income tax expense was up 29.7 per cent from 1980, due primarily to a greater level of pre-tax income, as well as to a reduction in the level of tax-exempt interest income. Federal income taxes increased approximately \$24.6 million, while foreign taxes were up \$4.7 million. State and local taxes declined \$873,000.

During 1980 the same factors accounted for most of the 80.5 per cent increase in income tax expense from 1979; a year ago, Federal income taxes rose \$22 million, foreign taxes increased \$16.5 million, and state and local taxes were up \$4 million.

The effective tax rate in 1981 was 32.2 per cent, compared with 29.8 per cent in 1980 and 21.4 per cent in 1979. These rates are lower than the statutory Federal rate of 46 per cent due to the treatment of tax-exempt interest and dividend income, investment tax credits, and capital gains on investment sales.

Note 14 to the financial statements provides further information on the Corporation's income taxes.

Asset Quality Analysis

Lending is Continental's principal business, and the extension of credit always carries some risk that a borrower will not be able to repay a loan when it matures. Although managing risk and maximizing the profitability of the overall loan portfolio is one key to performance in banking, credit losses must be considered a normal cost of doing business.

The basic policy governing the management of the lending portfolio is the diversification of risk over a variety of customers, industries, and countries. Appropriate diversification—combined with thorough evaluation, documentation, and follow-up on every credit by highly trained lending officers—lessens the effect of any potential loss that might result from a single event.

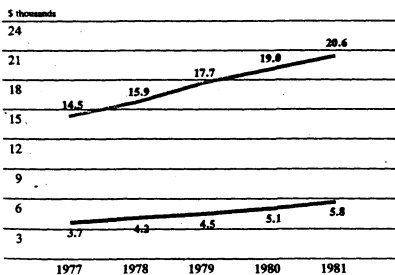
Overall credit losses must be evaluated against the profitability of the loan portfolio as a whole, as well as in light of Continental's total earning power.

Domestic and Foreign Loan Demand Continues Strong

The demand for credit which prevailed throughout 1980 continued into 1981, as corporate borrowers relied upon banks as an important liquidity source. Except for a modest softening of loan demand in February, average total loans increased each month, with somewhat heavier growth occurring in the second half of the year. While increases in foreign and domestic loans contributed varying percentages to each month's loan growth, on the average, domestic loans accounted for about 68 per cent of the annual increase.

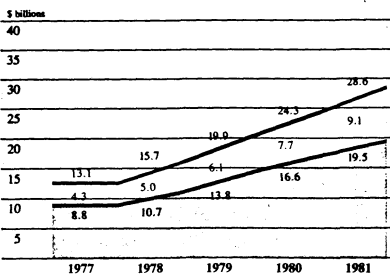
Staff Expense
(Average Per Employee)

Salaries and wages ■■■
Employee benefits ■■■



Average Loans

Foreign ■■■
Domestic ■■■



Commercial and industrial loans remained the largest and fastest-growing domestic loan category, increasing 24.3 per cent to average \$10.7 billion. Mortgage and real estate loans, which increased 12.9 per cent to \$3.7 billion, and loans to financial institutions, up 13.5 per cent to \$2.4 billion, also contributed significantly to domestic loan growth.

The allocation of resources among domestic and foreign loans is influenced by the trend of the return on capital employed, as well as by internally established country lending limits. These limits take into account both political and economic conditions abroad.

The following tables show estimated distributions of foreign loans, based on the domicile of the guarantor. To conform to 1981 presentation, certain 1980 amounts have been reclassified.

Foreign Loans (\$ in millions)	December 31	
	1981	1980
Europe	\$ 3,741	\$3,330
North America	1,833	1,493
Latin America/Caribbean	2,133	1,820
Asia/Pacific	1,811	1,243
Africa/Middle East	528	496
Total	\$10,046	\$8,382

The following classifications are based primarily on the most recent criteria established by the World Bank. Although the aggregate data displayed in the table have gained common acceptance, they are not the most appropriate way to measure risk, which must always be evaluated on a case-by-case basis.

Foreign Loans by Per-Capita Income Level (\$ in millions)

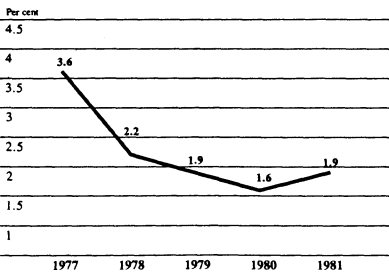
	December 31 1981		December 31 1980	
	\$	%	\$	%
Developed countries	5,734	57.1%	\$5,073	60.5%
Oil-exporting countries	1,499	14.9	627	7.5
Developing countries:				
Higher income (over \$699)	2,206	22.0	2,272	27.1
Middle income (\$300-\$699)	484	4.8	296	3.5
Lower income (less than \$300)	24	0.2	13	0.2
Centrally planned economies	99	1.0	101	1.2
Total	\$10,046	100.0%	\$8,382	100.0%

Non-Performing Loans and Credit Losses Reflect Economic Conditions

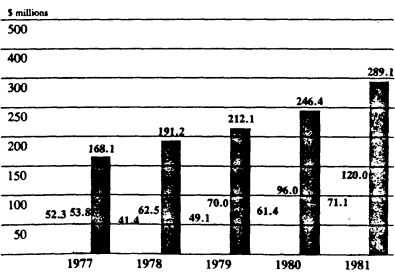
Non-performing loans and lease financing receivables include cash-basis credits, on which interest is recorded only when received, and renegotiated credits, on which the terms have been restructured to provide for the reduction or deferral of interest or principal payments, primarily to accommodate the weakened financial condition of borrowers.

Non-performing credits and their effect on earnings in the aggregate reflect the economic conditions prevailing during a year, and periodic variations must be expected. As a result of high interest rate levels and an economic slowdown in 1981, non-performing credits of \$653 million represented 1.9 per cent of total loans and lease receivables outstanding at year-end, compared with \$444 million or 1.6 per cent at year-end 1980. Before the cyclic rise in 1981, non-performing credits declined steadily from \$705 million or 5.7 per cent of the total loan and lease portfolio reported at year-end 1975, amid a severe economic slump.

Non-Performing Credits (As Percentage of Total Credits at Year-End)



Reserve for Credit Losses



The following table provides a summary of the loan and lease financing portfolio by category, with related credit loss and non-performing data (\$ in millions):

	December 31, 1981			1981		1977-1981	
	Balance	Non-performing	Non-performing credit percentage	Net credit losses	Average balance	Net credit losses (a)	Average net credit loss percentage (a)
Loans:							
Domestic:							
Commercial and industrial loans	\$12,862	\$187	1.45%	\$34	\$10,741	0.31%	0.18%
Mortgage and real estate loans	3,957	293	7.40	2	3,713	0.05	0.36
Loans to financial institutions (b)	2,633	50	1.89	(1)	2,409	—	0.30
Loans for purchasing or carrying securities	212	—	—	(1)	336	—	—
Consumer installment loans	1,588	9	0.56	23	1,447	1.58	1.73
All other loans	878	27	3.07	5	1,002	0.49	0.26
<i>Total</i>	22,130	566	2.55	62	19,648	0.31	0.34
Foreign	10,046	71	0.70	8	9,078	0.08	0.10
<i>Total loans</i>	32,176	637	1.97	70	28,726	0.24	0.26
Lease financing receivables	1,123	16	1.42	1	842	0.11	0.03
<i>Total loans and lease financing receivables</i>	\$33,299	\$653	1.96%	\$71	\$29,568	0.24%	0.26%
Less: Unearned income	423	—	—	—	304	—	—
<i>Total loans and lease financing receivables (net)</i>	\$32,876	\$653	1.98%	\$71	\$29,264	0.24%	0.26%

(a) As a percentage of average balance.

(b) Includes loans to real estate investment trusts.

The following table shows worldwide non-performing credits by component. The \$209 million increase in non-performing loans and lease receivables during 1981

reflects the generally sluggish economic conditions which must be expected periodically within the normal business cycle.

Non-Performing Loans and Lease Financing Receivables (\$ in millions)	December 31				
	1981	1980	1979	1978	1977
Cash-basis loans and lease receivables:					
Mortgage and real estate	\$252	\$169	\$235	\$192	\$276
All other loans (a)	295	232	160	131	180
Lease receivables	16	20	24	16	—
<i>Total cash basis</i>	563	421	419	339	456
Renegotiated loans and lease receivables:					
Mortgage and real estate	\$ 49	\$ 21	\$ —	\$ —	\$ 1
All other loans (a)	41	2	27	75	90
Lease receivables	—	—	—	—	—
<i>Total renegotiated</i>	90	23	27	75	91
<i>Total</i>	\$653	\$444	\$446	\$414	\$547

(a) Includes loans to real estate investment trusts.

(\$ in millions, except per-share data)	1981			1980		
	Cash-basis	Renegotiated	Total	Cash-basis	Renegotiated	Total
Interest income that would have been recorded at the original rate for the year ended December 31	\$ 107	\$ 3	\$ 110	\$ 56	\$ 5	\$ 61
Interest income that was recorded for the year ended December 31	24	—	24	21	1	22
Lost interest income for the year ended December 31 (pre-tax)	\$ 83	\$ 3	\$ 86	\$ 35	\$ 4	\$ 39
Lost interest income for the year ended December 31 (after-tax)	\$ 42	\$ 2	\$ 44	\$ 18	\$ 2	\$ 20
Per-share impact (after-tax)	\$1.08	\$0.04	\$1.12	\$0.45	\$0.05	\$0.50

As shown in the table above, the computed loss of after-tax income associated with non-performing credits totaled \$44 million in 1981. The increase in the computed loss was caused by an increase in principal and the higher interest rates prevailing in 1981, partially offset by an increase in interest received.

In 1981 net credit losses increased 15.8 per cent to \$71.1 million from 1980, amid a downturn in the American economy. Recoveries on loans previously charged off totaled \$21.1 million in 1981 and significantly reduced losses. Despite the higher dollar amount charged off, net credit losses remained 0.24 per cent of average loans and lease financing receivables, unchanged from last year's level. While the aggregate percentage relationship was below the five-year average, data in the table at the top of page 23 show that there has been no consistent historical loss pattern for individual loan categories. Net credit card losses again declined, to \$18.7 million on \$651 million average loan volume in this area, compared with \$25 million on \$663 million average volume in 1980.

Reserve for Credit Losses Increased

As in the past, the 1981 provision for credit losses exceeded net credit losses for the year, continuing the expansion of the reserve to a level appropriate to the expanded volume of credit. The net addition to the reserve for credit losses was \$42.7 million in 1981, compared with \$34 million in 1980 and almost \$21 million in 1979. The reserve for credit losses of \$289.1 million equaled 0.87 per cent of total credits at year-end, compared with \$246.4 million or 0.89 per cent at the close of 1980.

Management considers the reserve for credit losses adequate to absorb potential losses, based on the quality of credits in the portfolio, past experience, and economic prospects in the U.S. and abroad. Review of loans and leases is a thorough and continuous process, with special attention given to any problem credits.

Although the table on page 52 shows an allocation of the reserve for credit losses for the past five years, the entire reserve is available for any loan which might be charged off.

Reconcilements of the consolidated reserve for credit losses and of that portion of the reserve allocated to foreign operations for the past three years may be found in Note 5 to the financial statements.

Statement of Condition Analysis

The consolidated statement of condition as of the end of the year reflects Continental's financial condition on that date. A more meaningful analysis of condition can be obtained by reviewing statements of condition based on average balances.

Asset, Capital Bases Increase

Average total assets grew by about \$4.4 billion or 11.2 per cent in 1981. As in previous years, interest-earning assets increased substantially, reflecting higher loan and lease financing receivable balances. The average loan portfolio grew 17.7 per cent, to \$28.6 billion.

Yields on investment securities were less attractive in 1981 than yields on other alternatives, and average investment securities held did not change significantly from 1980. The portfolio mix did change, however; U.S. Treasury and Federal agency securities increased to 46 per cent of the total from 40 per cent in 1980, and state, county, and municipal securities declined to 38 per cent from 45 per cent. This shift in portfolio composition reduced tax-exempt interest income from 1980.

Customers' liability on acceptances, a fee-generating asset as opposed to an interest-earning asset, increased 21.2 per cent, in line with the corporate goal of expanding non-interest income. This growth also was reflected in the off-setting liability of acceptances outstanding.

As in prior years, the growth in earning assets was financed largely through interest-bearing liabilities. In 1981 these sources of funds supported 90.6 per cent of earning assets, compared with 90.2 per cent in 1980. The major components of interest-bearing liabilities have been foreign time deposits, short-term borrowings, and commercial certificates of deposit.

(\$ in millions)	1981		1981	1980
	Average balance	Average interest rate	Average balance as a percentage of average earning assets	
Time deposits in foreign offices	\$12,814	15.1%	34.5%	35.7%
Short-term borrowings:				
Federal funds purchased and securities sold under repurchase agreements	\$ 8,557	16.4%	23.0%	23.9%
Commercial paper	958	16.8	2.6	2.3
Other short-term borrowings	1,507	12.8	4.1	3.6
Total short-term borrowings	\$11,022	15.9%	29.7%	29.8%
Commercial certificates of deposit	\$ 6,431	16.1%	17.3%	14.9%

In 1981 average foreign time deposits increased \$1 billion or 8.7 per cent from 1980, while short-term borrowings were up 11.8 per cent from last year's \$9.8 billion average. Commercial certificates of deposit averaged \$6.4 billion, an increase of 31.2 per cent over 1980.

Demand deposits declined slightly in 1981, reflecting more sophisticated client cash-management techniques and the October adoption of same-day settlement procedures for interbank settlements made through the Clearinghouse Interbank Payment System (CHIPS). Domestic demand deposits averaged \$4.2 billion in 1981, down 0.5 per cent from last year, while demand deposits in foreign offices declined 5.0 per cent, averaging \$1.3 billion.

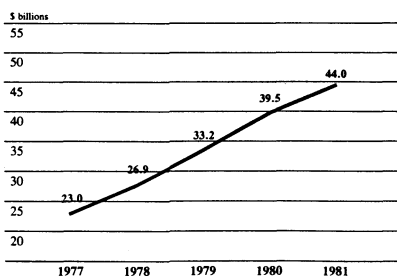
Savings deposits also declined slightly in 1981, as higher rates available elsewhere continued to attract consumer funds. Savings deposits averaged \$1.2 billion, down 0.5 per cent from 1980. Savings deposits funded 3.3 per cent of average earning assets in 1981, down from 3.8 per cent in 1980.

Stockholders' equity averaged \$1.6 billion in 1981, a 12.0 per cent increase from 1980, and was 3.64 per cent of total assets at year-end. Leverage (average total assets/average equity) decreased slightly to 27.2x in 1981 from 27.4x in 1980.

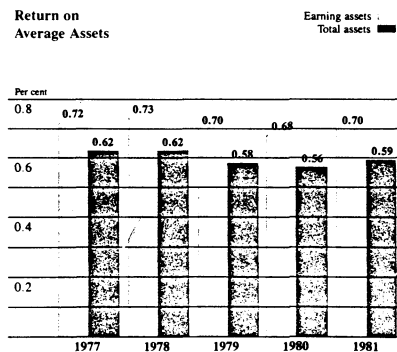
Earnings retention was the primary source of equity growth in 1981. The internal funding rate—which measures the growth in equity generated by earnings after dividends to stockholders—was 11.4 per cent in 1981, compared with 10.9 per cent last year. Stockholders received 28.88 per cent of 1981 income before security transactions in the form of dividends, while in 1980 the dividend pay-out ratio was 29.78 per cent.

At December 31, 1981, there were no plans for capital expenditures or other commitments that depend on additional equity for financing. The need for additional equity for any purpose is monitored through a continuous planning and review program which takes into account asset growth, dividend policy, and internal funding, as well as general economic conditions.

Average Total Assets



Return on Average Assets



The following table shows a two-year comparison of Continental's quarterly stock quotations and dividends declared.

	High	Low	Cash dividends declared
1981			
First	\$36½	\$30%	\$0.45
Second	42%	33%	0.45
Third	40½	34%	0.50
Fourth	39%	32½	0.50
<i>Total</i>			\$1.90
1980			
First	\$29½	\$21½	\$0.40
Second	30%	25%	0.40
Third	31½	27%	0.45
Fourth	32%	27%	0.45
<i>Total</i>			\$1.70

Although Continental defines its capital base as stockholders' equity, other definitions have broadened the concept to include long-term debt. Long-term obligations include notes, mortgage notes, and a capitalized lease (see Note 8 to the financial statements).

During 1981 two debt offerings were made: one domestic, the other foreign. Both offerings included warrants which, if exercised, would result in an additional \$400 million (par amount) of debt outstanding.

At December 31, 1981, long-term debt represented 33.5 per cent of capital as measured in the broader definition—equity plus debt. This ratio, which has shown little change over the past few years, was 30.7 per cent at year-end 1980. Between December 31, 1979, and December 31, 1981, net long-term debt increased by \$332.7 million, while stockholders' equity grew by \$347.7 million.

Liquidity, Interest Rate Sensitivity Policies to Meet Earnings Goals

Liquidity management policies are designed to provide a continuing flow of funds to meet the financial commitments of the Corporation and the needs of its customers. In the ordinary course of business, cash flows are generated from interest and fee income, as well as from loan repayments and the maturity or sale of other earning assets, providing varying amounts of the liquidity needed.

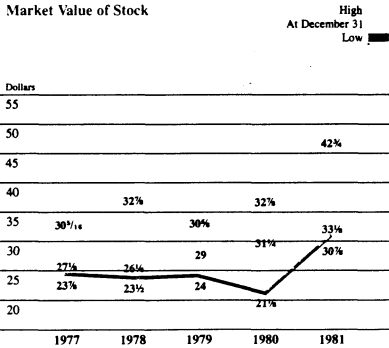
The most important sources of liquidity are the acquisition of new deposits and borrowings and the rollover of maturing deposits and borrowings. Domestically, the Corporation has relied on Federal funds purchased, securities sold under repurchase agreements, commercial paper, and commercial certificates of deposit as major liquidity sources. Time deposits in foreign offices have been the primary source of funds from outside the United States. Longer-term funds have been provided by a variety of debt instruments, including two innovative \$100 million long-term note issues with warrants in 1981.

Continental employs the funds acquired to finance the expansion of its earning asset base, which has largely centered in loan growth during the past three years. In 1981 average loans increased \$4.3 billion.

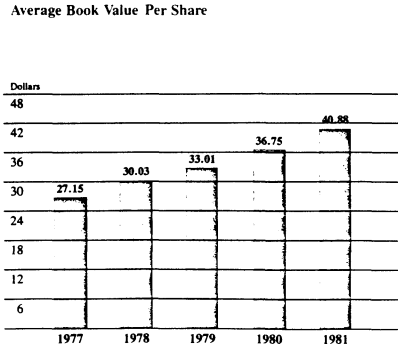
Interest rate sensitivity management, which involves the lengthening and shortening of maturity schedules of assets and liabilities in anticipation of interest rate cycles, is closely related to liquidity management.

One of management's goals is to generate net interest income growth through all interest rate cycles by managing the relationship between rate-sensitive assets and liabilities. Allowance must be made in this process, however, for asset and liability levels which may be determined by market demands, business constraints, regulatory restrictions,

Market Value of Stock



Average Book Value Per Share



long-term marketing programs, or other factors beyond management's immediate control.

As improved management information systems have developed, the process of measuring interest rate sensitivity has been enhanced. Close monitoring of the interest rate sensitivity of assets and liabilities is essential not only because Continental uses money market borrowings as a major funding source, but also because of the variety of assets and pricing alternatives which these funds support.

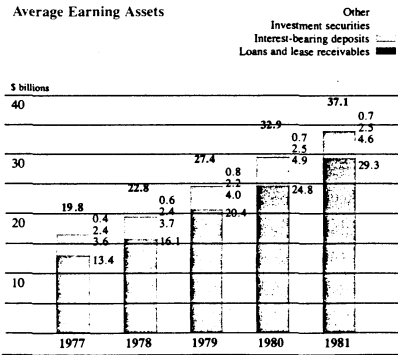
The following table provides a breakdown at December 31, 1981, of assets and liabilities according to their sensi-

tivity to interest rate changes. These data are as of one day, and significant swings can occur daily in the sensitivity relationships.

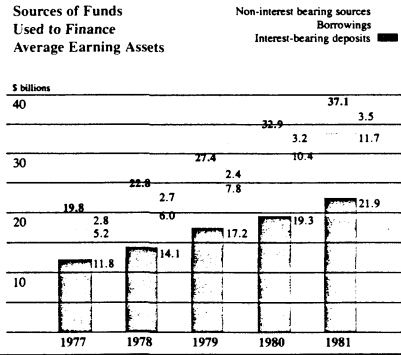
The interest-sensitive structure below reflects both market forces and Continental's management of rate sensitivity. Interest-sensitive gaps within specific time frames may be established to capitalize on anticipated interest rate shifts within these periods. Continental's access to a variety of funding sources, in addition to its various asset pricing structures, enables it to manage these rate-sensitive gaps effectively.

(\$ in millions)	0-30 days	31-90 days	91-180 days	181-365 days	Over 1 year	Total
Earning assets:						
Domestic loans	\$11,180	\$4,932	\$ 503	\$ 423	\$4,983	\$22,021
Foreign loans	4,421	2,745	2,078	377	412	10,033
Interest-bearing deposits	1,493	1,833	1,551	181	25	5,083
All other	756	58	101	167	2,487	3,569
Total	\$17,850	\$9,568	\$ 4,233	\$ 1,148	\$7,907	\$40,706
% of earning assets	43.9%	23.5%	10.4%	2.8%	19.4%	100.0%
Interest-bearing liabilities:						
Short-term borrowings	\$ 9,641	\$ 605	\$ 304	\$ 372	\$ 91	\$11,013
Commercial CDs	2,496	3,306	1,232	169	47	7,250
Time deposits in foreign offices	6,610	3,655	3,108	512	246	14,131
All other	1,360	519	583	182	1,093	3,737
Total	\$20,107	\$8,085	\$ 5,227	\$ 1,235	\$1,447	\$36,131
% of interest-bearing liabilities	55.6%	22.4%	14.5%	3.4%	4.1%	100.0%
Interest-sensitive gap	\$(2,257)	\$1,483	\$(994)	\$(87)	\$6,430	\$ 4,575

Average Earning Assets



Sources of Funds Used to Finance Average Earning Assets



(\$ in millions)	Maturing			Total
	Within one year	Over one year but within five	After five years	
Loans with predetermined interest rates	\$ 5,672	\$ 2,332	\$ 1,357	\$ 9,361
Loans with floating interest rates	9,621	7,562	3,130	20,313
Total	\$15,293	\$9,894	\$4,487	\$29,674

As shown in the table above, at year-end 1981, 68.4 per cent of all loans outstanding (excluding consumer loans and loans secured by 1-4-family residential properties) had floating interest rates. Among loans maturing between one and five years, 76.4 per cent had floating rates, while 69.7 per cent of loans maturing in more than five years were in this category. Floating rate loans enable Continental to avoid locking in disadvantageous interest rates when extending credit, especially over long periods of time.

The following table presents the maturity distribution of time certificates of deposit of \$100,000 or more issued by the Bank's domestic office:

(\$ in millions)	December 31	
	1981	1980
3 months or less	\$5,527	\$4,211
Over 3 through 6 months	2,047	1,795
Over 6 through 12 months	257	258
Over 12 months	56	59
Total	\$7,887	\$6,323

Non-Bank Subsidiaries

Total assets of the consolidated non-bank subsidiaries were 3.5 per cent of total corporate assets at December 31, 1981.

compared with 4.1 per cent at the previous year-end.

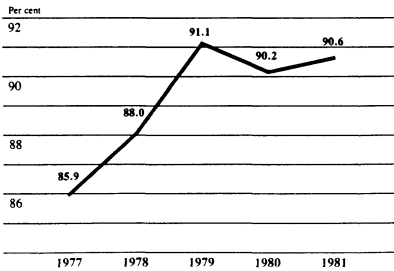
The decline resulted from the transfer of ownership of the Canadian subsidiary from the Corporation to the Bank in July 1981. This subsidiary became a full-service bank in 1981 as a result of a recent change in the Canadian banking laws.

A summarized statement of condition for non-bank subsidiaries follows:

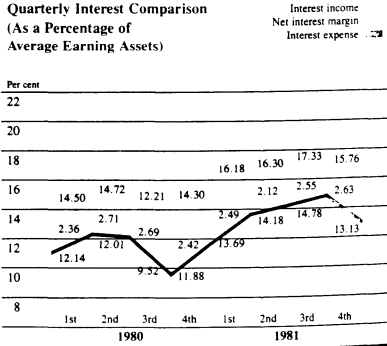
Combined Statement of Condition (\$ in millions)	December 31 1981	
Assets		
Interest-bearing deposits	\$ 190	\$ 311
Investment securities	112	57
Loans:		
To Parent Company*	246	147
Other	456	793
Lease financing receivables	732	410
Total loans and leases	1,434	1,350
Less: Unearned income	188	82
Reserve for credit losses	19	18
Net loans and leases	1,227	1,250
All other assets	138	123
Total assets	\$1,667	\$1,741
Liabilities		
Deposits	\$ 386	\$ 528
Advances from Parent Company*	660	388
Short-term borrowings	10	349
Other liabilities	154	137
Bonds, mortgages, and similar debt	261	176
Total liabilities	1,471	1,578
Capital	196	163
Total liabilities and capital	\$1,667	\$1,741

*Eliminated in consolidation.

Interest-Bearing Liabilities
(As a Percentage of Average Earning Assets)



Quarterly Interest Comparison
(As a Percentage of Average Earning Assets)



As a group, non-bank subsidiaries made their largest contribution to consolidated earnings in 1981, and have been profitable in each of the last five years. A significant part of 1981 earnings was generated from gains on the sale of equity investments which amounted to \$39.8 million pre-tax, compared with pre-tax gains of \$6.7 million in 1980. Sales of equity investments are recurring, normal transactions, although the amounts vary from year to year.

A condensed statement of income follows:

Combined Statement of Income Year ended December 31 (\$ in millions)	1981	1980
Interest income	\$248	\$203
Interest expense	208	176
Net interest income	40	27
Provision for credit losses	3	2
Other operating income	43	10
Other operating expense	23	22
Income before income taxes	57	13
Applicable income taxes	15	(1)
Income before security gains or losses	42	14
Security gains (losses)—after taxes	(1)	*
Net income	\$ 41	\$ 14

*Less than \$1 million.

Fourth Quarter Summary of Operations

During the fourth quarter of 1981, lending business advanced, with relatively strong loan demand further stimulated by declining interest rates. On three occasions in the fourth quarter, Continental Bank led the banking industry in reducing its prime rate, as economic activity slowed and inflation eased.

Fourth quarter income before security transactions totaled \$72.8 million, compared with \$53.6 million in 1980. The higher earnings reflect gains in both net interest income and other operating income, partially offset by increased other operating expense.

Losses on the sale of investment securities were \$2.3 million, compared with losses of \$807,000 in 1980, and brought net income to \$70.5 million, compared with \$52.8 million in last year's fourth quarter.

Net interest income on a taxable equivalent basis totaled \$266.6 million, an increase of 27.2 per cent from the fourth quarter of 1980. This increase in net interest income can be attributed to a higher volume of earning assets, coupled with a wider net interest margin. A comparative analysis of fourth quarter net interest income may be found on page 54.

Other operating income rose 16.5 per cent from the fourth quarter of 1980, as increases in trust, security trading, and fee income were partially offset by declines in foreign exchange profits and income from all other sources.

Other Operating Income (\$ in millions)	Fourth Quarter	
	1981	1980
Trust income	\$14.6	\$11.5
Security trading profits and commissions	22.4	(0.8)
Foreign exchange profits:		
Trading operations	4.2	11.1
Translation gains (losses) net	(5.8)	2.5
Fee income:		
Domestic	24.3	21.6
Foreign	20.3	15.1
Gains on sales of equity investments	3.3	6.1
All other income	0.8	5.1
Total	\$84.1	\$72.2

Other operating expense was up \$27.2 million, with employee-related expenses accounting for \$13.5 million of the total increase. Net occupancy expense was up \$3.9 million, while equipment and other expenses increased by \$9.8 million.

The provision for credit losses was \$35 million, compared with \$27 million a year earlier. Net credit losses in the period of \$19.8 million compare with last year's losses of \$18.8 million.

Income taxes of \$44.1 million rose \$12.7 million from the fourth quarter of 1980. Higher taxes reflect a 37.5 per cent increase in pre-tax income, as well as adjustments made during the quarter to bring the provision for taxes into line with the year's results. Complete quarterly income statements may be found on page 53.

Supplemental Information on the Effects of Inflation

The influence of inflation on business results and financial statements has become a subject of increasing interest as inflation itself has increased. The financial information throughout this Report has been prepared on the traditional historical-cost basis, in keeping with generally accepted accounting principles, and thus does not attempt to reflect changes in the purchasing power of the dollar over the years.

Inflation-adjusted accounting is still an experimental approach, and how it relates to banking industry performance is still in question, but the following supplemental discussion may help provide some insight on inflation's effects on business enterprise, based on two different methods of illustration.

The first is *Constant Dollar Accounting*, which measures the effects of "general inflation" by applying a uniform index, the average Consumer Price Index (CPI), to corporate financial statements. Under this method, assets and the related depreciation expense are indexed based upon acquisition dates, and their amounts are restated in terms of the purchasing power of 1981 dollars. This method assumes that the CPI is a representative index of the overall level of inflation in the economy. Since this

index is consumer oriented, however (i.e., composed of the prices of food, clothing, housing, and so forth), it is not directly applicable to a corporation's financial statements.

The second method, *Current Cost Accounting*, adjusts financial statements to reflect the changes in "specific prices" of assets. With the exception of internally developed data applicable to computer equipment, all specific changes are measured using various indexes developed by the U.S. Departments of Commerce and Labor. Since this method allows a different index to be used to adjust buildings than the index used to adjust office equipment, the valuation of assets under the current cost approach provides a finer estimate than under the constant dollar approach.

Depreciation Adjustment

During periods of inflation, the value of capital assets generally will rise. However, under historical-cost financial statements, depreciation currently charged to operations reflects an allocation of the acquisition cost, not the anticipated cost of replacing those assets at future inflated prices. To provide a more realistic presentation of income and cash-flow requirements, one aspect of inflation-adjusted statements entails restating reported results to give effect to changing prices of assets.

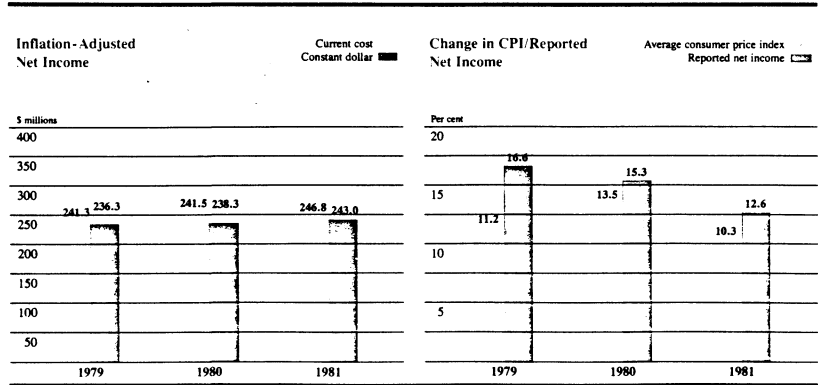
Depreciation expense for 1981 was \$35 million as recorded in the primary financial statements. As shown below, depreciation under the constant dollar and current cost bases has been increased by \$12 million and \$8 million, respectively. Since there is no tax benefit for the ultimate increased cost of replacing a corporation's capital

assets, these adjustments are carried through to net income without any change in income taxes. Absorbing this increased cost through after-tax earnings results in an effective tax rate of 33.2 per cent under constant dollar and 32.9 per cent under current cost, compared with the reported 1981 rate of 32.2 per cent.

Net Monetary Loss

One final result of inflation is the purchasing power loss derived from the holding of assets fixed in their currency value (monetary assets). Theoretically, the "value" of monetary assets declines with inflation, while that of other assets does not. Considerable controversy still exists about the application of this concept, particularly for banks, since much of the theory pertains to industrial firms. Being a net holder of monetary assets does not adversely affect the Corporation or the banking industry. Continental generates earnings and pays dividends by making loans, which are, of course, monetary assets. Holding monetary assets in the form of cash is essential to the banking industry's operation. For the Corporation, the loss from holding net monetary assets was \$95 million for 1981. The calculation of the loss ignores the fact that the majority of the Corporation's loans are issued with floating interest rates, which serve as a partial hedge against a purchasing power decline.

A better measure of a bank's ability to deal with inflationary trends encompasses a review of the maintenance of its net interest margins, the rate sensitivity and maturity of its portfolio, and its funding strategy in anticipation of rate changes. Management believes that referencing these topics covered in the historical-cost analysis will provide further insight on the subject.



Three-Year Analysis

The following table presents a comparison of selected financial data for the past three years adjusted for inflation according to the two methods discussed previously.

Prior years' data have been indexed forward by the CPI to state these amounts in terms of the purchasing power of 1981 dollars. This procedure eliminates the effect of inflation and allows comparison with prior years' data to reflect real growth or decline during the period.

In addition, depreciation expense has been adjusted to reflect the changing value of physical assets, as measured by general and specific price indexes. These depreciation adjustments, along with the decline in the value of net monetary assets and the increase in the value of property and equipment, are reflected in the table's net asset figures.

The table indicates that the Corporation's net income in 1981 increased over net income in 1979 and 1980 under both current cost and constant dollar methods.

(\$ in millions, except per-share data)	Average 1981 Dollars					
	Adjusted for changes in specific prices (current cost)			Adjusted for changes in general inflation (constant dollar)		
	1981	1980	1979	1981	1980	1979
Net interest and other operating income	\$ 1,008	\$ 969	\$ 892	\$ 1,008	\$ 969	\$ 892
Depreciation and amortization expense	43	42	37	47	45	42
Other operating expense	588	582	549	588	582	549
Total other operating expense	631	624	586	635	627	591
Income before income taxes and security gains or losses	377	345	305	373	342	300
Applicable income taxes	124	106	66	124	106	66
Income before security gains or losses	253	239	239	249	236	234
Net gains or (losses) on security transactions after related income taxes	(6)	2	2	(6)	2	2
Net income	\$ 247	\$ 241	\$ 241	\$ 243	\$ 238	\$ 236
Per-Share Data						
Income before security gains or losses	\$ 6.38	\$ 6.10	\$ 6.10	\$ 6.29	\$ 6.02	\$ 5.98
Net income	6.24	6.15	6.15	6.14	6.07	6.03
Loss on holding net monetary assets	\$ 95	\$ 127	\$ 139	\$ 95	\$ 127	\$ 139
Net assets (stockholders' equity) at year-end	\$ 1,790	\$ 1,741	\$ 1,715	\$ 1,780	\$ 1,723	\$ 1,706
Increase in specific values of properties and equipment held during the year	\$29,585	\$62,713	\$ 21,436			
Effect of increase in general price level	34,513	44,767	44,923			
Effect of increase in specific prices at a rate over (below) increase in the general price level	\$(4,928)	\$17,946	\$(23,487)			

Notes:

- At December 31, 1981, the current cost amount of property and equipment was \$432,663,000.
- Inflation-adjusted depreciation has been calculated based upon the same methods and estimated useful lives used in historical-cost financial statements.

Five-Year Analysis

To gain further perspective, an extended five-year analysis of selected financial data is presented. The upward trend in net interest and other operating income indicates growth at

a rate greater than the general inflation rate in each of the last five years. The table also shows that by periodically increasing dividends, the Corporation has allowed the stockholders to keep pace with inflation.

(\$ in millions, except per-share data)	1981	1980	1979	1978	1977
Net interest income after provision for credit losses	\$ 686	\$ 700	\$ 632	\$ 620	\$ 581
Other operating income	322	269	260	232	209
Net interest and other operating income	\$1,008	\$ 969	\$ 892	\$ 852	\$ 790
Per-Share Data					
Cash dividends declared	\$ 1.90	\$ 1.87	\$ 1.90	\$ 1.92	\$ 1.89
Market price at year-end	32 ¹ / ₁₆	32 ¹³ / ₁₆	34 ³ / ₈	35 ¹ / ₁₆	39 ¹¹ / ₁₆
Average Consumer Price Index (1967=100)	272.4	246.8	217.4	195.4	181.5

Consolidated Statement of Condition
Continental Illinois Corporation and Subsidiaries

December 31 (\$ in thousands)	1981	1980
Assets		
Cash and due from depository institutions:		
Cash and non-interest-bearing deposits	\$ 2,513,080	\$ 4,361,504
Interest-bearing deposits	5,082,703	4,294,045
Investment securities:		
Market value: 1981—\$1,903,941, 1980—\$2,324,409	2,169,303	2,505,924
Trading account securities	169,164	128,065
Other short-term investments	499,817	417,207
Loans	32,175,497	26,909,698
Lease financing receivables	1,123,729	720,003
<i>Total loans and lease receivables</i>	<i>33,299,226</i>	<i>27,629,701</i>
Less: Unearned income	423,000	262,663
Reserve for credit losses	289,169	246,413
<i>Net loans and lease receivables</i>	<i>32,587,057</i>	<i>27,120,625</i>
Properties and equipment	298,715	276,479
Customers' liability on acceptances	2,469,917	1,898,071
Interest receivable	832,686	665,775
Other assets	349,313	421,713
<i>Total assets</i>	<i>\$46,971,755</i>	<i>\$42,089,408</i>
Liabilities		
Deposits:		
Domestic—Demand	\$ 4,838,568	\$ 5,230,741
Time	10,124,535	8,348,583
Deposits in foreign offices	14,630,902	13,734,343
<i>Total deposits</i>	<i>29,594,005</i>	<i>27,313,667</i>
Short-term borrowings	11,013,222	9,564,947
Acceptances outstanding	2,477,137	1,898,816
Other liabilities	1,314,402	1,110,719
Bonds, mortgages, and similar debt	862,297	676,317
<i>Total liabilities</i>	<i>45,261,063</i>	<i>40,564,466</i>
Stockholders' Equity		
Preferred stock—without par value:		
Authorized: 10,000,000 shares, none issued		
Common stock—\$5 par value:		
Authorized: 80,000,000 shares both years		
Issued and outstanding: 1981—39,601,775 shares		
1980—39,337,925 shares	198,009	196,690
Capital surplus	522,812	517,824
Retained earnings	989,871	810,428
<i>Total stockholders' equity</i>	<i>1,710,692</i>	<i>1,524,942</i>
<i>Total liabilities and stockholders' equity</i>	<i>\$46,971,755</i>	<i>\$42,089,408</i>

Commitments and contingent liabilities (Notes 9 and 10).
See notes to financial statements.

Consolidated Statement of Income

Continental Illinois Corporation and Subsidiaries

Year ended December 31 (\$ in thousands)	1981	1980	1979
Interest and fees on loans	\$4,796,322	\$3,448,973	\$2,437,870
Lease financing income	90,327	65,838	39,190
Interest on deposits with banks	747,149	658,355	455,931
Interest and dividends on investment securities:			
Taxable income	148,910	133,215	75,955
Income exempt from Federal income taxes	64,194	70,951	77,568
Trading account interest	34,032	29,307	19,510
Interest on short-term investments	83,281	65,874	62,103
Total interest income	5,964,215	4,472,513	3,168,127
Interest on deposits	3,316,677	2,397,443	1,739,743
Interest on short-term borrowings	1,760,764	1,279,679	806,611
Interest on bonds, mortgages, and similar debt	80,993	65,097	47,920
Total interest expense	5,158,434	3,742,219	2,594,274
Net interest income	805,781	730,294	573,853
Provision for credit losses	120,000	96,000	70,000
Net interest income after provision for credit losses	685,781	634,294	503,853
Trust income	53,600	44,809	37,434
Security trading profits and commissions	27,888	6,122	15,730
Foreign exchange profits	31,155	32,284	12,583
All other income	209,764	160,422	141,983
Total other operating income	322,407	243,637	207,730
Net interest and other operating income	1,008,188	877,931	711,583
Salaries and wages	265,614	227,758	199,501
Pension, profit sharing, and other employee benefits	74,877	61,473	51,187
Net occupancy expense	65,747	53,314	41,401
Equipment rentals, depreciation, and maintenance	36,857	36,801	27,549
Other expense	180,759	178,874	144,894
Total other operating expense	623,854	558,220	464,532
Income before income taxes and security gains or losses	384,334	319,711	247,051
Applicable income taxes	124,019	95,568	52,925
Income before security gains or losses	260,315	224,143	194,126
Security gains or (losses) less applicable income taxes of \$(5,392), \$1,433, and \$1,689, respectively	(5,692)	1,798	1,681
Net income	\$ 254,623	\$ 225,941	\$ 195,807
Income per common share:			
Income before security gains or losses	\$ 6.58	\$ 5.70	\$ 4.95
Net income	\$ 6.44	\$ 5.75	\$ 4.99
Dividends declared per common share	\$ 1.90	\$ 1.70	\$ 1.52
Average shares outstanding (in thousands)	39,537	39,256	39,195

See notes to financial statements.

Year ended December 31 (\$ in thousands)	1981	1980	1979
Financial Resources Were Provided By:			
Net income	\$ 254,623	\$ 225,941	\$ 195,807
Non-cash charges included in net income:			
Provision for credit losses	120,000	96,000	70,000
Provision for depreciation and amortization	35,797	32,165	26,294
Deferred income taxes	20,079	22,825	19,603
<i>Financial resources provided by operations</i>	430,499	376,931	311,704
Other sources:			
Increases in:			
Deposits	2,280,338	3,306,467	2,846,950
Short-term borrowings	1,448,275	1,798,126	1,130,346
Bonds, mortgages, and similar debt, net	189,803	146,785	79,075
Decreases in:			
Cash and due from depository institutions	1,059,766	—	421,866
Other short-term investments	—	—	53,417
Investment and trading securities	295,522	—	—
Other resources, net	87,841	—	267,403
Issuance of common stock under stock option plans	6,307	2,870	959
<i>Total</i>	\$5,798,351	\$5,631,179	\$5,111,720
Financial Resources Were Used For:			
Increases in:			
Cash and due from depository institutions	\$ —	\$ 1,253,593	\$ —
Other short-term investments	82,610	109,033	—
Investment and trading securities	—	218,548	126,712
Net loans and lease receivables	5,586,432	3,852,799	4,870,442
Properties and equipment	56,228	80,327	56,565
Other resources, net	—	52,122	—
Cash dividends paid	73,081	64,757	58,001
<i>Total</i>	\$5,798,351	\$5,631,179	\$5,111,720

See notes to financial statements.

Consolidated Statement of Changes in Stockholders' Equity

Continental Illinois Corporation and Subsidiaries

Year ended December 31 (\$ in thousands)	1981	1980	1979
Common Stock			
Balance at beginning of year	\$ 196,690	\$ 196,095	\$ 195,839
Shares issued under stock option plans: 263,850 shares in 1981, 118,985 shares in 1980, and 51,215 shares in 1979	1,319	595	256
<i>Balance at end of year</i>	198,009	196,690	196,095
Capital Surplus			
Balance at beginning of year	517,824	510,349	508,646
Proceeds received over par value of shares issued under stock option plans	4,988	2,275	703
Transfer from retained earnings	—	5,200	1,000
<i>Balance at end of year</i>	522,812	517,824	510,349
Retained Earnings			
Balance at beginning of year	810,428	656,458	521,239
Net income for year	254,623	225,941	195,807
Cash dividends declared: \$1.90 per share in 1981, \$1.70 per share in 1980, and \$1.52 per share in 1979	(75,180)	(66,771)	(59,588)
Transfer to capital surplus	—	(5,200)	(1,000)
<i>Balance at end of year</i>	989,871	810,428	656,458
<i>Total stockholders' equity at end of year</i>	\$1,710,692	\$1,524,942	\$1,362,902

See notes to financial statements.

Trust Company of Chicago and Subsidiaries

December 31 (\$ in thousands)	1981	1980
Assets		
Cash and due from depository institutions:		
Cash and non-interest-bearing deposits	\$ 2,512,215	\$ 4,358,860
Interest-bearing deposits	4,985,297	4,016,237
Investment securities:		
Market value: 1981—\$1,670,021, 1980—\$2,097,859	1,947,710	2,333,649
Trading account securities	137,313	115,081
Other short-term investments	499,817	417,207
Loans	31,285,051	25,937,864
Lease financing receivables	391,798	310,156
<i>Total loans and lease receivables</i>	<i>31,676,849</i>	<i>26,248,020</i>
Less: Unearned income	233,127	172,135
Reserve for credit losses	265,280	224,788
<i>Net loans and lease receivables</i>	<i>31,178,442</i>	<i>25,851,097</i>
Properties and equipment	232,921	208,114
Customers' liability on acceptances	2,469,917	1,898,071
Interest receivable	807,717	643,919
Other assets	316,962	391,947
<i>Total assets</i>	<i>\$45,088,311</i>	<i>\$40,234,182</i>
Liabilities		
Deposits:		
Domestic—Demand	\$ 4,842,116	\$ 5,236,866
Time	10,132,941	8,353,673
Deposits in foreign offices	14,884,706	13,496,667
<i>Total deposits</i>	<i>29,859,763</i>	<i>27,087,206</i>
Short-term borrowings	9,786,597	8,719,859
Acceptances outstanding	2,477,137	1,898,816
Other liabilities	1,172,070	971,716
Bonds, mortgages, and similar debt	16,989	12,641
<i>Total liabilities</i>	<i>43,312,556</i>	<i>38,690,238</i>
Capital		
Common stock—\$10 par value:		
Authorized, issued and outstanding:		
20,000,000 shares both years	200,000	200,000
Surplus	550,000	550,000
Undivided profits	1,025,755	793,944
<i>Total capital</i>	<i>1,775,755</i>	<i>1,543,944</i>
<i>Total liabilities and capital</i>	<i>\$45,088,311</i>	<i>\$40,234,182</i>

Commitments and contingent liabilities (Notes 9 and 10).

See notes to financial statements.

Member Federal Deposit Insurance Corporation.

Note 1—Summary of Significant Accounting Policies: The accounting principles followed by Continental Illinois Corporation (the Corporation), Continental Illinois National Bank and Trust Company of Chicago (the Bank), and other subsidiaries, and the method of applying these principles, conform with generally accepted accounting principles and with general practice within the banking industry where applicable. Those principles materially affecting the determination of financial position, changes in financial position, or results of operations are summarized below.

Basis of Presentation: The Corporation's consolidated financial statements include the accounts of the Parent Company and all wholly-owned subsidiaries. The Bank's consolidation policy parallels that of the Corporation. Material intercompany accounts and transactions are eliminated.

Equity investments, principally foreign investments, representing less than 50% ownership are carried at cost, since the Corporation's management does not control or significantly influence the operation of any such affiliate. Income from such investments is recognized only as cash dividends are received.

Gains and losses on disposition of affiliates and other equity investments are included in all other income.

Included in other assets in the Corporation's consolidated financial statements is goodwill resulting from the acquisition of two foreign units, which is amortized over a 40-year period.

Income per share of common stock is computed using the weighted average number of shares of the Corporation's common stock outstanding. Dividends declared per share of common stock are based on the number of shares of common stock outstanding at the record date of the dividend.

Foreign Operations: Foreign operations include the activities of the International Banking Department and the International Banking Facility in Chicago, foreign branches, Edge Act subsidiaries, and foreign subsidiaries of the Bank and Corporation.

Securities: Investment securities are stated at cost, adjusted for amortization of premiums and accretion of discounts. Net gains or losses on the sale of investment securities other than equity investments are determined by using the average cost and are shown separately in the Consolidated Statement of Income as security gains or losses. Equity securities held for investment are discussed above under Basis of Presentation.

Trading account securities are carried at market in the statements of condition. The trading account inventory is maintained primarily in connection with the Bank's operations as a primary dealer in U.S. Government and state, county, and municipal debt obligations, buying and selling for its own account.

Purchases and sales of trading account securities are considered to be a normal part of operations. Trading account securities are valued to market monthly, and these adjustments along with the results of normal day-to-day transactions are included in security trading profits and commissions.

Transfers of securities are not permitted between the trading account and the investment portfolio.

Loans: Loans are stated at principal outstanding with interest income accrued daily as earned. It is the policy of the Corporation to stop accruing income and to place the recognition of interest on a cash basis under the following delinquency situations: when a domestic commercial loan remains unpaid 30 days past its final maturity—60 days for foreign loans and 180 days for government-guaranteed loans—unless the delay in payment is deemed by loan administration authority not to be an indication of uncollectibility. Loans with interest or principal installments past due for similar periods are reviewed and placed on a cash basis at the direction of loan administration. Once placed on a cash basis, interest receivable which had been previously credited to income is reversed, with the effect of the reversal reflected in the current reporting period. Reversals of interest and charge offs of consumer installment loans are made on a systematic basis, related to delinquency criteria of 120 to 180 days.

Lease Financing: The Bank and certain of the Corporation's non-bank subsidiaries have entered into equipment leasing contracts under a variety of leasing arrangements with various lessees. Lease income is recorded in decreasing amounts over the term of the contract, resulting in a level rate of return on the net investment in the lease.

Reserve for Credit Losses: For financial reporting purposes, the provision for credit losses is based upon a credit review of the loan and lease financing receivables portfolio, past credit loss experience, current economic conditions, and other pertinent factors which form a basis for determining the adequacy of the reserve for credit losses. For tax purposes, the general policy is to provide additions to the reserve for credit losses in accordance with maximum amounts allowed under applicable tax laws.

Foreign Exchange: Foreign exchange profits include gains or losses resulting from trading activities and from translating foreign assets and liabilities and related hedge contracts.

Properties and Equipment: Properties and equipment are stated at cost, less allowances for depreciation and amortization. Provisions for depreciation and amortization included in other operating expense are computed on the straight-line method for properties and on an accelerated method for equipment.

Income Taxes: For purposes of financial reporting, certain items of income or expense are recognized in time periods different from those for computing taxable income, thus giving rise to deferred income taxes.

Investment tax credits relating to properties and equipment purchased for the Corporation's own use are included in net income in the year of acquisition (flow-through method). Investment tax credits relating to assets owned by the Corporation and leased to others are amortized over the term of the lease and are included in lease financing income. The Corporation and its U.S. incorporated subsidiaries file a consolidated Federal income tax return, with each unit recognizing and remitting to the Corporation its share of the tax liability, except that tax benefits of losses and tax credits are allocated to the unit incurring such losses and credits to the extent they reduce taxes payable.

Pension Plan: The Corporation and certain of its subsidiaries have a non-contributory pension plan covering substantially all full-time employees.

The Corporation's policy is to fund accrued pension costs. Actuarially-computed contributions under the plan are based on the unit credit method, which includes the amortization of prior service costs over a period of 30 years and gives recognition to market value of the assets in the pension fund.

Note 2—Pledged Assets:

At December 31, 1981, assets stated at \$1,357,804,000 were pledged to secure government, public, and trust deposits as required by law; at December 31, 1980, the corresponding amount was \$1,508,212,000.

Note 3—Investment Securities:

Book and approximate market value of investment securities are shown below (\$ in thousands):

December 31	1981	1980
Book Value		
U.S. Treasury and Federal agency securities	\$ 859,211	\$1,151,119
State, county, and municipal securities	911,121	1,008,096
Other securities*	398,971	346,709
Total	\$2,169,303	\$2,505,924
Market Value		
U.S. Treasury and Federal agency securities	\$ 740,956	\$1,048,733
State, county, and municipal securities*	761,124	888,580
Other securities	401,861	387,096
Total	\$1,903,941	\$2,324,409

*State, county, and municipal securities of any single issuer were less than 10% of stockholders' equity at both reporting dates.

Note 4—Loans and Lease Financing Receivables:
The following schedule presents loans and lease financing receivables by type (\$ in millions):

December 31	1981	1980
Loans:		
Domestic:		
Commercial and industrial loans	\$12,862	\$ 9,845
Mortgage and real estate loans	3,957	3,530
Loans to financial institutions*	2,633	2,451
Loans for purchasing or carrying securities	212	379
Consumer installment loans	1,588	1,459
All other loans	878	864
Total domestic	22,130	18,528
Foreign	10,046	8,382
Total loans	32,176	26,910
Less: Unearned income	122	126
Loans (net of unearned income)	32,054	26,784
Lease financing receivables (net of unearned income):		
Direct financing lease receivables	673	488
Leveraged lease receivables	149	95
Total lease financing receivables	822	583
Total loans and lease financing receivables (net of unearned income)	32,876	27,367
Less: Reserve for credit losses	289	246
Net loans and lease financing receivables	\$32,587	\$27,121

*Includes loans to real estate investment trusts.

During the period 1979 to 1981 loans exceeding \$500,000 were outstanding to three non-officer directors. These loans were made on substantially the same terms as those prevailing at the time for comparable transactions with other persons and did not involve more than the normal risk of collectibility or present other unfavorable features. Information with respect to these loans is presented below (\$ in thousands):

	1981	1980	1979
Balance at January 1	\$1,416	\$2,642	\$2,516
Additions	512	363	162
Collections	213	1,589	36
Balance at December 31	\$1,715	\$1,416	\$2,642

Note 5—Reserve for Credit Losses:

Presented below is a reconciliation of the reserve for credit losses that is available for loan and lease loss charges (\$ in thousands):

	1981	1980	1979
Continental Illinois Corporation and Subsidiaries			
Balance at January 1	\$246,413	\$212,180	\$191,237
Provision charged to operating expense	120,000	96,000	70,000
Recoveries on previous credit losses	21,108	11,904	17,040
Credit losses	(92,273)	(73,321)	(66,108)
Other adjustments	(6,079)	(350)	11
Balance at December 31	\$289,169	\$246,413	\$212,180

A portion of the above reserve has been allocated to foreign operations. A reconciliation of the amounts allocated is shown below (\$ in thousands):

	1981	1980	1979
Foreign Operations			
Balance at January 1	\$60,400	\$42,100	\$40,700
Provision charged to operating expense	16,000	15,300	15,200
Recoveries on previous credit losses	297	3,200	1,000
Credit losses	(8,480)	(1,000)	(14,800)
Other adjustments	(6,079)	800	—
Balance at December 31	\$62,138	\$60,400	\$42,100

Note 6—Properties and Equipment:

The gross book value, accumulated depreciation, and carrying value of properties and equipment are summarized below (\$ in thousands):

December 31	Gross book value	Accumulated depreciation	Carrying value
1981			
Properties (including land of \$46,123)	\$293,416	\$ 76,794	\$216,622
Equipment—furniture	124,740	70,113	54,627
Leasehold improvements	41,808	14,342	27,466
Total	\$459,964	\$161,249	\$298,715
1980			
Properties (including land of \$42,320)	\$264,914	\$ 68,200	\$196,714
Equipment—furniture	109,251	56,191	53,060
Leasehold improvements	42,048	15,343	26,705
Total	\$416,213	\$139,734	\$276,479

Note 7—Short-Term Borrowings:

Short-term borrowings include Federal funds purchased and securities sold under agreements to repurchase, which generally mature within 30 days, and commercial paper, which generally matures within nine months from the date of issuance.

Details of short-term borrowings are shown below (\$ in thousands):

	1981	1980
Federal funds purchased and securities sold under agreements to repurchase:		
Balance at December 31	\$ 7,998,482	\$ 7,360,870
Maximum balance at any month-end	9,149,035	8,675,572
Average interest rate:		
During year*	16.42%	13.30%
At December 31	12.45%	21.31%
Commercial paper:		
Balance at December 31	\$ 1,218,511	\$ 756,061
Maximum balance at any month-end	1,306,962	1,011,980
Average interest rate:		
During year*	16.82%	13.15%
At December 31	13.09%	16.98%
Other borrowings:		
Balance at December 31	\$ 1,796,229	\$ 1,448,016
Maximum balance at any month-end	2,060,034	1,948,308
Average interest rate:		
During year*	12.85%	10.77%
At December 31	12.37%	19.59%
Total short-term borrowings:		
Balance at December 31	\$11,013,222	\$ 9,564,947
Maximum balance at any month-end	11,563,197	10,926,035
Average amount outstanding	11,022,288	9,856,568
Average interest rate:		
During year*	15.97%	12.98%
At December 31	12.50%	20.73%

*Based on annual average balance.

At December 31, 1981, the Parent Company had line-of-credit arrangements with unaffiliated banks for \$381.8 million. Compensating balances were not maintained in support of these arrangements. There were no borrowings under the arrangements at December 31, 1981.

Note 8—Bonds, Mortgages, and Similar Debt:

The following is a listing of the long-term notes, mortgage notes, and a capitalized lease (\$ in thousands):

December 31	1981	1980
Notes due 9/7/84 (14¼%)	\$100,000	\$ —
Notes due 1984-1986 (8¾%)	6,000	6,000
Notes due 11/1/85 (8½%)	100,000	100,000
Notes due 11/1/85 (13¾%)	100,000	—
Notes due 7/1/86 (9¾%)	149,400	149,306
Notes due 5/1/87 (Floating rate)	200,000	200,000
Notes due 9/15/89 (Floating rate)	26,005	31,864
Notes due 3/31/97 (8¾%)	150,000	150,000
Other debt*	30,163	16,777
Less: unamortized discount**	20,804	—
Total long-term notes	840,764	653,947
Mortgage notes payable*	16,131	10,902
Capitalized lease	5,402	11,468
Total	\$862,297	\$676,317

*Long-term borrowings of the Corporation's non-bank subsidiaries not guaranteed by the Parent Company were \$13,354,000 at December 31, 1981, and \$12,229,000 at December 31, 1980.

**Associated with notes issued during 1981.

During September 1981, a wholly-owned subsidiary of the Corporation issued \$100,000,000 of 14¾% notes due in 1984 with warrants exercisable within one year of date of offering of the notes to purchase an aggregate of \$200,000,000 of zero coupon bonds due in 1988. Interest on the notes is payable annually on September 7. The bonds have been priced to yield approximately 14.50% per annum. The notes and bonds are unconditionally guaranteed by the Corporation.

During November 1981, the Corporation issued \$100,000,000 of 13¾% notes due in 1985 with warrants exercisable within one year of date of offering of the notes to purchase an aggregate of \$200,000,000 of zero coupon debentures due in 1989. Interest on the notes is payable semiannually on May 1 and November 1. The debentures have been priced to yield approximately 14.25% per annum.

Interest rates on floating rate notes are determined semi-annually according to formulas based on certain money market rates, as specified in the agreements governing the issues.

Interest on the \$200,000,000 of floating rate notes due in 1987 will be paid at a rate of 15.35% per annum for the period beginning November 1, 1981, and ending April 30, 1982. The average interest rates paid for 1981, 1980, and 1979 were 14.12%, 14.13%, and 10.98%, respectively. The notes are convertible prior to May 1, 1986, into 8½% debentures due in 2004. The notes are redeemable at principal plus accrued interest at the option of the Corporation in whole or in part on or after May 1, 1986.

Interest on the floating rate notes due in 1989 will be paid at a rate of 16.80% per annum in the period from September 15, 1981, to March 14, 1982. The average rates paid for 1981, 1980, and 1979 were 15.09%, 11.73%, and 10.15%, respectively. At the option of the holders thereof, the notes are repayable at principal amounts plus accrued interest on any semiannual interest date. As of December 31, 1981, \$53,995,000 of the notes

have been repaid at the option of the holder. The notes are redeemable at the option of the Corporation in whole or in part at principal plus accrued interest.

The terms of the notes due 1985, 1987, 1989, and 1997 provide restrictions on the Corporation's disposition of the shares of the capital stock of the Bank.

Note 9—Lease Commitments:

Future minimum lease payments and sublease rentals on capitalized and operating leases at December 31, 1981, are as follows (\$ in thousands):

Future minimum lease payments	Capitalized* lease	Operating leases
1982	\$1,076	\$ 21,796
1983	1,076	25,691
1984	1,076	24,192
1985	1,076	22,844
1986	1,076	21,839
Later years	3,586	288,449
Total minimum lease payments	\$8,966**	\$404,811
Future minimum sublease rentals	\$ 565	\$ 4,482

*In August 1981, a 50% interest in the property under the capitalized lease was purchased, with a commitment to purchase the remaining 50% by 1983.

**The \$8,966,000 of minimum lease payments on the capitalized lease comprises \$3,564,000 representing interest costs and \$5,402,000 representing the present value of the payments.

In addition to the amounts set forth above, certain of the leases require payments by the Corporation or its subsidiaries for taxes, insurance, and maintenance.

Rental expense for all operating leases (including equipment rentals based on usage) in other operating expense in the Consolidated Statement of Income amounted to \$34,264,000 in 1981, \$32,720,000 in 1980, and \$22,578,000 in 1979.

Note 10—Other Commitments and

Contingent Liabilities:

At December 31, 1981, commitments under standby letters of credit outstanding aggregated \$4,304,098,000.

At December 31, 1981, the Parent Company and the Bank subsidiary had loan commitments under master demand notes to certain of the Parent Company's non-bank subsidiaries aggregating \$920 million, of which \$653 million was outstanding. The Parent Company has agreed to guarantee or purchase certain indebtedness of its subsidiaries up to a maximum amount of \$264 million at December 31, 1981. The Corporation does not anticipate losses as a result of these transactions.

The Corporation makes commitments which are contractual obligations to extend credit in the normal course of its business. Such commitments are provided as a service principally to corporate customers, and substantially all commitments require a payment of a fee and have fixed expiration dates. The Corporation also extends lines of credit under which a customer may borrow up to a designated amount of funds on a short-term basis. Lines of credit are not contractual obligations and are subject to cancellation without notice. The Corporation generally receives no fee for extending lines of credit. Some lines of credit are available for short-term advances only, while others are multi-purpose, being available not only for short-term advances but also for bankers acceptances, overdrafts, and letters of credit. Consequently, it is not feasible to estimate the amount of lines of credit available only for loans.

The Corporation and certain subsidiaries, including the Bank, are defendants in various legal proceedings. With respect to each of these suits, it is either the opinion of legal counsel that it is without merit or the opinion of management of the Corporation that even if the plaintiff prevails therein the disposition thereof will not have a material effect on the financial condition of the Corporation.

Note 11—Interest-Bearing Deposits:

The annual interest expense associated with interest-bearing deposits is shown below (\$ in thousands):

	1981	1980	1979
Time certificates of deposit over \$100,000	\$ 1,136,377	\$ 692,054	\$ 505,423
Other time deposits	238,084	202,100	189,741
Deposits in foreign offices	1,942,216	1,503,289	1,044,579
Total	\$3,316,677	\$2,397,443	\$1,739,743

The aggregate principal amounts of time certificates of deposit and other time deposits of \$100,000 or more issued by the Bank's domestic office were \$7,887,433,000 and \$1,278,501,000 at December 31, 1981, and \$6,323,373,000 and \$1,043,018,000 at December 31, 1980.

Note 12—Stock Option Plans:

The Corporation has stock option plans under which 1,819,069 shares at December 31, 1981, and 2,174,689 shares at December 31, 1980, of the common stock of the Corporation were reserved for issuance to key personnel. Options available under the plans through May 20, 1981, were both qualified and non-qualified. Since May 21, 1981, only non-qualified options are available under the plans and can be exercised within ten years from the date of the grant. The plans permit the granting of stock appreciation rights to the holders of options granted under the plans. A stock appreciation right, generally, entitles the optionee to receive, in lieu of exercising the option, shares of common stock with a fair market value equivalent to the aggregate appreciation in market value over the option price for the shares under option. Obligations arising out of the exercise of stock appreciation rights may be settled in cash or in some combination of stock and cash. There are no charges or credits to expense in connection with the grant or exercise of options without rights. With respect to stock appreciation rights, periodic charges or credits to expense are required to reflect changes in the amount of potential payments for all stock appreciation rights granted. At December 31, 1981, options granted with stock appreciation rights attached amounted to 394,280 shares.

Data with respect to options are as follows:

	1981	1980	1979
Shares under option at year-end	1,107,375	871,495	1,069,680
Option price per share	\$12-39	\$12-26	\$12-26
Options exercised during the year*	263,690	115,735	51,215
Option price per share	\$12-26	\$12-26	\$12-24

*Excludes 160 shares issued during 1981 (3,250 shares during 1980) upon exercise of stock appreciation rights.

Note 13—Pension Plan:

The pension expense associated with the corporate plan amounted to \$14,265,000 in 1981, \$12,835,000 in 1980, and \$10,927,000 in 1979.

The approximate present value of the accumulated plan benefits (computed using a rate of return of 8.5% for 1981 and 6.5% for 1980) in comparison to the market value of the net assets available is presented below (\$ in millions):

December 31	1981	1980
Actuarial present value of accumulated benefits:		
Vested benefits	\$114	\$130
Non-vested benefits	4	6
Total	\$118	\$136
Market value of the net assets available	\$125	\$128

Note 14—Income Taxes:

The Corporation and its U.S. incorporated subsidiaries file a consolidated Federal income tax return. In connection therewith, the Corporation's equity in net income of wholly-owned overseas subsidiaries and affiliates and dividends from U.S. incorporated subsidiaries are excluded from Federal taxable income.

As the Corporation's income tax returns are filed a number of months following the end of the year, the amounts reported as current and deferred income taxes are subject to revision based on the actual amounts used in the Corporation's returns. The 1980 amounts have been restated to reflect the changes in current and deferred income taxes. Total income taxes reported are not affected by changes in current and deferred income taxes.

An analysis of income taxes, including the tax effect of security gains or losses reflected in the Consolidated Statement of Income, is as follows (\$ in thousands):

Year ended December 31	1981	1980	1979
Currently payable:			
Federal:			
Before investment tax credits			
credits	\$ 63,050	\$29,701	\$(10,966)
Investment tax credits	(24,237)	(18,862)	(1,332)
Total	38,813	10,839	(12,298)
State and local	12,171	12,468	7,567
<i>Total U.S. taxes payable</i>	50,984	23,307	(4,731)
Foreign taxes payable	52,956	49,436	38,053
<i>Total currently payable</i>	103,940	72,743	33,322
Deferred:			
Federal (includes investment tax credits)	9,707	13,058	14,187
State and local	465	1,041	1,868
<i>Total U.S. deferred taxes</i>	10,172	14,099	16,055
Foreign deferred taxes	9,907	8,726	3,548
<i>Total deferred</i>	20,079	22,825	19,603
	124,019	95,568	52,925
Tax effect of security gains or (losses) currently payable	(5,392)	1,433	1,689
<i>Total</i>	\$118,627	\$97,001	\$ 54,614

Presented below is a summary of the U.S. and foreign income tax expense and the related pre-tax income (\$ in thousands):

Year ended December 31	1981	1980	1979
Federal income tax expense	\$ 44,611	\$ 25,765	\$ 3,549
State and local income tax expense	12,206	13,617	9,577
<i>Total U.S. income tax expense</i>	\$ 56,817	\$ 39,382	\$ 13,126
Related pre-tax income	\$246,430	\$221,116	\$186,954
Foreign income tax expense	\$ 61,810	\$ 57,619	\$ 41,488
Related pre-tax income	\$126,820	\$101,826	\$ 63,467

The components of deferred income tax expense relate to the factors listed below (\$ in thousands):

Year ended December 31	1981	1980	1979
Provision for credit losses	\$(14,320)	\$(558)	\$12,020
Lease financing income	18,851	15,050	11,156
Investment tax credits	16,546	6,362	13,172
Investment tax credit carry-forward	—	(5,085)	(14,951)
Realization of investment tax credit carry-forward	5,085	14,951	—
Other	(6,083)	(7,895)	(1,794)
<i>Total</i>	\$ 20,079	\$22,825	\$19,603

A reconciliation of the income taxes included in the Consolidated Statement of Income to an income tax provision computed by applying the statutory U.S. Federal tax rate of 46% to income before income taxes is as follows (\$ in thousands):

Year ended December 31	1981	1980	1979
Federal income tax at statutory rate applied to income before taxes	\$171,695	\$148,553	\$115,194
State and local income taxes, net of Federal income tax benefit	6,591	7,353	5,171
Effect of non-taxable interest and dividend income	(48,921)	(52,605)	(54,096)
Other	(10,738)	(6,300)	(11,655)
<i>Total</i>	\$118,627	\$ 97,001	\$ 54,614

Investment Tax Credit: The amortization of investment tax credits relating to assets owned and leased to others is included in lease financing income in the Consolidated Statement of Income, and amounted to \$5,559,000 in 1981, \$5,699,000 in 1980, and \$5,256,000 in 1979.

Foreign Taxes: The undistributed earnings of overseas subsidiaries are reinvested to partially finance overseas expansion and operating requirements. Earnings of overseas subsidiaries are reported after considering the payment of taxes in the countries in which the subsidiaries are located. If such undistributed earnings were to be distributed or otherwise become subject to U.S. income taxes for reasons not presently contemplated, available credits would substantially reduce the income taxes otherwise payable. The amount of undistributed earnings was approximately \$49,081,000 at December 31, 1981, \$40,976,000 at December 31, 1980, and \$28,633,000 at December 31, 1979.

Note 15—Domestic and Foreign Operations: Because of the integrated nature of the Corporation's business, it is not possible to separate precisely domestic and foreign operations. Thus subjective judgments related to the distribution of earning assets, revenue, and costs were used to derive operating results. Rates used to determine charges or credits for funds that were not generated by the foreign units were based on the market cost of selected short-term funds. Equity is not allocated to the foreign units. Operating expense was allocated between areas for expenses incurred by one on behalf of another. Income taxes were adjusted for the difference between foreign and U.S. tax rates; to conform to the 1981 presentation, certain amounts have been reclassified. The information presented below for foreign operations is based on the location of the customer (\$ in millions):

	Earning assets at December 31	Operating income	Operating expense	Income before taxes	Net income
1981					
Continental Europe	\$ 5,630	\$ 814	\$ 766	\$ 48	\$ 28
Latin America/Caribbean	3,377	569	541	28	18
Asia/Pacific	2,774	340	323	17	9
United Kingdom	1,896	341	321	20	10
Other foreign countries	1,952	314	294	20	8
<i>Total foreign</i>	15,629	2,378	2,245	133	73
<i>Total domestic</i>	25,077	3,909	3,657	252	181
<i>Consolidated total</i>	\$40,706	\$6,287	\$5,902	\$385	\$254
1980					
Continental Europe	\$ 4,527	\$ 671	\$ 638	\$ 33	\$ 16
Latin America/Caribbean	2,377	310	287	23	14
Asia/Pacific	1,951	256	250	6	3
United Kingdom	2,785	394	362	32	20
Other foreign countries	1,403	197	179	18	10
<i>Total foreign</i>	13,043	1,828	1,716	112	63
<i>Total domestic</i>	21,617	2,888	2,680	208	163
<i>Consolidated total</i>	\$34,660	\$4,716	\$4,396	\$320	\$226
1979					
Continental Europe	\$ 4,709	\$ 480	\$ 466	\$ 14	\$ 9
Latin America/Caribbean	1,892	199	190	9	5
Asia/Pacific	1,466	172	167	5	4
United Kingdom	1,872	239	225	14	9
Other foreign countries	1,189	123	114	9	5
<i>Total foreign</i>	11,128	1,213	1,162	51	32
<i>Total domestic</i>	19,158	2,163	1,967	196	164
<i>Consolidated total</i>	\$30,286	\$3,376	\$3,129	\$247	\$196

The following table presents selected asset and liability balances attributable to foreign operations (\$ in millions):

December 31	1981	1980
Loans:		
Loans to banks	\$ 1,291	\$ 989
Loans to other financial institutions	244	267
Loans to governments or official institutions	690	406
Commercial and industrial loans	7,434	6,202
All other loans	387	518
Total loans	\$10,046	\$ 8,382
Balances with foreign banks:		
Interest-bearing balances	\$ 5,078	\$ 4,259
Non-interest-bearing balances	378	1,875
Total balances with foreign banks	\$ 5,456	\$ 6,134
Deposits:		
Banks	\$ 8,244	\$ 8,533
Deposits of governments	1,374	2,191
Other foreign demand deposits	358	118
Other foreign time deposits	5,237	3,327
Total deposits	\$15,213	\$14,169
Short-term borrowings	\$ 1,459	\$ 1,255
Bonds, mortgages, and similar debt	\$ 255	\$ 164

Foreign time deposits of \$100,000 or more included above amounted to \$12,750,674,000 at December 31, 1981, and \$8,057,975,000 at December 31, 1980.

Note 16—Dividend and Loan Restrictions:

The payments of dividends and extensions of credit by the Bank to the Parent Company carry certain restrictions under National Banking Laws. Dividends declared in any calendar year cannot exceed, without the approval of the Comptroller of the Currency, the Bank's net profits (as defined) for the year along with the retained net profits for the previous two years. Loans to any single affiliate, including the Parent Company, cannot exceed 10% of the Bank's Capital. Loans to all affiliates may not exceed 20%. All loans to affiliates must meet statutory collateralization requirements. Based on these restrictions, at December 31, 1981, the Bank could have declared approximately \$647 million of dividends without approval and could have extended loans of \$189 million to the Parent Company. The remaining portion of the Bank's net assets, \$939 million, which represented 54% of consolidated net assets, was restricted in regards to payment of dividends or extension of loans to the Parent Company.

Below is a schedule of cash dividends paid to the Parent Company during the past three years (\$ in thousands):

	1981	1980	1979
Cash Dividends Paid			
Bank subsidiary	\$ —	\$29,997	\$49,995
Other subsidiaries	26,465	—	—
Total	\$26,465	\$29,997	\$49,995

Note 17—Parent Company Statements:

Presented below are statements of condition, income, and changes in financial position for the Parent Company:

Statement of Condition

December 31 (\$ in thousands)	1981	1980
Assets		
Cash and due from depository institutions:		
Bank subsidiary*	\$ 457,258	\$ 229,156
Other	94,050	35,040
Investment securities	112,247	114,673
Loans:		
Loans to non-bank subsidiaries*	660,530	388,220
Other loans	586,344	303,281
Total loans	1,246,874	691,501
Less: Unearned income	2,248	8,439
Reserve for credit losses	5,339	3,899
Net loans	1,239,287	679,163
Investments in common stock of wholly-owned subsidiaries*		
	1,977,403	1,712,397
Other assets	87,077	56,964
Total assets	\$3,967,322	\$2,827,393
Liabilities		
Advances from non-bank subsidiary*	\$ 245,844	\$ 147,437
Short-term borrowings	1,368,142	624,937
Bonds, mortgages, and similar debt	585,022	487,864
Other liabilities	57,622	42,213
Total liabilities	2,256,630	1,302,451
Stockholders' equity		
	1,710,692	1,524,942
Total liabilities and stockholders' equity	\$3,967,322	\$2,827,393

*Eliminated in consolidation.

Statement of Income			
Year ended December 31 (\$ in thousands)	1981	1980	1979
Income			
Interest and dividends			
from subsidiaries*	\$148,739	\$109,047	\$109,589
Other interest income	83,956	42,798	24,430
All other income	772	2,104	5,259
Total operating income	233,467	153,949	139,278
Expense			
Interest expense on borrowings from non-bank subsidiary*	20,978	7,749	—
Other interest expense	205,912	125,358	83,485
All other expense	4,982	4,113	2,375
Total operating expense	231,872	137,220	85,860
Earnings			
Income before income taxes, undistributed income of subsidiaries, and security gains or losses	1,595	16,729	53,418
Applicable federal income tax expense (credit)	(6,798)	(4,973)	1,881
Equity in undistributed income of subsidiaries before security gains or losses	251,922	202,441	142,589
Income before security gains or losses	260,315	224,143	194,126
Security gains or (losses)	(5,692)	1,798	1,681
Net income	\$254,623	\$225,941	\$195,807

*Eliminated in consolidation.

Statement of Changes in Financial Position			
Year ended December 31 (\$ in thousands)	1981	1980	1979
Financial Resources Were Provided By:			
Net income	\$254,623	\$225,941	\$195,807
Non-cash charges (credits) included in net income:			
Equity in undistributed income of subsidiaries	(246,230)	(203,142)	(144,270)
Other	5,400	4,860	2,884
Financial resources provided from operations	13,793	27,659	54,421
Other sources:			
Decreases in:			
Investment securities	2,426	—	13,594
Other net resources	—	43,379	—
Increases in:			
Advances from non-bank subsidiary	98,407	147,437	—
Short-term borrowings	743,205	233,961	122,291
Bonds, mortgages, and similar debt	101,268	—	91,102
Sale of common stock	6,307	2,870	959
Total	\$965,406	\$455,306	\$282,367
Financial Resources Were Used For:			
Decreases in:			
Bonds, mortgages, and similar debt	\$ —	\$ 6,040	\$ —
Other net resources	22,482	—	50,316
Increases in:			
Cash and due from depository institutions	287,112	41,390	650
Investment securities	—	113,747	—
Net loans	563,955	162,458	163,29
Investments in wholly-owned subsidiaries	18,776	66,914	10,100
Cash dividends paid	73,081	64,757	58,00
Total	\$965,406	\$455,306	\$282,367

*Management Report**Report of Independent Accountants*

The financial statements and related notes appearing on pages 32 through 44 have been prepared in conformity with generally accepted accounting principles appropriate in the circumstances and present fairly the Corporation's financial position and results of operations. Where amounts must be based on estimates and judgments, they represent the best estimates of management. All financial information appearing in the Annual Report and Form 10-K is consistent with that in the financial statements.

The accounting system and related internal accounting controls are designed to provide reasonable assurance that assets are safeguarded and that transactions are properly executed and recorded. Emphasis is placed on proper segregation of duties and authorities, the development and dissemination of written policies and procedures, and a comprehensive program of internal audits and management follow-up. Inherent limitations exist in any system of internal accounting controls based upon the recognition that the cost of control should not exceed the benefit derived. Recognizing the cost/benefit relationship, the system provides reasonable assurance that material errors and irregularities are prevented or would be detected within a timely period by employees in the normal course of performing their assigned duties.

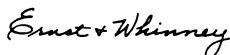
The financial statements have been examined by Ernst & Whinney, independent accountants who are responsible for conducting their examination in accordance with generally accepted auditing standards. Their resulting report appears on this page.

The Board of Directors pursues its oversight role for accounting and internal accounting control matters through an Audit Committee of the Board of Directors, composed entirely of outside directors. The Audit Committee meets periodically with management, internal auditors, and independent accountants. The independent accountants and internal auditors have full and free access to the Audit Committee, and meet with it privately as well as with management present to discuss internal control, accounting, and auditing matters.

Stockholders and Board of Directors of
Continental Illinois Corporation
Chicago, Illinois

We have examined the consolidated statement of condition of Continental Illinois Corporation and subsidiaries as of December 31, 1981 and 1980, and the related consolidated statements of income, changes in stockholders' equity, and changes in financial position for each of the three years in the period ended December 31, 1981, and the consolidated statement of condition of Continental Illinois National Bank and Trust Company of Chicago (a wholly-owned subsidiary) and its subsidiaries as of December 31, 1981 and 1980. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Continental Illinois Corporation and subsidiaries at December 31, 1981 and 1980 and the consolidated results of their operations and the changes in their financial position for each of the three years in the period ended December 31, 1981, and the consolidated financial position of Continental Illinois National Bank and Trust Company of Chicago and subsidiaries at December 31, 1981 and 1980, all in conformity with generally accepted accounting principles applied on a consistent basis.



Chicago, Illinois
January 18, 1982

Consolidated Average Statement of Condition and Net Interest Income
Continental Illinois Corporation and Subsidiaries

(\$ in millions)	1981			1980		
	Average balance	Interest	Average rate	Average balance	Interest	Average rate
Interest-Earning Assets						
Interest-bearing deposits due from depository institutions (primarily foreign)	\$ 4,633	\$ 747	16.12%	\$ 4,897	\$ 658	13.44%
Other short-term investments	497	83	16.75	508	66	12.95
U.S. Treasury and Federal agency securities ..	1,151	117	10.13	1,011	98	9.63
State, county, and municipal securities	963	115	11.93	1,124	130	11.57
Other securities	359	44	12.23	376	40	10.71
<i>Total investment securities</i>	2,473	276	11.14	2,511	268	10.66
Loans (net of unearned income):						
Domestic	19,541	3,368	17.23	16,614	2,433	14.64
Foreign	9,061	1,460	16.11	7,667	1,051	13.70
<i>Total loans</i>	28,602	4,828	16.88	24,281	3,484	14.34
Lease financing receivables (net of unearned income) (1)						
	662	98	17.78	520	73	16.78
<i>Total loans and lease receivables</i>	29,264	4,926	16.89	24,801	3,557	14.39
Trading account securities, net	246	37	14.77	262	31	11.68
<i>Total interest-earning assets</i>	\$37,113	\$6,069	16.40%	\$32,979	\$4,580	13.92
Other Assets						
Cash and non-interest-bearing deposits	3,534			3,769		
Properties and equipment	286			249		
Customers' liability on acceptances	2,093			1,726		
Interest receivable	801			596		
Other assets	442			476		
Reserve for credit losses	(265)			(230)		
<i>Total assets</i>	\$44,004			\$39,565		
Sources of Funds Used to Finance						
Interest-Earning Assets						
Sources on which interest is paid:						
Passbook savings	\$ 394	\$ 21	5.20%	\$ 438	\$ 23	5.26
Other time deposits	8,684	1,354	15.59	7,104	871	12.26
Time deposits in foreign offices	12,814	1,942	15.15	11,780	1,503	12.76
<i>Total interest-bearing deposits</i>	21,892	3,317	15.14	19,322	2,397	12.40
Short-term borrowings	11,022	1,761	15.97	9,857	1,280	12.98
Bonds, mortgages, and similar debt	722	81	11.21	600	65	10.84
<i>Total sources on which interest is paid</i>	\$33,636	\$5,159	15.33%	\$29,779	\$3,742	12.56
Other Liabilities and Stockholders' Equity						
Demand deposits: Domestic offices	4,226			4,252		
Foreign offices	1,310			1,379		
Acceptances outstanding	2,097			1,733		
Other liabilities	1,119			979		
Stockholders' equity	1,616			1,443		
<i>Total liabilities and stockholders' equity</i>	\$44,004			\$39,565		
Net interest income		\$ 910			\$ 838	
Net Interest Margin						
<i>Total interest income/average earning assets</i> (2)			16.40%			13.9
<i>Total interest expense/average earning assets</i>			13.94%			11.3
Net interest margin (3)			2.46%			2.5

(1) Rates are calculated on lease financing receivable (i) balances reduced by deferred liability for taxes and deferred investment tax credit, and (ii) income adjusted to include amortization of investment tax credit on a fully-taxable basis.

(2) Total interest income includes taxable equivalent adjustments used in adjusting interest on tax-exempt assets (primarily state, county, and municipal securities) to a fully-taxable basis. Such adjustments are based on the prevailing U.S. Federal and

1979			1978			1977		
Average balance	Interest	Average rate	Average balance	Interest	Average rate	Average balance	Interest	Average rate
\$ 4,039	\$ 456	11.28%	\$ 3,724	\$ 308	8.26%	\$ 3,585	\$ 225	6.27%
567	62	10.95	487	39	8.04	213	12	5.57
570	49	8.66	574	43	7.53	683	51	7.48
1,344	144	10.68	1,510	147	9.76	1,552	139	8.96
319	29	9.25	281	26	9.20	248	21	8.44
2,233	222	9.96	2,365	216	9.15	2,483	211	8.50
13,840	1,762	12.73	10,723	1,069	9.96	8,817	702	7.95
6,148	704	11.44	5,026	441	8.77	4,304	326	7.58
19,988	2,466	12.33	15,749	1,510	9.58	13,121	1,028	7.83
402	44	12.54	347	38	12.50	297	33	12.46
20,390	2,510	12.34	16,096	1,548	9.64	13,418	1,061	7.92
198	21	10.51	169	13	7.88	186	12	6.35
\$27,427	\$3,271	11.95%	\$22,841	\$2,124	9.31%	\$19,885	\$1,521	7.66%
3,733			2,865			2,370		
209			178			136		
1,054			539			300		
393			264			193		
633			454			330		
(197)			(176)			(170)		
\$33,252			\$26,965			\$23,044		
\$ 506	\$ 26	5.14%	\$ 566	\$ 28	5.00%	\$ 678	\$ 34	5.00%
6,460	669	10.35	5,934	457	7.71	4,496	269	5.99
10,230	1,045	10.21	7,571	564	7.44	6,698	394	5.87
17,196	1,740	10.11	14,071	1,049	7.45	11,872	697	5.86
7,281	806	11.07	5,616	444	7.90	4,894	278	5.69
521	48	9.20	419	34	8.03	329	27	8.18
\$24,998	\$2,594	10.37%	\$20,106	\$1,527	7.59%	\$17,095	\$1,002	5.86%
4,003			3,646			3,410		
1,171			939			860		
1,061			541			303		
725			611			411		
1,294			1,122			965		
\$33,252			\$26,965			\$23,044		
	\$ 677			\$ 597			\$ 519	
		11.95%			9.31%			7.66%
		9.47%			6.69%			5.04%
		2.48%			2.62%			2.62%

State of Illinois income tax rates. For 1981-1977 the adjustments, in thousands, amounted to \$104,625, \$107,580, \$103,533, \$90,536, and \$77,818.

(3) Net interest margin is net interest income on a taxable equivalent basis divided by average earning assets, including the average amount of loans and lease receivables on a cash basis.

Analysis of Year-to-Year Changes in Net Interest Income

Continental Illinois Corporation and Subsidiaries

The following table attributes changes in net interest income on a taxable equivalent basis either to changes in average balances or to changes in average rates for interest-earning assets and sources of funds on which interest is

paid. The change in interest due to both rate and volume has been allocated to change due to volume and change due to rate in proportion to the relationship of the absolute dollar amount of the change in each.

(\$ in millions)		1981/1980				
Assets		Interest-bearing balances with depository institutions	Loans & leases	Investment and trading securities	Other short-term investments	Total interest-earning assets
Change due to:						
Average balance		\$ (37)	\$ 697	\$ (5)	\$ (2)	\$ 616
Average rate		126	672	19	19	873
<i>Total</i>		\$ 89	\$ 1,369	\$ 14	\$ 17	\$ 1,489
Liabilities						
Change due to:		Domestic deposits	Foreign office deposits	Short-term borrowings	Bonds, mortgages, & similar debt	Total interest-bearing sources of funds
Average balance		\$204	\$ 140	\$163	\$14	\$ 525
Average rate		277	299	318	2	892
<i>Total</i>		\$481	\$ 439	\$481	\$16	\$ 1,417
(\$ in millions)		1980/1979				
Assets		Interest-bearing balances with depository institutions	Loans & leases	Investment and trading securities	Other short-term investments	Total interest-earning assets
Change due to:						
Average balance		\$106	\$ 594	\$ 36	\$ (7)	\$ 723
Average rate		96	453	20	11	586
<i>Total</i>		\$202	\$1,047	\$ 56	\$ 4	\$ 1,309
Liabilities						
Change due to:		Domestic deposits	Foreign office deposits	Short-term borrowings	Bonds, mortgages, & similar debt	Total interest-bearing sources of funds
Average balance		\$ 61	\$ 173	\$319	\$ 8	\$ 546
Average rate		138	285	155	9	602
<i>Total</i>		\$199	\$ 458	\$474	\$17	\$ 1,148

Average Deposit Analysis

Continental Illinois Corporation and Subsidiaries

(\$ in millions)	1981	1980	1979
Domestic Offices*			
Demand deposits:			
Individuals, partnerships, and corporations	\$ 2,935	\$ 3,047	\$ 3,051
Banks and bankers	979	920	660
Public funds	141	141	133
Certified and officers' checks	171	144	159
<i>Total</i>	4,226	4,252	4,003
Time deposits:			
Passbook savings	394	438	506
Other savings	857	820	834
Commercial certificates of deposit	6,431	5,533	4,145
Other time	1,396	751	1,481
<i>Total</i>	9,078	7,542	6,966
Foreign Offices			
Demand deposits	1,310	1,379	1,171
Time deposits	12,814	11,780	10,230
<i>Total</i>	14,124	13,159	11,401
<i>Total deposits</i>	\$27,428	\$24,953	\$22,370

*Foreign deposits held in the Bank's domestic offices averaged \$392 million in 1981, \$400 million in 1980, and \$409 million in 1979.

Investment Securities

Continental Illinois Corporation and Subsidiaries

December 31 (\$ in millions)	1981		1980	1979
	Amount	Yield	Amount	Amount
U.S. Treasury and Federal Agency Securities Maturing Within:				
0-1 year	\$ 71	7.80 %	\$ 155	\$ 151
1-5 years	508	9.93	682	271
5-10 years	75	10.32	105	—
10 years and over	205	9.49	209	212
<i>Total</i>	\$ 859	9.68 %	\$ 1,151	\$ 634
<i>Average months to maturity</i>	113		87	126
State, County, and Municipal Securities Maturing Within:				
0-1 year	\$ 60	11.69 %	\$ 43	\$ 91
1-5 years	289	12.14	280	374
5-10 years	423	12.14	494	547
10 years and over	139	12.84	191	188
<i>Total</i>	\$ 911	12.22 %	\$ 1,008	\$ 1,200
<i>Average months to maturity</i>	80		90	80
Other Securities Maturing Within:				
0-1 year	\$ 102	14.36 %	\$ 77	\$ 47
1-5 years	76	9.31	76	92
5-10 years	99	12.34	107	78
10 years and over*	122	3.33	87	175
<i>Total</i>	\$ 399	9.52 %	\$ 347	\$ 392
<i>Total investment securities</i>	\$2,169	10.72 %	\$2,506	\$2,226

*Includes all equity investments.

The weighted average yields are calculated on the basis of the cost and effective yields weighted for the scheduled maturity of each issue. The yields for state, county, and

municipal securities are calculated on a taxable equivalent basis incorporating a combined Federal and state effective tax rate of approximately 50%.

Maturity of Loans

Continental Illinois Corporation and Subsidiaries

The following table shows an estimated distribution of the maturity of loans excluding consumer loans and

loans secured by 1-4 family residential properties at December 31, 1981.

(\$ in millions)	One year or less	One to five years	Over five years	Total
Maturity of Loans				
Domestic:				
Commercial and industrial loans	\$ 6,147	\$4,421	\$2,294	\$12,862
Mortgage and real estate loans	1,800	1,103	140	3,043
Loans to financial institutions*	869	1,139	625	2,633
Loans for purchasing or carrying securities	206	6	**	212
All other loans	533	179	166	878
<i>Total domestic</i>	9,555	6,848	3,225	19,628
Foreign	5,738	3,046	1,262	10,046
<i>Total loans</i>	\$15,293	\$9,894	\$4,487	\$29,674

*Includes loans to real estate investment trusts.

**Less than \$1 million.

Loans and Lease Financing Receivables

Continental Illinois Corporation and Subsidiaries

December 31 (\$ in millions)	1981	1980	1979	1978	1977
Loans					
Domestic:					
Commercial and industrial loans	\$12,862	\$ 9,845	\$ 8,221	\$ 6,343	\$ 4,786
Mortgage and real estate loans	3,957	3,530	3,123	1,971	1,249
Loans to financial institutions*	2,633	2,451	2,117	1,764	1,736
Loans for purchasing or carrying securities	212	379	595	993	1,091
Consumer installment loans	1,588	1,459	1,289	1,029	719
All other loans	878	864	1,021	696	431
<i>Total domestic</i>	22,130	18,528	16,366	12,796	10,012
Foreign	10,046	8,382	6,816	5,650	4,837
<i>Total loans</i>	32,176	26,910	23,182	18,446	14,849
Less: Unearned income	122	126	108	56	37
<i>Loans, net</i>	32,054	26,784	23,074	18,390	14,812
Lease Financing Receivables	1,123	720	609	452	419
Less: Unearned income	301	137	107	88	89
<i>Lease financing receivables, net</i>	822	583	502	364	330
<i>Total loans and lease receivables, net</i>	\$32,876	\$27,367	\$23,576	\$18,754	\$15,142

*Includes loans to real estate investment trusts.

Average Loans and Lease Financing Receivables

Continental Illinois Corporation and Subsidiaries

(\$ in millions)	1981	1980	1979	1978	1977
Loans					
Domestic:					
Commercial and industrial loans	\$10,741	\$ 8,637	\$ 7,108	\$ 5,632	\$ 4,562
Mortgage and real estate loans	3,713	3,288	2,288	1,300	997
Loans to financial institutions*	2,409	2,121	1,813	1,717	1,561
Loans for purchasing or carrying securities	336	481	615	660	680
Consumer installment loans	1,447	1,271	1,172	817	639
All other loans	1,002	897	892	627	397
<i>Total domestic</i>	19,648	16,695	13,888	10,753	8,836
Foreign	9,078	7,684	6,159	5,035	4,314
<i>Total loans</i>	28,726	24,379	20,047	15,788	13,150
Less: Unearned income	124	98	59	39	29
<i>Loans, net</i>	28,602	24,281	19,988	15,749	13,121
Lease Financing Receivables	842	641	497	432	375
Less: Unearned income	180	121	95	85	78
<i>Lease financing receivables, net</i>	662	520	402	347	297
<i>Total loans and lease receivables, net</i>	\$29,264	\$24,801	\$20,390	\$16,096	\$13,418

*Includes loans to real estate investment trusts.

Analysis of Net Credit Loss Experience

Continental Illinois Corporation and Subsidiaries

Year ended December 31 (\$ in millions)	1981	1980	1979	1978	1977
Reserve for credit losses—beginning of year	\$246	\$212	\$191	\$168	\$165
Provision for credit losses	120	96	70	63	54
Charge offs:					
Domestic loans:					
Commercial and industrial loans	40	26	9	8	12
Mortgage and real estate loans	5	6	6	19	18
Loans to financial institutions	4	2	*	11	23
Loans for purchasing or carrying securities	—	—	—	*	—
Consumer installment loans	28	34	35	11	5
All other loans	6	4	1	*	1
Total domestic loans	83	72	51	49	59
Foreign loans	8	1	15	9	7
Total loans	91	73	66	58	66
Lease financing receivables	1	*	*	—	—
Total charge offs	92	73	66	58	66
Recoveries:					
Domestic loans:					
Commercial and industrial loans	6	2	1	11	7
Mortgage and real estate loans	3	1	5	2	1
Loans to financial institutions	5	(1)	7	*	*
Loans for purchasing or carrying securities	1	—	—	—	—
Consumer installment loans	5	6	3	2	4
All other loans	1	1	*	*	—
Total domestic loans	21	9	16	15	12
Foreign loans	*	3	1	1	2
Total loans	21	12	17	16	14
Lease financing receivables	—	—	—	—	—
Total recoveries	21	12	17	16	14
Other adjustments	(6)	(1)	*	2	1
Reserve for credit losses—year-end	\$289	\$246	\$212	\$191	\$168
Net credit losses	\$ 71	\$ 61	\$ 49	\$ 42	\$ 52
Net credit losses as a percentage of average loans and lease receivables	0.24%	0.24%	0.24%	0.26%	0.39%

*Less than \$1 million in the period.

Allocation of Reserve for Credit Losses

Continental Illinois Corporation and Subsidiaries

The following table shows an allocation of the reserve for credit losses for the past five years. The reserve allocation is based on a five-year historical credit loss experience computed as a per cent of the average annual principal. The reserve per cent represents the allocated reserve relative to the year-end balance.

(\$ in millions)	1981		1980		1979		1978		1977	
	Reserve amount	Reserve per cent	Reserve amount	Reserve per cent	Reserve amount	Reserve per cent	Reserve amount	Reserve per cent	Reserve amount	Reserve per cent
Loan Category:										
Commercial and industrial loans . . .	\$ 27	0.20%	\$ 18	0.18%	\$ 12	0.14%	\$ 10	0.15%	\$ 10	0.20%
Mortgage and real estate loans . . .	17	0.42	24	0.67	23	0.73	15	0.76	9	0.72
Loans to financial institutions* . . .	10	0.37	6	0.24	15	0.70	20	1.13	23	1.32
Loans for purchasing or carrying securities	—	—	—	—	—	—	—	—	—	—
Consumer installment loans	31	1.95	25	1.71	19	1.47	10	0.97	5	0.69
Other loans	3	0.34	1	0.11	1	0.09	—	—	—	—
<i>Total domestic</i>	88	0.39	74	0.40	70	0.42	55	0.42	47	0.46
Foreign loans	11	0.10	9	0.10	10	0.14	12	0.21	10	0.20
<i>Total loans</i>	99	0.30	83	0.30	80	0.34	67	0.36	57	0.38
Lease financing receivables	8	0.71	7	0.97	7	1.14	6	1.32	2	0.47
Allocated	107	0.32	90	0.33	87	0.36	73	0.39	59	0.39
Unallocated	182	0.55	156	0.56	125	0.53	118	0.62	109	0.72
<i>Total reserve</i>	\$289	0.87%	\$246	0.89%	\$212	0.89%	\$191	1.01%	\$168	1.11%

*Includes loans to real estate investment trusts.

Selected Quarterly Financial Data

Continental Illinois Corporation and Subsidiaries

(\$ in thousands, except per-share data)	First quarter	Second quarter	Third quarter	Fourth quarter
1981				
Interest income	\$1,367,586	\$1,418,025	\$1,611,249	\$1,567,355
Net interest income	188,986	162,237	214,420	240,138
Provision for credit losses	30,000	23,000	32,000	35,000
Income before income taxes and security gains or losses	93,930	80,250	93,220	116,934
Income before security gains or losses	62,139	58,053	67,299	72,824
Net income	59,189	57,798	67,097	70,539
Per Share:				
Income before security gains or losses	\$ 1.57	\$ 1.47	\$ 1.70	\$ 1.84
Net income	1.50	1.46	1.69	1.79
1980				
Interest income	\$1,087,911	\$1,165,346	\$1,004,956	\$1,214,300
Net interest income	152,322	190,585	202,452	184,935
Provision for credit losses	14,000	30,000	25,000	27,000
Income before income taxes and security gains or losses	56,385	95,413	82,891	85,022
Income before security gains or losses	47,682	65,587	57,235	53,639
Net income	47,635	67,748	57,726	52,832
Per Share:				
Income before security gains or losses	\$ 1.21	\$ 1.67	\$ 1.46	\$ 1.36
Net income	1.21	1.73	1.47	1.34
1979				
Interest income	\$ 699,913	\$ 728,319	\$ 776,323	\$ 963,572
Net interest income	143,982	138,470	147,011	144,390
Provision for credit losses	14,000	14,000	25,000	17,000
Income before income taxes and security gains or losses	63,357	57,362	69,790	56,542
Income before security gains or losses	47,147	45,823	50,809	50,347
Net income	46,860	47,341	51,085	50,521
Per Share:				
Income before security gains or losses	\$ 1.20	\$ 1.17	\$ 1.29	\$ 1.29
Net income	1.19	1.21	1.30	1.29

Consolidated Statement of Income

Continental Illinois Corporation and Subsidiaries

(\$ in thousands)	Fourth quarter	
	1981	1980
Interest and fees on loans	\$1,246,747	\$ 950,788
Lease financing income	26,121	21,965
Interest on deposits with banks	215,319	165,974
Interest and dividends on investment securities:		
Taxable income	38,244	35,837
Income exempt from Federal income taxes	15,999	16,092
Trading account interest	7,454	5,565
Interest on short-term investments	17,471	18,079
Total interest income	1,567,355	1,214,300
Interest on deposits	914,093	613,703
Interest on short-term borrowings	388,337	397,932
Interest on bonds, mortgages, and similar debt	24,787	17,730
Total interest expense	1,327,217	1,029,365
Net interest income	240,138	184,935
Provision for credit losses	35,000	27,000
Net interest income after provision for credit losses	205,138	157,935
Trust income	14,644	11,521
Security trading profits and commissions	22,455	(875)
Foreign exchange profits	(1,671)	13,685
All other income	48,749	47,868
Total other operating income	84,177	72,199
Net interest and other operating income	289,315	230,134
Salaries and wages	75,319	63,895
Pension, profit sharing, and other employee benefits	16,046	13,881
Net occupancy expense	18,862	14,974
Equipment rentals, depreciation, and maintenance	10,114	9,986
Other expense	52,040	42,376
Total other operating expense	172,381	145,112
Income before income taxes and security losses	116,934	85,022
Applicable income taxes	44,110	31,383
Income before security losses	72,824	53,639
Security losses less applicable income taxes of \$2,232 and \$864, respectively	2,285	807
Net income	\$ 70,539	\$ 52,832
Income per common share:		
Income before security losses	\$ 1.84	\$ 1.36
Net income	\$ 1.79	\$ 1.34
Dividends declared per common share	\$ 0.50	\$ 0.45
Average shares outstanding (in thousands)	39,595	39,297

See notes to financial statements.

Consolidated Average Statement of Condition and Net Interest Income

Continental Illinois Corporation and Subsidiaries

(\$ in millions)	Fourth quarter 1981			Fourth quarter 1980		
	Average balance	Interest	Average rate	Average balance	Interest	Average rate
Interest-Earning Assets						
Interest-bearing deposits due from depository institutions (primarily foreign)	\$ 5,326	\$ 215	16.03%	\$ 5,089	\$ 166	12.97%
Other short-term investments	479	17	14.46	443	18	16.22
U.S. Treasury and Federal agency securities	1,096	29	10.55	1,166	27	9.34
State, county, and municipal securities	928	28	11.90	1,007	29	11.62
Other securities	384	13	13.16	360	10	10.53
<i>Total investment securities</i>	2,408	70	11.48	2,533	66	10.42
Loans (net of unearned income):						
Domestic	21,124	858	16.11	17,531	683	15.50
Foreign	9,922	397	15.87	8,224	275	13.32
<i>Total loans</i>	31,046	1,255	16.03	25,755	958	14.80
Lease financing receivables (net of unearned income) (1)						
	755	28	17.53	543	24	20.94
<i>Total loans and lease receivables</i>	31,801	1,283	16.06	26,298	982	14.91
Trading account securities, net	214	8	14.86	184	6	12.77
<i>Total interest-earning assets</i>	\$40,228	\$1,593	15.76%	\$34,547	\$1,238	14.30%
Other Assets						
Cash and non-interest-bearing deposits	2,659			3,970		
Properties and equipment	298			263		
Customers' liability on acceptances	2,479			1,865		
Interest receivable	934			600		
Other assets	467			461		
Reserve for credit losses	(284)			(246)		
<i>Total assets</i>	\$46,781			\$41,460		
Sources of Funds Used to Finance						
Interest-Earning Assets						
Sources on which interest is paid:						
Passbook savings	\$ 370	\$ 5	5.19%	\$ 433	\$ 6	5.32%
Other time deposits	9,607	372	15.36	7,651	236	12.32
Time deposits in foreign offices	14,316	537	14.88	11,785	371	12.52
<i>Total interest-bearing deposits</i>	24,293	914	14.92	19,869	613	12.28
Short-term borrowings	11,571	388	13.31	10,412	398	15.20
Bonds, mortgages, and similar debt	824	25	11.93	678	18	10.40
<i>Total sources on which interest is paid</i>	\$36,688	\$1,327	14.35%	\$30,959	\$1,029	13.22%
Other Liabilities and Stockholders' Equity						
Demand deposits: Domestic offices	4,223			4,559		
Foreign offices	426			1,608		
Acceptances outstanding	2,486			1,867		
Other liabilities	1,263			963		
Stockholders' equity	1,695			1,504		
<i>Total liabilities and stockholders' equity</i>	\$46,781			\$41,460		
Net interest income		\$ 266			\$ 209	
Net Interest Margin						
<i>Total interest income/average earning assets (2)</i>			15.76%			14.30%
<i>Total interest expense/average earning assets</i>			13.13%			11.88%
Net interest margin (3)			2.63%			2.42%

(1) Rates are calculated on lease financing receivable (i) balances reduced by deferred liability for taxes and deferred investment tax credit, and (ii) income adjusted to include amortization of investment tax credit on a fully-taxable basis.

(2) Total interest income includes taxable equivalent adjustments used in adjusting interest on tax-exempt assets (primarily state, county and municipal securities) to a fully-taxable basis. Such adjustments are based on the prevailing U.S. Federal

and the State of Illinois income tax rates. For the four quarters of 1981 and 1980 the adjustments, in thousands, amounted to \$26,479 and \$24,538, respectively.

(3) Net interest margin is net interest income on a taxable equivalent basis, divided by average earning assets, including the average amount of loans and lease receivables on a cash basis.

Form 10-K

Securities and Exchange Commission
 Washington, D.C. 20549
 Form 10-K

**Annual Report Pursuant to Section 13 or 15(d) of
 The Securities Exchange Act of 1934**
 For the fiscal year ended December 31, 1981
 Commission file number 1-5872

Continental Illinois Corporation
 Incorporated in State of Delaware
 I.R.S. Employer Identification No.: 36-2664023
 Address: 231 South LaSalle Street, Chicago, Illinois 60693
 Telephone: 312/828-2345

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock—\$5 par value	New York Stock Exchange, Inc. Midwest Stock Exchange Pacific Stock Exchange, Inc.
Floating Rate Notes due 1987 (Convertible Prior to May 1, 1986, into 8½% Debentures due 2004)	New York Stock Exchange, Inc.
Floating Rate Notes due September 15, 1989	New York Stock Exchange, Inc.
8½% Notes due November 1, 1985	New York Stock Exchange, Inc.
13% Notes due May 1, 1985	New York Stock Exchange, Inc.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.
 Yes No

The aggregate market value of the voting stock held by non-affiliates of the registrant as of February 26, 1982, based on the reported closing price on that date on the New York Stock Exchange—Composite Transactions of \$30¼ per share:

Common Stock—\$5 par value—\$1,188,032,546*

*Based on reported beneficial ownership by all directors and executive officers; however, this determination does not constitute an admission of affiliate status for any of these stockholders.

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of February 26, 1982:

Common Stock—\$5 par value—39,605,965 shares

Documents Incorporated by Reference

Portions of the Proxy Statement of the registrant for the Annual Meeting of Stockholders to be held April 26, 1982, are incorporated by reference into Parts I and III.

10-K Cross-Reference Index

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Executive Officers of the Registrant	14
10 Management Remuneration and Transactions	*
Part IV	
11 Exhibits, Financial Statement Schedules, and Reports on Form 8-K	
Financial Statements Filed:	
Continental Illinois Corporation:	
Consolidated Statement of Condition	
Consolidated Statement of Income	
Consolidated Statement of Changes in Financial Position	
Consolidated Statement of Changes in Stockholders' Equity	
Financial Schedules Filed:	
All schedules applicable to the Corporation are included in the notes to the financial statements.	
Exhibits	56
There were no reports filed on Form 8-K during 1981.	

*Incorporated by reference to the registrant's March 1982 Proxy Statement.

This Report on Form 10-K has not been approved or disapproved by the Securities and Exchange Commission nor has the Commission passed upon the accuracy or adequacy of this Form 10-K. Portions of the 1981 Annual Report to the Corporation's stockholders are not required by the Form 10-K and are not "filed" as part of the Form 10-K. Only those sections of the Annual Report referenced in the above index are incorporated in to the Form 10-K.

Continental Illinois Corporation Form 10-K For The Fiscal Year Ended December 31, 1981*

3(a) —Restated Certificate of Incorporation of the Company, as amended. Incorporated by reference to Exhibit 2(b) contained in the Company's Registration Statement on Form S-7, File No. 2-61849 (\$6.00).
3(b) —By-laws of the Company, as amended. Incorporated by reference to Exhibit 2(c) contained in the Company's Registration Statement on Form S-7, File No. 2-61849 (\$2.75).
4(a)(1) —Indenture, dated as of November 1, 1981, between the Company and Harris Trust and Savings Bank, as Trustee, relating to the Company's 13% Notes due May 1, 1985. Incorporated by reference to Exhibit 2, contained in the Company's Registration Statement on Form 8-A as amended by Amendment No. 2 on Form 8, File No. 1-5872 (\$10.50).
4(a)(2) —Indenture, dated as of May 1, 1979, between the Company and Harris Trust and Savings Bank, as Trustee, relating to the Company's Floating Rate Notes due 1987 (Convertible prior to May 1, 1986, into 8½% Debentures due 2004). Incorporated by reference to Exhibit (b)(2), contained in the Company's Registration Statement on Form S-16, File No. 2-64008 (\$12.75).
4(a)(3) —Indenture, dated as of August 1, 1974, between the Company and Harris Trust and Savings Bank, as Trustee, relating to the Company's Floating Rate Notes due September 15, 1989. Incorporated by reference to Exhibit 2, contained in the Company's Registration Statement on Form S-7, File No. 2-50246 (\$13.00).
4(a)(4) —Indenture, dated as of May 1, 1978, between the Company and Harris Trust and Savings Bank, as Trustee, relating to the Company's 8½% Notes due November 1, 1985. Incorporated by reference to Exhibit 2, contained in the Company's Registration Statement on Form S-7, File No. 2-61217 (\$11.50).
4(a)(5) —Note Purchase Agreement, dated December 14, 1976, relating to the Company's 8.75% Notes due March 31, 1997. Incorporated by reference to Exhibit 1 to the Company's Report on Form 8-K dated January 7, 1977, File No. 1-5872 (\$12.50).
10(b)(1) —Copy of lease on land on which part of the Bank's banking headquarters is located. Incorporated by reference to Exhibit 9(b), contained in the Company's Registration Statement on Form 10, File No. 1-5872 (\$15.50).
10(c)(1) —The Company's 1979 Stock Option Plan (\$1.00).
10(c)(2) —The Company's 1974 Stock Option Plan (\$1.00).
10(c)(3) —The Company's 1968 Stock Option Plan (\$1.00).
10(c)(4) —The Company's Excess Benefit Plan (\$1.25).
10(c)(5) —The Company's Life Insurance Plan (\$6.00).
10(c)(6) —The Company's Life Insurance Plan for members of Senior Management (\$1.00).
10(c)(7) —The Continental Illinois Deferred Compensation Plan for Directors (\$1.50).
22 —List of subsidiaries of the Company (\$0.25).

*Stockholders may obtain a copy of any exhibit by writing to Mr. J. Joseph Anderson, Executive Vice President and Controller, Continental Illinois Corporation, 231 S. LaSalle Street, Chicago, Illinois 60693. All requests must be accompanied by a check or money order payable to Continental Illinois Corporation in the amount indicated in the parentheses after the exhibit ordered. No payment is required on orders under \$2.50.

Legal Proceedings

Along with several other Chicago banks, the Bank was named as a defendant in a treble damage antitrust class action entitled *Weir, et al v. Continental Illinois National Bank and Trust Company of Chicago, et al*, filed August 1970, in the United States District Court for the Northern District of Illinois. The named plaintiffs are three individual customers of the Bank's Charge Card Division who contend that the Bank and other banks illegally conspired (1) to fix interest rates charged cardholders who elect to defer payment of a portion of their charge card accounts, (2) to fix discount rates charged merchants who participate in the charge card program, and (3) to require such merchants, and also to require correspondent banks which participate in the charge card program, to maintain "static accounts" with the defendant banks. Plaintiffs sued on behalf of themselves and all other persons similarly situated. Four of the six counts in their complaint claimed damages of \$100,000,000, one count claimed damages of \$300,000,000, and one count claimed damages of \$500,000,000; in each count, judgment was sought for three times the claimed amount. The Court certified as a class action Counts I-IV and notice to the class issued. The Court had previously granted summary judgment to the defendants with respect to the "discount rate" count (Count V, \$300,000,000) and the "static account" count (Count VI, \$100,000,000). On December 22, 1978, the District Court ordered the suit dismissed as to the Bank and one other defendant. On September 6, 1979, the District Court entered a further order dismissing the remaining defendants and dismissing the suit in its entirety. On February 11, 1981, the Court of Appeals (one judge dissenting) affirmed the District Court's decisions dismissing all defendants, and on April 13, 1981, the Court of Appeals denied plaintiffs' petition for rehearing with suggestion of rehearing *en banc*. On July 10, 1981, plaintiffs filed a petition for writ of *certiorari* with the Supreme Court of the United States, seeking reversal of the judgment of the Court of Appeals. On October 5, 1981, the Supreme Court entered an order inviting the United States Solicitor General to file an *amicus curiae* brief expressing the views of

the United States on whether the petition should be granted or denied. On February 8, 1982, the Solicitor General filed an *amicus* brief recommending that the plaintiffs' petition for writ of *certiorari* be denied and on March 1, 1982, the Supreme Court entered an order denying plaintiffs' petition. Under the rules of the Supreme Court, the plaintiffs have 25 days from March 1, 1982 to petition for reconsideration of such denial. In the opinion of management of the Corporation and of Mayer, Brown and Platt, counsel for the Corporation, plaintiffs' claims against the Bank are without merit.

In *Brabec, et al v. Continental Illinois National Bank and Trust Company of Chicago, et al*, last reported in the Report on Form 10-K for the year ended December 31, 1980, the plaintiffs alleged that the Bank improperly purchased and retained or advised the purchase and retention of certain securities for various trust and agency accounts. The plaintiffs sought damages in excess of \$2,900,000 and also asserted claims for prejudgment interest, bringing their total claims to approximately \$10,000,000. On January 28, 1982, the case was dismissed pursuant to an agreement of settlement.

The Corporation and certain subsidiaries, including the Bank, are defendants in various other legal proceedings. With respect to each of these suits, it is either the opinion of legal counsel that it is without merit or the opinion of management of the Corporation that even if the plaintiff prevails therein the disposition thereof will not have a material effect on the financial condition of the Corporation.

Properties

The Bank's banking headquarters and the Corporation's principal offices are located at 231 South LaSalle Street, Chicago, Illinois, in a 23-story building owned by the Bank on land of which one-half is owned by the Bank and one-half is held under a lease expiring in 1996. Approximately 90 per cent of the building is occupied by the Bank. The Corporation and certain other subsidiaries, including the Bank, own directly or beneficially other unimproved and improved land in Chicago and own or lease office space at various locations in the United States and in foreign countries. See Notes 6 and 9 to the financial statements.

Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly

caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Continental Illinois Corporation

By Roger E. Anderson

Roger E. Anderson
Chairman of the Board of Directors

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the

following persons on behalf of the Company and in the capacities and on the date indicated.

Roger E. Anderson

Roger E. Anderson
Chairman of the Board of Directors, Chief Executive Officer and Director

Vernon R. Loucks, Jr.

Vernon R. Loucks, Jr.
Director

Donald C. Miller

Donald C. Miller
Vice Chairman, Principal Financial Officer and Director

Frank W. Luerssen

Frank W. Luerssen
Director

J. Joseph Anderson

J. Joseph Anderson
Executive Vice President, Controller and Principal Accounting Officer

Robert H. Malott

Robert H. Malott
Director

Raymond C. Baumhart, S.J.

Raymond C. Baumhart, S.J.
Director

Marvin G. Mitchell

Marvin G. Mitchell
Director

James F. Beré

James F. Beré
Director

John H. Perkins

John H. Perkins
Director

Weston R. Christopherson

Weston R. Christopherson
Director

Keith R. Potter

Keith R. Potter
Director

Gordon R. Corey

Gordon R. Corey
Director

John M. Richman

John M. Richman
Director

Robert A. Hanson

Robert A. Hanson
Director

Paul J. Rizzo

Paul J. Rizzo
Director

William A. Hewitt

William A. Hewitt
Director

William L. Weiss

William L. Weiss
Director

William B. Johnson

William B. Johnson
Director

Blaine J. Yarrington

Blaine J. Yarrington
Director

Jewel S. Lafontant

Jewel S. Lafontant
Director

March 1, 1982

Worldwide Facilities

Continental Illinois Corporation
Continental Illinois National Bank and Trust Company of Chicago

North America/United States

Chicago
Continental Illinois Corporation, *Head Office*
Continental Illinois National Bank and Trust Company of Chicago, * *Head Office*
Continental Bank International,** *Head Office*
Continental Illinois Commercial Corporation,* *Head Office*
Continental Illinois Venture Corporation*
Continental Illinois Equity Corporation*
Continental International Finance Corporation**
231 South LaSalle Street
Chicago, Illinois 60693
Personal Banking Services Department
209 South LaSalle Street, Chicago
30 North LaSalle Street, Chicago
Clark and Division Streets, Chicago
(Mailing address: 231 South LaSalle Street, Chicago, Illinois 60693)
Trust and Investment Services Department
30 North LaSalle Street, Chicago
(Mailing address: 231 South LaSalle Street, Chicago, Illinois 60693)
Representative Office—Northbrook
500 Skokie Boulevard
Northbrook, Illinois 60062
Representative Office—Oak Brook
2122 York Road, Suite 340
Oak Brook, Illinois 60521
Continental Illinois Leasing Corporation,*
Head Office
209 South LaSalle Street, Chicago
(Mailing address: 231 South LaSalle Street, Chicago, Illinois 60693)
CI General Equipment Leasing Corporation
CI Leasing Corporation
CI Transportation Leasing Corporation
231 South LaSalle Street
Chicago, Illinois 60693
Republic Realty Mortgage Corporation,*
Head Office
111 West Washington Street
Chicago, Illinois 60602
Atlanta
Regional Office of Continental Bank
260 Peachtree Street, N. W., Suite 1710
Atlanta, Georgia 30303
Republic Realty Mortgage Corporation*
Atlanta Branch
5780 Peachtree-Dunwoody Road, N.E.
Suite 350
Atlanta, Georgia 30342
Boca Raton
Continental Illinois Trust Company
of Florida, N.A.*
1499 West Palmetto Park Road
Boca Raton, Florida 33432
Cincinnati
Continental Illinois Leasing Corporation*
Cincinnati Office
580 Walnut Street, Suite 101
Cincinnati, Ohio 45202
Cleveland
Continental Bank International**
Cleveland Branch
1300 East 9th Street, Suite 711
Cleveland, Ohio 44114

Regional Office of Continental Bank
1300 East 9th Street, Suite 711
Cleveland, Ohio 44114

Dallas
Continental Bank International**
Dallas Branch
700 North Pearl, Suite 1700
Dallas, Texas 75201
Continental Illinois Leasing Corporation*
Dallas Office
700 North Pearl, Suite 1700
Dallas, Texas 75201
Regional Office of Continental Bank
700 North Pearl, Suite 1700
Dallas, Texas 75201

Denver
Regional Office of Continental Bank
410 Seventeenth Street, Suite 2400
Denver, Colorado 80202

Detroit
Regional Office of Continental Bank
26261 Evergreen Road, Suite 220
Southfield, Michigan 48076

Houston
Continental Bank International**
Houston Branch
1100 Milam Building, Suite 3500
Houston, Texas 77002

Continental Illinois Energy Development Corporation*
One Allen Center, Suite 780
Houston, Texas 77002

Regional Office of Continental Bank
1100 Milam, Suite 3510
Houston, Texas 77002

Kansas City
Republic Realty Mortgage Corporation*
Kansas City Branch
9233 Ward Parkway
Kansas City, Missouri 64114

Los Angeles
Continental Bank International**
Los Angeles Branch
515 South Flower Street, Suite 960
Los Angeles, California 90071
Leasing Representative Office
515 South Flower Street
Los Angeles, California 90071

Regional Office of Continental Bank
515 South Flower Street, Suite 900
Los Angeles, California 90071

Miami
Continental Bank International**
Miami Branch
888 Brickell Avenue, Miami, Florida 33131
Continental Illinois Commercial Corporation*
Miami Office
888 Brickell Avenue, Miami, Florida 33131

Milwaukee
Republic Realty Mortgage Corporation*
Milwaukee Branch
10701 West North Avenue
Wauwatosa, Wisconsin 53226

Minneapolis
Continental Bank International**
Minneapolis Branch
510 Marquette Avenue, Suite 300
Minneapolis, Minnesota 55402

Regional Office of Continental Bank
510 Marquette Avenue, Suite 300
Minneapolis, Minnesota 55402

New York
Continental Bank International**
New York Branch
One Liberty Plaza, New York, New York 10006
Continental Illinois Leasing Corporation*
New York Office
277 Park Avenue, New York, New York 10172
Regional Office of Continental Bank
277 Park Avenue, New York, New York 10172

Philadelphia
Continental Bank International**
Philadelphia Branch
3 Girard Plaza, 14th Floor
Philadelphia, Pennsylvania 19102
Commercial
3 Girard Plaza, 14th Floor
Philadelphia, Pennsylvania 19102

St. Louis
Republic Realty Mortgage Corporation*
St. Louis Branch
11 South Mieramec Avenue, Suite 906
St. Louis, Missouri 63105

San Francisco
Continental Bank International**
San Francisco Branch
50 California Street, Suite 1201
San Francisco, California 94111

Leasing Representative Office
50 California Street, Suite 1270
San Francisco, California 94111

Regional Office of Continental Bank
50 California Street, Suite 3010
San Francisco, California 94111

Seattle
Continental Bank International**
Seattle Branch
800 Fifth Avenue, Suite 3771
Seattle, Washington 98104

Regional Office of Continental Bank
800 Fifth Avenue, Suite 3770
Seattle, Washington 98104

White Plains
Regional Office of Continental Bank
3 Barker Avenue
White Plains, New York 10601

Canada

Calgary
Continental Illinois Bank (Canada)**
Calgary Branch
311 Sixth Avenue, S. W., Suite 1300
Calgary, Alberta T2P 3H2

Toronto
Continental Illinois Bank (Canada),**
Head Office
First Canadian Place, P.O. Box 369
Toronto, Ontario M5X 1H2
Continental Illinois Leasing Canada Limited
Subsidiary of Continental Illinois Bank
(Canada)

First Canadian Place, P.O. Box 369
Toronto, Ontario M5X 1H2

*Subsidiary of Continental Illinois Corporation
**Subsidiary of Continental Bank

Europe**Belgium**

Continental Bank S.A./N.V.,** *Head Office*
Rue de la Loi 227, 1040 Brussels

Continental Bank S.A./N.V.**

Kipdorp 10-12, 2000 Antwerp

France

Paris Branch

10, Avenue Montaigne, 75008 Paris

Germany, Federal Republic of

Frankfurt Branch

Bockenheimer Landstrasse 24, 6000 Frankfurt

Greece

Athens Branch

24 Stadiou Street, Athens

Piraeus Branch

25 Akti Miaouli Street, Piraeus

Thessaloniki Branch

3 Ionos Dragoumi Street, Thessaloniki

Italy

Continental Illinois Finanziaria S.p.A.**

Via Montenapoleone, 27, 20121 Milan

Milan Branch

Via Montenapoleone, 27, 20121 Milan

Rome Representative Office

Via dei Cappuccini, 6, 00187 Rome

The Netherlands

Amsterdam Branch

Weteringschans 109, 1017 SB Amsterdam

Spain

Barcelona Branch

Avenida Diagonal, 427 bis-429

Barcelona-36

Madrid Branch

Calle Jose Ortega y Gasset No. 29, Fifth Floor

Madrid 6

Switzerland

Continental Illinois Bank (Switzerland)**

Bahnhofstrasse 18, CH 8022 Zurich

Continental Illinois Investment Advisory

Corporation (CIAC)*

62, rue du Rhône, CH 1204 Geneva

Geneva Representative Office

40, rue du Rhône, CH 1204 Geneva

United Kingdom

Continental Illinois International Investment

Corporation (CIIC)*

Continental Bank House

162 Queen Victoria Street

London EC4V 4BS

Continental Illinois Limited*

Continental Bank House

162 Queen Victoria Street

London EC4V 4BS

Leasing Representative Office

Continental Bank House

162 Queen Victoria Street

London EC4V 4BS

London Branch

Continental Bank House

162 Queen Victoria Street

London EC4V 4BS

Latin America/Caribbean**Argentina**

Buenos Aires Branch

25 de Mayo 537, Buenos Aires 1002

Bahamas

Nassau Branch

Charlotte House, Suite B

Charlotte and Shirley Streets, Nassau

Brazil

Continental Illinois Leasing Do Brazil*

Avenida Brigaderio Faria Lima, 1815—

9º Andar

Caixa Postal 20.981, São Paulo, SP

São Paulo Representative Office

Avenida Paulista, 2439—6º Andar

Caixa Postal 369, 01311 São Paulo, SP

Chile

Chicago Continental Bank

Santiago Branch

Moneda 1138, Clasificador 233, Correo Central

Santiago

Colombia

Bogotá Representative Office

Edificio Ugi

Avenida 40A No. 13-09 Oficina 17-03-04

Apartado Aereo 91966, Bogotá

Mexico

Mexico City Representative Office

Edificio Plaza Comermex

Boulevard M. Avila Camacho No. 1

Mexico 10, D.F.

Puerto Rico

Puerto Rico Branch

Mercantil Plaza, Suite 813

Ponce de Leon Avenue, Hato Rey

Venezuela

Caracas Representative Office

Edificio Centro Altamira, Piso 5, Oficina 2

Avenida San Juan Bosco

Urbanizacion Altamira, Caracas

Africa/Middle East**Bahrain**

Manama Representative Office

Bab al Bahrain Building

P.O. Box 5237, Manama

Kenya

Nairobi Representative Office

Prudential Assurance Building, 3rd Floor

Wabera Street, Nairobi

Lebanon

Continental Development Bank, S.A.L.,**

Head Office

Ghanous Building, Dora Boulevard, Dora

Asia/Pacific**Australia**

Sydney Representative Office

Macquarie House, 7th Floor

167 Macquarie Street, Sydney 2000, N.S.W.

Hong Kong

Underwriters Bank (Overseas) Limited**

New World Tower, Ground Floor

16-18 Queen's Road Central, Hong Kong

Indonesia

Jakarta Representative Office

Wisma Kosgoro, 14th Floor

Jalan M.H. Thamrin No. 53, Jakarta

Japan

Osaka Branch

Hasegawa Dai-Ichi Building

40, Hiranomachi 5-chome, Higashi-ku

Osaka 541

Tokyo Branch

Mitsui Seimei Building, 2-3

Ohtemachi 1-chome

Chiyoda-ku, Tokyo 100

Korea

Seoul Branch

Daewoo Center Building, 18th Floor

No. 541, 5-KA, Namdaemoon-ro

Chong-ku 100, Seoul

The Philippines

Manila Representative Office

Solidbank Building, 8th Floor

Paseo de Roxas

Makati, Metro Manila, Philippines 3117

Singapore

Singapore Branch

2101 OCBC Centre

Chulia Street, Singapore 0104

Taiwan

Taipei Branch

62, Nanking East Road, Section 2

Taipei

Thailand

Bangkok Representative Office

Panuee Building, 9th Floor

518-3 Plerchit Road

Tambol Lumpini, Amphur Patumwan

Bangkok

Continental Illinois Thailand Limited**

Panuee Building, 9th Floor

518-3 Plerchit Road

Tambol Lumpini, Amphur Patumwan

Bangkok

Investments in Affiliated Banks and Financial Institutions**Australia**

Commercial Continental Limited,

Sydney; Melbourne

Lease Industrial Finance Limited, Brisbane

Colombia

Corporacion Financiera del Valle, Cali

Ecuador

Compania Financiera Ecuatoriana de Desarrollo

S.A., "COFIEC," Quito; Guayaquil

Malaysia

Malaysian International Merchant Bankers

Berhad, Kuala Lumpur

Nigeria

NAL Merchant Bank Limited, Lagos

Pakistan

Pakistan Industrial Credit & Investment

Corporation Limited, Karachi

The Philippines

House of Investments, Inc., Manila

Rizal Commercial Banking Corporation,

Makati, Rizal

Singapore

Private Investment Company for Asia S.A.,

Singapore; Tokyo

Taiwan

China Investment and Trust Company Limited,

Taipei

*Subsidiary of Continental Illinois Corporation

**Subsidiary of Continental Bank

Stockholder Information

Annual Meeting

The Annual Meeting of Stockholders will be held Monday, April 26, 1982, at 10:00 a.m. in the Columbus Drive Auditorium of the Art Institute of Chicago, Columbus Drive at Monroe Street, Chicago, Illinois.

Corporate Information

Additional copies of this Annual Report and Form 10-K and supplemental financial reports published quarterly may be obtained without charge from Corporate Affairs, Continental Illinois Corporation, 231 South LaSalle Street, Chicago, Illinois 60693.

The following materials also are available without charge from Corporate Affairs:

Behind That Quiet Facade, a history of Continental Bank from its founding in 1857 to the present.

... *Because We Live Here*, a series outlining Continental's involvement in its communities.

Stock Listing

Continental Illinois Corporation stock is traded on the New York, Midwest, Pacific, and London exchanges. Many newspapers report the daily price per share of the stock as traded on the New York exchange, commonly using the abbreviation ContIll. The official trading symbol is CIL.

Transfer Agent

Continental Illinois National Bank and Trust Company
of Chicago
231 South LaSalle Street, Chicago, Illinois 60693

Registrar

Chicago Title and Trust Company
111 West Washington Street, Chicago, Illinois 60602

Co-registrar and Co-transfer Agent

Manufacturers Hanover Trust Company
350 Park Avenue, New York, New York 10005

No. 6643
STATE OF OKLAHOMA }
CADDO COUNTY } SS.
FILED FOR RECORD



APPENDIX B

APR 7 1982

Recorded in Book 211 Page 865 ASSIGNMENT OF OVERRIDING ROYALTY INTERESTS

Jack VanDerCater, County Clerk
Jack VanDerCater

STATE OF OKLAHOMA }
COUNTY OF CADDO }

SS: KNOW ALL MEN BY THESE PRESENTS:

In consideration of the sum of One and No/100 Dollars (\$.100) and other good and valuable consideration, receipt of which is hereby acknowledged, GHK EXPLORATION COMPANY, as Assignor, does hereby grant, bargain, assign, transfer, sell and convey unto Continental Leasing Company, a general partnership, whose address is c/o Mr. Bill Patterson, Penn Square Bank, P.O. Box 26208, Oklahoma City, Oklahoma, 73126, its heirs, successors and assigns, as Assignee, an overriding royalty interest of one-eighth of eight eighths (1/8th of 8/8ths) of all the oil, gas and other hydrocarbons and all other minerals produced, saved and sold, if as and when produced, saved and sold, but not otherwise, from the lands set out and covered by the oil and gas leases set out on Exhibit "A" attached hereto and made a part hereof (the "Subject Leases").

Said overriding royalty interest shall, as to each Subject Lease, be reduced by any landowner's royalty in excess of the usual one-eighth (1/8) and any overriding royalty interest, production payment or any other burden upon production to which the Subject Lease is subject on the date hereof.

Said overriding royalty interest shall apply to extensions or renewals of the Subject Leases, an extension or renewal lease being defined as a lease acquired by Assignor, its successors or assigns, prior to six (6) months after the expiration or release of a Subject Lease covering the same land, or the expiration or release of a prior extension or renewal lease covering the same land.

Said overriding royalty interest shall be free of all development, production, marketing and operating expense; however, said interest shall bear and pay currently its portion of gross production taxes, pipeline taxes and all other taxes assessed against the gross production subject to said overriding royalty interest. It is agreed that nothing herein contained shall impose upon the Assignor, its successors and assigns, any duty or obligation to develop or operate the properties covered by the Subject Leases for oil, gas, other hydrocarbons or other minerals not imposed by the provisions of said Subject Leases, nor to maintain said Subject Leases in effect by the payment of delay rentals.

It is understood and agreed that the Assignor shall have the right to pool the Subject Leases and the lands covered thereby, or any part thereof, with other lands and leases into voluntary units or into units established by any governmental authority having jurisdiction and if the Subject Leases, and the lands covered thereby, or any part thereof is pooled accordingly, the overriding royalty interest herein conveyed shall be reduced in the proportion that the acreage burdened by said overriding royalty interest bears to all the acreage included in any such pooled unit.

If any Subject Lease covers less than the full interest in the minerals in and under the lands (or portion thereof) covered by such Subject Lease, then the overriding royalty interest herein conveyed as to such Subject Lease shall be reduced and paid only in the proportion that the interest in the minerals in such lands or portion thereof covered by such Subject Lease bears to the full interest in the minerals in such lands; and, if the interest of Assignor in a Subject Lease is less than the full interest therein, the overriding royalty interest herein conveyed shall be reduced and paid only in the proportion that the interest of Assignor bears to the full interest in such Subject Lease.

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This assignment is made without warranty, either express or implied.

All of the provisions of this assignment shall be binding upon all the heirs, successors, representatives and assigns of the Assignor and Assignee.

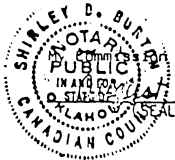
In witness hereof, this instrument is executed on this 7th day of April, 1982.

GHK EXPLORATION COMPANY

By: Larry A. Ray
LARRY A. RAY
ATTORNEY-IN-FACT

STATE OF OKLAHOMA)
) SS:
COUNTY OF OKLAHOMA)

The foregoing instrument was acknowledged before me this 7th day of April, 1982, by Larry A. Ray, Attorney-in-fact for GHK EXPLORATION COMPANY.



Expires: 11.1984

Shirley D. Burton
NOTARY PUBLIC

ASSIGNMENT OF OVERRIDING ROYALTY INTEREST

THIS ASSIGNMENT dated April 5, 1982, is made by:

GHK EXPLORATION COMPANY,
an Oklahoma partnership,
6441 Northwest Grand Boulevard
Oklahoma City, Oklahoma 73116

("Assignor")

IN FAVOR OF

CONTINENTAL ILLINOIS ENERGY
DEVELOPMENT CORPORATION,
a Delaware corporation,
1 Allen Center
Suite 780
Houston, Texas 77002

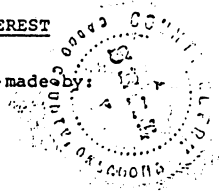
("Assignee").

NOW THE ASSIGNOR AGREES AS FOLLOWS:

1. INTERPRETATION. In this Assignment, unless the context otherwise requires:

"Affiliate" means any corporation directly or indirectly controlling, controlled by, or under common control with, the Assignor. The term "control" as used herein in relation to a corporation, means the right to exercise, directly or indirectly, more than fifty percent (50%) of the voting rights attributable to shares of a corporation having ordinary voting rights for the election of directors.

"Assignee" means Continental Illinois Energy Development Corporation and includes its successors and assigns.



No. 6547
STATE OF OKLAHOMA }
CADDO COUNTY } SS.
FILED FOR RECORD

APR 6 1982
ALB M R recorded in Book 241 Page 407-460
Jack VanDeventer County Clerk
BY [Signature] DEP. (SEAL)

407

(S.E. Ana.)

"Assignor" means GHK Exploration Company and includes its transferees, successors and assigns;

"Assignor's Interest" means, in respect of a lease, the undivided interest of the Assignor in the Working Interest of that Lease;

"Leases" means the leases described in Exhibit A hereto and, individually, each of the Leases is called a "Lease";

"Leased Lands" means the lands covered by the Leases;

"Overriding Royalty Interest" means with respect to a Lease, one percent (1%) of the Assignor's Interest in that Lease. For example, if the Assignor owns the full interest in a Lease and if the royalty, and any overriding royalty, payable to the lessor of that Lease is $\frac{3}{16}$ ths of the production from or attributable to that Lease, the Overriding Royalty Interest in that Lease conveyed to the Assignee hereunder shall be 1% times $\frac{13}{16}$ th of the oil, gas and other leased substances produced from or attributable to that Lease;

"Working Interest" means with respect to a Lease, all oil, gas and other hydrocarbons and hydrocarbon production from or attributable to that Lease after deducting therefrom only the oil, gas and other hy-

drocarbons and hydrocarbon production attributable to any royalty or overriding royalty interests of the Lessor of that Lease, but without deduction for (i) overriding royalty interests other than those of the Lessor of that Lease, (ii) net profit interests, (iii) production payments, or (iv) any other similar burdens upon production heretofore or hereafter created.

For the purpose of calculating overriding royalties, including the Overriding Royalty Interest, the oil, gas and other hydrocarbon production shall be deemed not to include all oil, gas, casinghead gas or other hydrocarbons from that Lease consumed for operating, development or production purposes (including recycling or repressuring operations) or unavoidably lost, provided that any gas or casinghead gas used for recycling or repressuring operations which is saved and marketed from time to time shall be included in production as of such time.

The singular includes the plural, and vice-versa.

Sections headings are for convenience or reference only and shall not affect the interpretation or construction of this Assignment.

2. ASSIGNMENT OF OVERRIDING ROYALTY INTERESTS. For TEN DOLLARS and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the As-

signor hereby sells, assigns, conveys, transfers and sets over to the Assignee an Overriding Royalty Interest in each of the Leases, TO HAVE AND TO HOLD the Overriding Royalty Interests for and during the terms and according to the terms and conditions of each respective Lease and according to the terms and conditions of this Assignment.

3. CONDITIONS OF OVERRIDING ROYALTY INTEREST.

3.1 Payment for Production. The Assignee shall be paid for the production attributable to the Overriding Royalty Interest based upon the amounts realized from the sale thereof computed at the well, provided that, if such production is not sold or is sold to an Affiliate, payment shall be based upon the value of the production at the well as determined for the purposes of paying the lessor's royalty under the relevant Lease.

3.2 Lease Terms; Provisions of Leases. Each Overriding Royalty Interest is assigned to the Assignee for and during the term of the relevant Lease.

Each Overriding Royalty Interest is subject to the terms and conditions of the relevant Lease as the same may from time to time be amended. The Assignor is not under an obligation, expressed or implied, to keep or maintain any Lease in force whether by payment of rentals, compensatory royalties, or other payments, or by the drilling of any wells upon the Leased Lands or lands unitized therewith.

3.3 Costs and Taxes. The Overriding Royalty Interests shall be free and clear of all drilling, developing and operating costs and expenses, but the Assignee shall bear and pay all taxes (including, without limitation, all production, severance, gathering or similar taxes) which may now or hereafter be directly levied or directly applicable to any Overriding Royalty Interest in the oil, gas and other hydrocarbons produced from or attributable to a relevant Lease.

3.4 Pooling and Unitization. If the Leased Land, or any portion thereof, is pooled or unitized for development and operation as a unit with other lands, the Overriding Royalty Interest shall be delivered and paid on that proportion of the entire unit production which the acreage in the Leased Lands placed in the unit bears to the entire acreage in the Unit.

3.5 Other Overriding Royalties. The Overriding Royalty Interests are in addition to any other overriding royalty interest or other payments out of production which may burden the Leases.

4. REPRESENTATIONS AND WARRANTIES. The Assignor states, based on its best information and belief after making examination of its records and after making such other investigation as is customarily made by prudent purchasers in connection with the acquisition of similar leases, that the Assignor's Interest, expressed as a decimal fraction of the

oil, gas and other hydrocarbons and hydrocarbon production under a Lease, is .8125 in the case of each Lease shown on Exhibit A except those for which a decimal fraction is shown in the column headed "Assignor's Interest" on Exhibit B hereto and for the latter is the decimal fraction for each Lease shown on said Exhibit B. Assignor represents and warrants that its title in each of the Leases is free from all liens, charges or encumbrances created or existing by, through or under the Assignor. Assignor further agrees to warrant and defend title to each and every Overriding Royalty Interest unto the Assignee, its successors and assigns against any and every third party lawfully claiming the same or any part thereof by, through or under any right acquired or purported to be acquired from the Assignor. The Assignor further represents and covenants that it has good and legal right to grant and assign the Overriding Royalty Interest to the Assignee. Except as set forth above, Assignor makes no warranty, either express or implied.

5. FEDERAL LEASES. The Assignor requests the Assignee to take cognizance of the fact that applicable Federal law and regulations, including but not limited to Section 3103.3-6, Title 43, Code of Federal Regulations provided that where the lessor's royalty and overriding royalties on any lease which is subject to the Mineral Leasing Act of 1920 (as amended) (a "Federal Lease") exceed 17.5% of the oil, gas and other minerals produced, saved, and marketed from a well

thereon, such overriding royalties (to the extent in excess of such 17.5% of the oil and liquid hydrocarbons produced) shall be suspended when the average production of oil per well per day, averaged on a monthly basis, is fifteen (15) barrels or less. Such suspension applies to any zone or portion of a Federal Lease segregated for computing the lessor's royalty. The Assignor also requests the Assignee to take cognizance of the fact that certain applicable state or Indian laws and regulations provide that where lessor's royalty and/or overriding royalties on a lease subject to said laws and regulations exceed a certain percentage of the oil, gas, and other minerals produced, saved and marketed from a well thereon, overriding royalties (to the extent in excess of the specified percentage of the oil, gas or other minerals produced) shall be suspended under certain circumstances. It is further requested of the Assignee that it recognize that the aforesaid laws and regulations may be amended or revised to change the circumstances whereupon suspension of excess overriding royalties is required. It is a condition of this Assignment that in the event any portion of the Overriding Royalty Interest on a Lease is required by any present or future laws or regulations, to be suspended by the Assignor, it may do so.

6. ASSIGNMENTS.

6.1 Assignor. The Assignor may sell, assign, convey or otherwise dispose of all or any part of its retained

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interest in the Leases, provided that any instrument of sale, assignment, conveyance or other disposition shall contain specific language which (i) subjects said instrument to the terms of this Assignment, and (ii) refers to the pertinent recording data hereof.

6.2 Assignee. The Assignee may sell, assign or otherwise dispose of all or any part of any Overriding Royalty Interest, and the terms of this Assignment shall inure to the benefit of the successors and assigns of the Assignee.

6.3 Counterparts. This Conveyance is being executed in multiple original counterparts, all of which are identical except that, to facilitate filing and recording, counterparts to be filed and recorded in the appropriate records of each county may have included in Exhibit A only the portions of Exhibit A containing the specific descriptions of the Leases located in said county. Every counterpart of this Conveyance shall be deemed an original for all purposes and all counterparts together shall constitute one and the same Conveyance.

IN WITNESS WHEREOF the Assignor has executed this Assignment the day and year first hereinabove written.

GHK EXPLORATION COMPANY

By Larry A. Ray
LARRY A. RAY, Attorney-in-Fact

STATE OF OKLAHOMA)
) ss.
COUNTY OF OKLAHOMA)

The foregoing instrument was acknowledged before me this 5th day of April, 1982 by Larry A. Ray, as Attorney-in-Fact on behalf of GHK Exploration Company, a partnership.

My commission expires:

1-28-86

Kathleen Thompson
Notary Public



(Cyril)

No. 2323
 STATE OF OKLAHOMA } SS.
 CADDO COUNTY
 FILED FOR RECORD

CONVEYANCE AND ASSIGNMENT

FEB 9 1982

KNOW ALL MEN BY THESE PRESENTS:

Recorded in Book 230 Page 112-116
 Jack VanDoverney, County Clerk
 Caddo County, Oklahoma
 (SEAL)

That THIS CONVEYANCE AND ASSIGNMENT ^{dated as of} February 2, 1982 (the "Conveyance and Assignment") is made in two parts, Part I being a Conveyance of Overriding Royalty Interest from Robert A. Hefner III ("Assignor"), a single man, to U.K. Leasing Company, a general partnership created pursuant to the Uniform Partnership Act of the State of Oklahoma ("Assignee"), c/o Bill Patterson, Penn Square Bank, 1919 Penn Square, P. O. Box 26208, Oklahoma City, Oklahoma 73126, and Part II being an Assignment of Oil and Gas Leases from Assignor to GHK Exploration Company, a general partnership created pursuant to the Uniform Partnership Act of the State of Oklahoma ("Exploration"); 6441 N.W. Grand Boulevard, Oklahoma City, Oklahoma 73116.

PART ICONVEYANCE OF OVERRIDING ROYALTY INTEREST

Assignor, for and in consideration of the sum of Ten Dollars (\$10.00) and other good and valuable consideration to it paid by Assignee, the receipt and sufficiency of which are hereby acknowledged, has BARGAINED, SOLD, GRANTED, CONVEYED, TRANSFERRED, ASSIGNED, SET OVER and DELIVERED, and by these presents does hereby BARGAIN, SELL, GRANT, CONVEY, TRANSFER, ASSIGN, SET OVER and DELIVER unto Assignee, overriding royalty interests (the "Overriding Royalty Interest") equal to 3.125 percent of 8/8ths of all Minerals in and under, and if, as and when produced (but not otherwise) from or attributable to the Leased Lands described in the Leases during the terms of the Leases and any extensions and renewals thereof and the Proceeds therefrom, subject to the terms and provisions of this Conveyance, including the provisions for proportionate reduction of the Overriding Royalty Interest contained in Section 2.01 and the provisions relating to extensions, renewals and certain new leases contained in Section 2.05 hereof. The Overriding Royalty Interest shall be applied and calculated separately as to each Lease. The words with initial capital letters are used as defined in Article I hereof.

TO HAVE AND TO HOLD the Overriding Royalty Interest, together with all and singular the rights and appurtenances thereto in anywise belonging unto Assignee, its successors and

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assigns, subject, however, to the Permitted Agreements and to the terms and provisions of this Conveyance; and Assignor does by these presents bind and obligate itself, its successors and assigns, to WARRANT and FOREVER defend all and singular the Overriding Royalty Interest unto the said Assignee, its successors and assigns, against every person whomsoever lawfully claiming or to claim the same or any part thereof by, through or under Assignor, but not otherwise.

ARTICLE I

Definitions

As herein used the following words, terms or phrases have the following meanings:

SECTION 1.01. "Affiliate" means, as to the party specified, any Person controlling, controlled by or under common control with such party, with the concept of control in such context meaning the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of another, whether through the ownership of voting securities, by contract or otherwise.

SECTION 1.02. "Conveyance" means the Conveyance of Overriding Royalty Interest which is Part I of this instrument.

SECTION 1.03. "Effective Date" means 12:00 o'clock midnight local time in effect at the location of each Lease on the date of this Conveyance.

SECTION 1.04. "Leased Lands" means the tract or tracts of land described in each of the Leases set out in Exhibit A hereto and shall include all gross acres included within the boundaries of such tract or tracts without regard to the portion of the mineral interest or leasehold interest covered by any particular Lease.

SECTION 1.05. "Leases" means the oil, gas and mineral leases described in Exhibit A hereto.

SECTION 1.06. "Minerals" means oil, gas, condensate, sulphur and all other minerals, whether similar or dissimilar.

SECTION 1.07. "Non-Affiliate" means, as to the party specified, any Person who is not an Affiliate of such party.

SECTION 1.08. "Permitted Agreements" means all applicable operating agreements, gas purchase contracts and unitization or pooling agreements in existence on the Effective Date, and all applicable agreements with Non-Affiliates to

which the Leases were subject at the time of the acquisition by Assignor or any Affiliate of an interest in such Leases.

SECTION 1.9. "Person" means any individual, corporation, partnership, trust, estate or other entity or organization.

SECTION 1.10. "Proceeds" means

(a) the amounts realized from the sale of Minerals to a Non-Affiliate, determined at the well;

(b) on Minerals sold to Subject Lessee or an Affiliate and not Processed, either: (i) the market value at the well of such Minerals, or (ii) the amount paid by Subject Lessee or such Affiliate for such Minerals, whichever is the greater; and

(c) on Minerals (A) used off the Leased Lands described in the Lease on which the well from which such Minerals are produced or off lands pooled or unitized therewith or (B) Processed by Subject Lessee or an Affiliate, the market value at the well, with market value at the well of Minerals Processed being determined by either: (i) amounts realized from the sale to a Non-Affiliate or (ii) market value at the Processing plant where sold or used by Subject Lessee or an Affiliate of any and all products including residue gas resulting from Processing, less either the: (i) actual Processing costs, and, if not included in such costs, a reasonable return on invested capital, and expenses incurred and borne by Subject Lessee or an Affiliate relating to such Minerals, or (ii) reasonable charges for Processing, relating to such Minerals, whichever is the lesser.

SECTION 1.11. "Process" means to manufacture, refine, treat for marketing, extract, absorb, or compress or otherwise deal with Minerals in a manner which does not constitute Well Operations. "Processing" and "Processed" mean the act of such Process.

SECTION 1.12. "Royalty Owner" means the Assignee while it owns an interest in the Overriding Royalty Interest, and any other Person who subsequently acquires legal title to all or any portion of the Overriding Royalty Interest.

SECTION 1.13. "Subject Lessee" means Assignor while it owns all or part of the Leases other than a royalty or pro-

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duction payment interest and any other Person who acquires all or any part of the Leases other than a royalty or production payment interest.

SECTION 1.14. "Well Operations" means gravity separation of Minerals and other normal operations in the vicinity of the well but does not include compression, transportation or Processing of the Minerals, or absorption, or fractionalization, and other plant operations.

ARTICLE II

Special Provisions Relating to Overriding Royalty Interest

SECTION 2.01. Proportionate Reductions. If any Lease covers less than the full interest in the Minerals in and under the Leased Lands (or portion thereof) covered by such Lease, then the Overriding Royalty Interest as to such Lease shall be reduced and paid only in the proportion that the interest in the Minerals in such lands or portion thereof covered by such Lease bears to the full interest in the Minerals in such Leased Lands; and, if the interest of Assignor in a Lease is less than the full interest therein, the Overriding Royalty Interest shall be reduced and paid only in the proportion that the interest of Assignor bears to the full interest in such Lease.

SECTION 2.02. Costs and Taxes. The Overriding Royalty Interest shall not bear, either directly or indirectly, any part of the costs or expenses of development and production of the Minerals attributable to the Subject Interests. The Overriding Royalty Interest shall bear its pro rata portion of all taxes legally imposed on the Minerals attributable to the Leases, including production, severance, ad valorem, pipeline and windfall profits taxes but excluding any federal, state or local income taxes.

SECTION 2.03. Minerals Lost in Production. There shall be excluded from the Overriding Royalty Interest any amount for Minerals attributable to the Leases unavoidably lost in the production thereof or used by Subject Lessee in conformity with prudent practices for drilling, production and plant operations (including gas injection, secondary recovery, pressure maintenance, repressuring, cycling operations, plant fuel or shrinkage) conducted for the purpose of producing Minerals or from any unit to which the Leases are committed, but only so long as such Minerals are so used.

SECTION 2.04. Federal Leases. So long as and to the extent that the same may be required by applicable laws and regulations, in the case of any Lease from the United States of America included in the Leases from which the average production of oil per well per day averaged on the monthly basis is 15 barrels or less, the obligation to pay and the right of the Royalty Owner to receive the proceeds of oil produced from such Lease shall be ratably reduced or suspended to the extent that all presently effective lease burdens exceed 5% of 8/0th, excluding lessor's royalty, until said average production of oil per well per day exceeds said minimum amount, and such suspension shall apply separately to any zone or portion of such Lease segregated for computing government royalties.

SECTION 2.05. Application to Extensions, Renewals and New Leases. The Overriding Royalty Interest shall apply to an extension or renewal of a Lease or to a new lease, to the extent that any such renewal, extension or new lease covers the same interest in the same land as a Lease, which is acquired by grant or assignment by Assignor, its successors or assigns, prior to a date which is six months after the expiration or termination of the Lease or prior to six months after the expiration or termination of any prior lease to which the Overriding Royalty Interest applied, provided that any such lease is acquired during the period of the life of the last survivor of the descendants of Joseph P. Kennedy, father of the late President of the United States of America, living on the date of the execution hereof, plus 21 years after the death of such last survivor.

ARTICLE III

Payment by Assignor

SECTION 3.01. Payment by Assignor. If for any reason Assignor or its Affiliate receives any monies attributable to the Overriding Royalty Interest, Assignor shall, and shall cause its Affiliate to, pay by the twenty-fifth day of the month following the month of receipt thereof such amounts to the Assignee. Prior to receipt by Assignee of such amounts, Assignor or its Affiliate, as the case may be, shall hold such amounts in trust for the benefit of Assignee.

ARTICLE IV

Non-Liability of Royalty Owner

SECTION 4.01. Non-Liability of Royalty Owner. In no event shall Royalty Owner be liable or responsible in any

way for any production costs or other costs or liabilities incurred by Subject Lessee or other lessees attributable to the Leases or to the Minerals produced therefrom, except for the costs borne by the Overriding Royalty Interests under the definition of the term "Proceeds."

ARTICLE V

Unitization

SECTION 5.01. Pooled Leases. Certain of the Leases may have been heretofore pooled and unitized for the production of Minerals. Such Leases are and shall be subject to the terms and provisions of such pooling and unitization agreements, and the Overriding Royalty Interest in each such Leases shall apply to and affect only the production from such units which accrues to such Leases under and by virtue of the applicable pooling and unitization agreements.

SECTION 5.02. Right to Pool. Subject Lessee shall have the right and power, exercisable only during the period provided in Section 5.03 hereof, to pool and unitize any of the Leases and to alter, change, amend or terminate any pooling or unitization agreements heretofore or hereafter entered into, as to all or any part of the land covered hereby, as to any one or more of the formations or horizons thereunder, and as to any one or more Minerals, upon such terms and provisions as Subject Lessee shall in its sole discretion determine. If and whenever through the exercise of such right and power, or pursuant to any law hereafter enacted or any rule, regulation or order of any governmental body or official hereunder promulgated, any of the Leases are pooled or unitized in any manner, the Overriding Royalty Interest insofar as it affects such Lease shall also be pooled and unitized, and in any such event such Overriding Royalty Interest in such Lease shall apply to and affect only the production which accrues to such Lease under and by virtue of the pooling and unitization.

SECTION 5.03. Applicable Period. Subject Lessee's power and right to pool and unitize the Leases and the Overriding Royalty Interest shall be exercisable and enjoyed only during the period of the life of the last survivor of the descendants of Joseph P. Kennedy, father of the late President of the United States of America, living on the date of execution hereof, plus 21 years after the death of such last survivor.

ARTICLE VI

Government Regulation

SECTION 6.01. Government Regulation. All obligations of the Subject Lessee hereunder shall be subject to all applicable provisions of the Emergency Petroleum Allocation Act of 1973, the Department of Energy Organization Act, the Natural Gas Act, the Natural Gas Policy Act of 1978 and each other statute purporting to provide comparable regulations for the sale of Minerals or establishing maximum prices at which the same may be sold and all applicable laws, orders, rules and regulations thereunder of the Federal Energy Regulatory Commission, the Department of Energy and each other legislative or governmental body, agency, board or commission having jurisdiction. Rates permitted under the Natural Gas Act, the Natural Gas Policy Act of 1978, the Emergency Petroleum Allocation Act of 1973 and each such other statute and the rules and regulations thereunder to be paid for the Minerals attributable to Leases shall be controlling if lower than prices established in contracts for the sale thereof or if lower than the rates used in determining Proceeds. The Subject Lessee shall be entitled to use its reasonable discretion in making filings, for itself and on behalf of the Royalty owner, with the Federal Energy Regulatory Commission, the Department of Energy or any other governmental body, agency, board or commission having jurisdiction, affecting the price or prices at which Minerals attributable to Leases may be sold.

Compliance with any now or hereafter existing statute or law of the federal or any state government or with orders, judgments, decrees, rules, regulations made by federal or state courts, offices, boards, commissions or agencies having jurisdiction shall not constitute a violation of any of the terms of this Conveyance or be considered a breach of any clause, obligation, covenant, undertaking, condition or stipulation contained herein and this agreement shall be subject to all federal and state laws, orders, rules or regulations.

ARTICLE VII

Assignments

SECTION 7.01. Assignment by Subject Lessee. Subject Lessee shall have the right to assign, sell, transfer, convey, mortgage or pledge the Leases, or any part thereof, subject to the Overriding Royalty Interest and the terms and provisions of this Conveyance and any such assignment shall relieve such Assignor of all obligations thereafter accruing hereunder to the extent of the interest assigned.

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SECTION 7.02. Assignment by Royalty Owner. Royalty Owner has the right to assign the Overriding Royalty Interest in whole or in part. However, no such assignment will affect the method of computing the Proceeds.

SECTION 7.03. Change in Ownership. No change of ownership or right to receive payment of the Overriding Royalty Interest, or of any part thereof, however accomplished, shall be binding upon Subject Lessee until notice thereof shall have been furnished by the Person claiming the benefit thereof, and then only with respect to payments thereafter made. Notice of sale or assignment shall consist of a certified copy of the recorded instrument accomplishing the same; notice of change of ownership or right to receive payment accomplished in any other manner (for example by reason of incapacity, death or dissolution) shall consist of certified copies of recorded documents and complete proceedings legally binding and conclusive of the rights of all parties. Until such notice shall have been furnished Subject Lessee as above provided, the payment or tender of all sums payable on the Overriding Royalty Interest may be made in the manner provided herein precisely as if no such change in interest or ownership or right to receive payment has occurred. The kind of notice herein provided shall be exclusive, and no other kind, whether actual or constructive, shall be binding on Subject Lessee.

ARTICLE VIII

Miscellaneous

SECTION 8.01. Further Assurances. Should any additional instruments of assignment and conveyance be required to describe more specifically any interest subject hereto, Assignor agrees to execute and deliver the same. Also, if any other or additional instruments are required in connection with the transfer of federal or state lease interests in order to comply with applicable laws or regulations, Assignor will execute and deliver the same.

SECTION 8.02. Binding Effect. This Conveyance shall bind and inure to the benefit of successors and assigns of Assignor and Assignee.

SECTION 8.03. Governing Law. The validity, effect and construction of this Conveyance shall be governed by the laws of the jurisdiction in which the Leases are located.

SECTION 8.04. Headings. Article and Section headings used in this Conveyance are for convenience only and shall not affect the construction of this Conveyance.

SECTION 8.05. Substitution of Warranty. This Conveyance is made with full substitution and subrogation of Assignee in and to all covenants of warranty by others heretofore given or made with respect to the Leases or any part thereof or interest therein.

SECTION 8.06. Limited Obligation. The Assignee and its successors and assigns agree to look solely to the Overriding Royalty Interests for payment of the amounts herein provided to be paid, and without recourse to the Subject Lessee, or its successors and assigns, provided that nothing contained in this Section 8.06 shall discharge, limit or otherwise affect the Assignor's liabilities under its warranties, covenants, agreements and other obligations contained herein.

PART II

ASSIGNMENT OF OIL AND GAS LEASES

Assignor, for and in consideration of the sum of Ten Dollars (\$10.00) and other good and valuable considerations to it paid by Exploration, does hereby assign, transfer, set over and convey unto Exploration all of his right, title and interest in and to the oil and gas leases described in Exhibit A attached hereto insofar as said leases cover the lands described in said Exhibit A (the "Leases"), subject to all of the terms and provisions of the Conveyance of Overriding Royalty Interest which is Part I of this Conveyance and Assignment and subject to the Overriding Royalty Interest conveyed thereby, together with all personal property used or obtained in connection therewith.

TO HAVE AND TO HOLD unto Exploration, subject to the aforesaid Overriding Royalty Interest and to all of the covenants and conditions hereof.

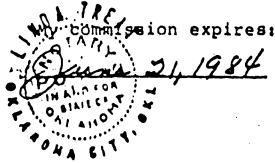
This assignment is made without warranty, either express or implied, but is made with full substitution and subrogation of Exploration in and to all covenants of warranty by others heretofore given or made with respect to the Leases or any part thereof or interest therein.

STATE OF OKLAHOMA)
) ss.
COUNTY OF OKLAHOMA)

BEFORE ME, the undersigned authority, on this day personally appeared ROBERT A. HEFNER III, known to me to be the person whose name is subscribed to the foregoing instrument and acknowledged to me that he executed the same for the purposes and consideration therein expressed.

Given under my hand and seal of office this the 2nd day of February, 1982.

Linda West
Notary Public



*Co. S. L. O. City
Real Estate Rec.*

MORTGAGE, DEED OF TRUST, ASSIGNMENT, SECURITY
AGREEMENT AND FINANCING STATEMENT

FROM

GHK EXPLORATION COMPANY

TO

Laurel Cavalla, Trustee

AND

Kurt M. Wegleiter Trustee

AND

CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST
COMPANY OF CHICAGO, as Agent

Dated as of April 5, 1982

5298
No. _____
STATE OF OKLAHOMA | SS.
CADDO COUNTY
FILED FOR RECORD

APR 29 1982
ALB M A Recorded in Book 918-647-714
Jack VanDeventer, County Clerk
BY Lawler DEP. (SEAL)



"THIS INSTRUMENT CONTAINS AFTER-ACQUIRED PROPERTY PROVISIONS."

"THIS INSTRUMENT SECURES PAYMENT OF FUTURE ADVANCES."

"THE OIL AND GAS INTERESTS INCLUDED IN THE MORTGAGED PROPERTY WILL BE FINANCED AT THE WELLHEADS OF THE WELLS LOCATED ON THE PROPERTIES DESCRIBED IN EXHIBIT A HERETO, AND THIS FINANCING STATEMENT IS TO BE FILED FOR RECORD, AMONG OTHER PLACES, IN THE REAL ESTATE RECORDS."

"SOME OF THE PERSONAL PROPERTY CONSTITUTING A PORTION OF THE MORTGAGED PROPERTY IS OR IS TO BE AFFIXED TO THE PROPERTIES DESCRIBED IN EXHIBIT A HERETO AND THIS FINANCING STATEMENT IS TO BE FILED FOR RECORD, AMONG OTHER PLACES, IN THE REAL ESTATE RECORDS."

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MORTGAGE, DEED OF TRUST, ASSIGNMENT, SECURITY
AGREEMENT AND FINANCING STATEMENT.

THIS MORTGAGE, DEED OF TRUST, ASSIGNMENT, SECURITY AGREEMENT AND FINANCING STATEMENT, dated as of April 5, 1982, is from GHK EXPLORATION COMPANY, an Oklahoma partnership (herein called the "Mortgagor"), to Laura L. Cavallo, and Kurt M. Weidinger of Chicago, Illinois, as Trustees (herein collectively called the "Trustees") and CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO, a national banking association (herein called the "Agent"), as Agent for itself and PENN SQUARE BANK, N.A. (CONTINENTAL ILLINOIS NATIONAL BANK AND TRUST COMPANY OF CHICAGO and Penn Square Bank, N.A., being herein collectively called the "Banks").

LAM 1. The Mortgagor and the Banks have entered into a Secured Revolving Credit Agreement, dated as of April 5, 1982 (herein, as the same may be amended, modified or supplemented from time to time, called the "Loan Agreement"), pursuant to which the Banks have agreed to lend to the Mortgagor amounts not to exceed \$50,000,000 and the Mortgagor, to evidence its indebtedness to the Banks under one Loan Agreement, has executed and delivered to the Banks its promissory notes (herein called the "Loan Notes"), dated as of April 5, 1982, in the aggregate principal amount of \$50,000,000, to mature on December 1, 1983, one Loan Note being payable to the order of each of the Banks, bearing interest at the rates provided for therein, and containing provisions for payment of attorneys' fees and acceleration of maturity in the event of default, as therein set forth.

2. For all purposes of this instrument, unless the context otherwise requires:

A. "Oil and gas leases" shall include oil, gas and mineral leases and shall also include subleases and assignments of operating rights.

B. "Hydrocarbons" shall mean oil, gas and other liquid or gaseous hydrocarbons.

C. "Production Sale Contracts" shall mean contracts now in effect, or hereafter entered into by the Mortgagor, or the Mortgagor's predecessors in interest, for the sale, purchase, exchange or processing of Hydrocarbons produced from the lands described in Exhibit A attached hereto and made a part hereof.

D. "lands described in Exhibit A" shall include any lands, the description of which is incorporated in Exhibit A by reference to another instrument or document, and shall also include any lands now or hereafter unitized or pooled with lands which are either described in Exhibit A or the description of which is incorporated in Exhibit A by reference.

E. "Operating Equipment" shall mean all surface or subsurface machinery, equipment, facilities or other property of whatsoever kind or nature (excluding drilling rigs, trucks, automotive equipment or other property taken to the premises to drill a well or for other similar temporary uses) now or hereafter located on any of the lands described in Exhibit A which are useful for the production, treatment, storage or transportation of oil, gas, and other liquid or gaseous hydrocarbons, including, but not by way of limitation, all oil wells, gas wells, water wells, injection wells, casing, tubing, rods, pumping units and engines, christmas trees, derricks, separators, gun barrels, flow lines, tanks, gas systems (for gathering, treating and compression), water systems (for treating, disposal and injection), power plants, poles, lines, transformers, starters and controllers, machine shops, tools, storage yards and equipment stored therein, buildings and camps, telegraph, telephone and other communication systems, roads, loading racks and shipping facilities.

F. "Mortgaged Property" shall mean the properties, rights and interests hereinafter described and defined as the Mortgaged Property.

G. "Indebtedness", "Note" and "Notes" shall have the respective meanings set forth in Section 1.2.

NOW, THEREFORE, the Mortgagor, for and in consideration of the premises and of the debts and trusts hereinafter mentioned, has granted, bargained, sold, warranted, mortgaged, assigned, transferred and conveyed, and by these presents does grant, bargain, sell, warrant, mortgage, assign, transfer and convey unto the Trustees, for the use and benefit of the Agent, for the pro rata benefit of the Banks, all the Mortgagor's right, title and interest, whether now owned or hereafter acquired, in all of the hereinafter described properties, rights and interests; and, insofar as such properties, rights and interests consist of equipment, general intangibles, accounts, contract rights, inventory, fixtures, proceeds of collateral or any other personal property of a kind or character defined in or

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subject to the applicable provisions of the Uniform Commercial Code (as in effect in the appropriate jurisdiction with respect to each of said properties, rights and interests), the Mortgagor hereby grants to said Trustees a security interest therein; namely:

(a) the oil and gas leases, overriding royalty, and other interests which are specifically described in Exhibit A,

(b) the presently existing unitization and pooling agreements and the properties covered and the units created thereby (including all units formed under orders, regulations, rules or other official acts of any federal, state or other governmental agency having jurisdiction) which are specifically described in Exhibit A or which relate to any of the properties and interests specifically described in Exhibit A,

(c) the Hydrocarbons which are attributable to the oil and gas leases and other interests described in Exhibit A,

(d) the Production Sale Contracts,

(e) the Operating Equipment, and

(f) the proceeds and products of the foregoing,

together with any and all corrections or amendments to, or renewals, extensions or ratifications of, any of the same, or of any instrument relating thereto, and all contracts, operating agreements, records, logs, right-of-way, franchises, easements, surface leases, permits, licenses, tenements, hereditaments and appurtenances now existing or in the future obtained in connection with any of the aforesaid, and all other things of value and incident thereto which the Mortgagor might at any time have or be entitled to,

all the aforesaid properties, rights and interests, together with any additions thereto which may be subjected to the lien of this instrument by means of supplements hereto, being hereinafter called the "Mortgaged Property".

Subject, however, to (i) the restrictions, exceptions, reservations, conditions, limitations, interests and other matters, if any, set forth or referred to in the specific descriptions of such properties and interests in Exhibit A (including all presently existing royalties, payments out of

production and other burdens which are referred to in Exhibit A and which are taken into consideration in computing the decimal or fractional interest as set forth in Exhibit A), (ii) the assignment of production contained in Article III hereof, but only insofar and so long as said assignment of production is not inoperative under the provisions of Section 3.5, (iii) the right in the Mortgagor to obtain a release of the lien granted or created hereunder pursuant to Section 2.7 hereof, and (iv) the condition that neither the Trustees nor the Agent shall be liable in any respect for the performance of any covenant or obligation of the Mortgagor in respect of the Mortgaged Property.

TO HAVE AND TO HOLD the Mortgaged Property unto the Trustees forever to secure the payment of the Indebtedness and to secure the performance of the obligations of the Mortgagor herein contained.

The Mortgagor, in consideration of the premises and to induce the Bank to make the loan above described, hereby covenants and agrees with both the Trustees and the Banks as follows:

ARTICLE I

Indebtedness Secured

1.1 Items of Indebtedness Secured. The following items of indebtedness are secured hereby:

- (a) The Loan Notes, and all other obligations and liabilities of the Mortgagor under the Loan Agreement;
- (b) Any sums advanced or expenses or costs incurred by the Trustees or the Bank (or any receiver appointed hereunder) which are made or incurred pursuant to, or permitted by, the terms hereof, plus interest thereon at the rate herein specified or otherwise agreed upon, from the date of the advances or the incurring of such expenses or costs until reimbursed;
- (c) Any extensions or renewals of all such indebtedness described in subparagraph (a) and (b) above, whether or not the Mortgagor executes any extension agreement or renewal instruments.

1.2 Indebtedness and the Notes Defined. All the items of indebtedness described in Section 1.1 hereof are hereinafter collectively referred to as the "Indebtedness." Any promissory note evidencing any part of the Indebtedness,

including, without limitation, the Loan Note, is hereinafter referred to as a "Note" and all such notes are hereinafter referred to collectively as the "Notes."

ARTICLE II

Particular Covenants and Warranties of the Mortgagor

2.1 Payment of the Indebtedness. The Mortgagor will duly and punctually pay the Indebtedness, including each and every obligation owing on account of the Notes.

2.2 Warranties. The Mortgagor warrants that (a) the oil and gas leases described in Exhibit A hereto are valid, subsisting leases, superior and paramount to all other oil and gas leases respecting the properties to which they pertain, (b) the Mortgagor, to the extent of the interest specified in Exhibit A, has valid, defensible title to each property right or interest constituting the Mortgaged Property and has a good and legal right to grant and convey the same to the Trustees, it being understood that the Mortgagor's interest in each oil and gas lease shall exceed the Mortgagor's net interest in production from such lease to the extent of the Mortgagor's proportionate share of the burden of all royalties, overriding royalties and other such payments out of production, (c) the Mortgaged Property is free from all encumbrances or liens whatsoever, except as may be specifically set forth in Exhibit A or as permitted by the provisions of Section 2.5(e) hereof, and (d) the Mortgagor is not obligated, by virtue of any prepayment under any contract providing for the sale by the Mortgagor of Hydrocarbons which contains a "take or pay" clause or under any similar arrangement, to deliver Hydrocarbons at some future time without then or thereafter receiving full payment therefor. The Mortgagor will warrant and forever defend the Mortgaged Property unto the Trustees against every person whomsoever lawfully claiming the same or any part thereof, and the Mortgagor will maintain and preserve the lien hereby created so long as any of the Indebtedness remains unpaid.

2.3 Further Assurances. The Mortgagor will execute and deliver such other and further instruments and will do such other and further acts as in the opinion of the Trustees may be necessary or desirable to carry out more effectually the purposes of this instrument, including, without limiting the generality of the foregoing, (a) prompt correction of any defect which may hereafter be discovered in the title to the

Mortgaged Property or in the execution and acknowledgment of this instrument, any Note, or any other document executed in connection herewith, and (b) prompt execution and delivery of all division or transfer orders which in the opinion of the Bank are needed to transfer effectually the assigned proceeds of production from the Mortgaged Property to the Agent.

2.4 Taxes. Subject to the Mortgagor's right to contest the same, the Mortgagor will promptly pay all taxes, assessments and governmental charges legally imposed upon this instrument or upon the Mortgaged Property or upon the interest of the Trustees, the Agent or the Banks therein, or upon the income and profits thereof.

2.5 Operation of the Mortgaged Property. So long as the Indebtedness or any part thereof remains unpaid, and whether or not the Mortgagor is the operator of the Mortgaged Property, the Mortgagor shall, at the Mortgagor's own expense:

(a) Do all things necessary to keep unimpaired the Mortgagor's rights in the Mortgaged Property and not, except in the ordinary course of business, abandon any well or forfeit, surrender or release any oil and gas lease or any rights in the Mortgaged Property or enter into any operating agreement with respect to the Mortgaged Property without the prior written consent of the Trustees;

(b) Cause the lands described in Exhibit A to be maintained, developed, protected against drainage, and continuously operated for the production of Hydrocarbons in a good and workmanlike manner as would a prudent operator, and in accordance with generally accepted practices, applicable operating agreements, and all applicable federal, state and local laws, rules and regulations, excepting those being contested in good faith;

(c) Cause to be paid, promptly as and when due and payable, all rentals and royalties payable in respect of the Mortgaged Property, and all expenses incurred in or arising from the operation or development of the Mortgaged Property;

(d) Cause the Operating Equipment to be kept in good and effective operating condition, and all repairs, renewals, replacements, additions and improvements thereof or thereto, needful to the production of

Hydrocarbons from the lands described in Exhibit A, to be promptly made;

(e) Cause the Mortgaged Property to be kept free and clear of liens, charges and encumbrances of every character, other than (1) the lien hereof, (2) taxes constituting a lien but not due and payable, (3) defects or irregularities in title, and liens, charges or encumbrances, which are not such as to interfere materially with the development, operation or value of the Mortgaged Property and not such as to affect materially title thereto, (4) those set forth or referred to in Exhibit A, (5) those being contested by the Mortgagor in good faith in such manner as not to jeopardize the Trustees' and the Agent's rights in and to the Mortgaged Property, and (6) those consented to in writing by the Trustees; and

(f) Carry in standard insurance companies and in amounts satisfactory to the Trustees the following insurance: (1) workmen's compensation insurance and public liability and property damage insurance in respect of all activities in which the Mortgagor might incur personal liability for the death or injury of an employee or third person, or damage to or destruction of another's property; and (2) to the extent such insurance is carried by others engaged in similar undertakings in the same general areas in which the Mortgaged Property is located, insurance in respect of the Operating Equipment, against loss or damage by fire, lightning, hail, tornado, explosion and other similar risks.

2.6 Recording, etc. The Mortgagor will promptly and at the Mortgagor's expense, record, register, deposit and file this and every other instrument in addition or supplemental hereto in such offices and places and at such times and as often as may be necessary to preserve, protect and renew the lien hereof as a first lien on real or personal property as the case may be and the rights and remedies of the Trustees, the Agent and the Banks, and otherwise will do and perform all matters or things necessary or expedient to be done or observed by reason of any law or regulation of any State or of the United States or of any other competent authority, for the purpose of effectively creating, maintaining and preserving the lien hereof on the Mortgaged Property.

2.7 Sale or Mortgage of the Mortgaged Property. The Mortgagor will not sell, convey, mortgage, pledge, or otherwise dispose of or encumber the Mortgaged Property nor any portion thereof, nor any of the Mortgagor's right, title

or interest therein. Notwithstanding the foregoing the Trustees and the Banks will provide the Mortgagor with any necessary release of the lien granted hereunder on any of the Mortgaged Property disposed with the consent of the Trustees. The Trustees and the Banks will provide the Mortgagor with such release as may be necessary in order to permit the Mortgagor to perform its obligations to transfer a lease or an interest therein pursuant to a farmout agreement, provided that,

(i) the farmout agreement has been entered into in the ordinary course of business,

(ii) there is no Event of Default or Unmatured Event of Default (as both those terms are defined in the Loan Agreement) in existence at the time of the execution and delivery of the release, and

(iii) the transfer would not, other than in the absence of this Section 2.7, constitute or create an event of default hereunder,

(iv) the Mortgagor retains a directly mortgageable economic interest in such Lease, and

(v) the Trustees retain a trust and prior lien over the interest so retained or the Mortgagor has the legal right to grant, and contemporaneously with the execution and delivery of the release does grant, a first and prior lien in favor of the Trustees, for the use and benefit of the Agent, for the pro rata benefit of the Banks on the interest so retained.

The Mortgagor will not enter into any arrangement with any gas pipeline company or other consumer of Hydrocarbons regarding the Mortgaged Property whereby said gas pipeline company or consumer may set off any claim against the Mortgagor by withholding payment for any Hydrocarbons actually delivered.

2.8 Records, Statements and Reports. The Mortgagor will keep proper books of record and account in which complete and correct entries will be made of the Mortgagor's transactions in accordance with generally accepted accounting principles and will furnish or cause to be furnished to the Banks (a) upon their request, but not more than once a year, reports prepared by an independent person or firm acceptable to the Bank concerning (1) the quantity of Hydrocarbons recoverable from the Mortgaged Property and (2) the projected income and expense attributable to the

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Mortgaged Property, (b) quarterly, a report showing, on a per well basis, (i) condensate yield, (ii) bottom hole pressures and (iii) surface shut in tubing pressures, and (c) monthly, a report showing, on a per well basis, (i) gross pipeline sales information, (ii) average monthly flowing tubing pressure, (iii) average choke size, (iv) significant well operating problems, and (v) such other information as the Banks may reasonably request, and (d) such other information concerning the business and affairs and financial condition of the Mortgagor as either Bank may from time to time reasonably request.

2.9 No Governmental Approvals. The Mortgagor warrants that no approval or consent of any regulatory or administrative commission or authority, or of any other governmental body, is necessary to authorize the execution and delivery of this instrument or of the Notes, or to authorize the observance or performance by the Mortgagor of the covenants herein or in the Notes contained, or that such approvals as are required have been obtained or will be obtained promptly.

2.10 Right of Entry. The Mortgagor will permit the Trustees, the Agent or the Banks, or the agents of any of them, to enter upon the Mortgaged Property, and all parts thereof, for the purpose of investigating and inspecting the condition and operation thereof.

ARTICLE III

Assignment of Production

3.1 Assignment. As further security for the payment of the Indebtedness, the Mortgagor hereby transfers, assigns, warrants and conveys to the Agent, for the pro rata benefit of the Banks, effective as of the date hereof, at 7:00 A.M., all Hydrocarbons which are thereafter produced from and which accrue to the Mortgaged Property, and all proceeds therefrom. All parties producing, purchasing or receiving any such Hydrocarbons, or having such, or proceeds therefrom, in their possession for which they or others are accountable to the Agent by virtue of the provisions of this Article, are authorized and directed to treat and regard the Agent as the assignee and transferee of the Mortgagor and entitled in the Mortgagor's place and stead to receive such Hydrocarbons and all proceeds therefrom; and said parties and each of them shall be fully protected in so treating and regarding the Agent, and shall be under no obligation to see to the application by the Agent of any such proceeds or payments received by it.

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3.6 Indemnity. The Mortgagor agrees to indemnify the Trustees, the Agent and the Banks against all claims, actions, liabilities, judgments, costs, attorneys' fees or other charges of whatsoever kind or nature (all hereinafter in this Section 3.6 called "claims") made against or incurred by them or any of them as a consequence of the assertion, either before or after the payment in full of the Indebtedness, that they or either of them received Hydrocarbons herein assigned or the proceeds thereof claimed by third persons, and the Trustees, the Agent and the Banks shall have the right to defend against any such claims, employing attorneys therefor, and unless furnished with reasonable indemnity, they or any of them shall have the right to pay or compromise and adjust all such claims. The Mortgagor will indemnify and pay to the Trustees, the Agent or the Banks any and all such amounts as may be paid in respect thereof or as may be successfully adjudged against them or any of them. The obligations of the Mortgagor as hereinabove set forth in this Section 3.6 shall survive the release of this instrument.

ARTICLE IV

Events of Default

4.1 Events of Default Hereunder. In case any one or more of the following "events of default" shall occur and shall not have been remedied:

- (a) the occurrence of an event of default under the terms and provisions of the Loan Agreement;
- (b) any warranty or representation made herein shall prove to be untrue in any material respect;
- (c) failure by the Mortgagor, within thirty (30) days after notice thereof from the Agent, to cure a default in the due performance or observance of any covenant or agreement contained in this instrument and not constituting a default in the payment of principal or of interest upon any Note or in the payment of any other Indebtedness; or
- (d) the title of the Mortgagor to the Mortgaged Property or any substantial part thereof shall become the subject matter of litigation which would or might, in the Agent's opinion, upon final determination result in substantial impairment or loss of the security provided by this instrument and upon notice by the Bank to the Mortgagor such litigation is not dismissed within thirty (30) days of such notice,

then and in any such event the Banks, at their option, may declare the entire unpaid principal of and the interest accrued on the Notes and all other Indebtedness secured hereby to be forthwith due and payable, without any notice or demand of any kind, both of which are hereby expressly waived.

ARTICLE V

Enforcement of the Security

5.1 Power of Sale. Upon the occurrence of an event of default and if such event shall be continuing, the Trustees shall have the right and power to sell, to the extent permitted by law, at one or more sales, as an entirety or in parcels, as they may elect, the Mortgaged Property, at such place or places and otherwise in such manner and upon such notice as may be required by law, or, in the absence of any such requirement, as the Trustees may deem appropriate, and to make conveyance to the purchaser or purchasers; and the Mortgagor shall warrant title to the Mortgaged Property to such purchaser or purchasers. The Trustees may postpone the sale of all or any portion of the Mortgaged Property by public announcement at the time and place of such sale, and from time to time thereafter may further postpone such sale by public announcement made at time of sale fixed by the preceding postponement. The right of sale hereunder shall not be exhausted by one or any sale, and the Trustees may make other and successive sales until all of the trust estate be legally sold. It shall not be necessary for the Trustees to have physically present at any such sale, or to have constructively in their possession, any or all of the personal property covered by this instrument, and the Mortgagor shall deliver all of such personal property to the purchaser at such sale on the date of sale, and if it should be impossible or impracticable to take actual delivery of such property, then the title and right of possession to such property shall pass to the purchaser at such sale as completely as if the same had been actually present and delivered.

5.2 Judicial Proceedings. Upon occurrence of an event of default and if such event shall be continuing, the Trustees, in lieu of or in addition to exercising the power of sale hereinabove given, may proceed by a suit or suits in equity or at law, whether for a foreclosure hereunder, or for the sale of the Mortgaged Property, or for the specific performance of any covenant or agreement herein contained or in aid of the execution of any power herein granted, or for

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the appointment of a receiver pending any foreclosure hereunder or the sale of the Mortgaged Property, or for the enforcement of any other appropriate legal or equitable remedy.

5.3 Certain Aspects of a Sale. The Agent or the Banks shall have the right to become the purchaser at any sale held by the Trustees or by any court, receiver or public officer, and the Agent or the Banks shall have the right to credit upon the amount of the bid made therefor, the amount payable out of the net proceeds of such sale to it. Recitals contained in any conveyance made to any purchaser at any sale made hereunder shall conclusively establish the truth and accuracy of the matters therein stated, including, without limiting the generality of the foregoing, nonpayment of the unpaid principal sum of, and the interest accrued on, the Notes after the same have become due and payable, advertisement and conduct of such sale in the manner provided herein or appointment of any successor Trustee hereunder.

5.4 Receipt to Purchaser. Upon any sale, whether made under the power of sale herein granted and conferred or by virtue of judicial proceedings, the receipt of the Trustees, or of the officer making sale under judicial proceedings, shall be sufficient discharge to the purchaser or purchasers at any sale for his or their purchase money, and such purchaser or purchasers, or his or their assigns or personal representatives, shall not, after paying such purchase money and receiving such receipt of the Trustees or of such officer therefor, be obliged to see to the application of such purchase money, or be in anywise answerable for any loss, misapplication or nonapplication thereof.

5.5 Effect of Sale. Any sale or sales of the Mortgaged Property, whether under the power of sale herein granted and conferred or by virtue of judicial proceedings, shall operate to divest all right, title, interest, claim and demand whatsoever either at law or in equity, of the Mortgagor of, in and to the premises and the property sold, and shall be a perpetual bar, both at law and in equity, against the Mortgagor, and the Mortgagor's successors or assigns, and against any and all persons claiming or who shall thereafter claim all or any of the property sold from, through or under the Mortgagor, or the Mortgagor's successors or assigns. Nevertheless, the Mortgagor, if requested by the Trustees so to do, shall join in the execution and delivery of all proper conveyances, assignments and transfers of the properties so sold.

5.6 Application of Proceeds. The proceeds of any sale of the Mortgaged Property, or any part thereof, whether under the power of sale herein granted and conferred or by virtue of judicial proceedings, shall be applied as follows:

First: To the payment of all expenses incurred by the Trustees in the performance of their duties including, without limiting the generality of the foregoing, to the Trustees and expenses of any entry, or taking of possession, of any sale, of advertisement thereof, and of conveyances, and as well, court costs, compensation of agents and employees and legal fees.

Second: To the payment of the Notes and of the other items of Indebtedness with interest to the date of such payment.

Third: Any surplus thereafter remaining shall be paid to the Mortgagor or the Mortgagor's successors or assigns, as their interests shall appear.

5.7 The Mortgagor's Waiver of Appraisalment, Marshalling, etc. Rights. The Mortgagor agrees, to the full extent that the Mortgagor may lawfully so agree, that the Mortgagor will not at any time insist upon or plead or in any manner whatever claim the benefit of any appraisalment, valuation, stay, extension or redemption law now or hereafter in force, in order to prevent or hinder the enforcement or foreclosure of this instrument or the absolute sale of the Mortgaged Property or the possession thereof by any purchaser at any sale made pursuant to any provision hereof, or pursuant to the decree of any court of competent jurisdiction; but the Mortgagor, for the Mortgagor and all who may claim through or under the Mortgagor, so far as the Mortgagor or those claiming through or under the Mortgagor now or hereafter lawfully may, hereby waives the benefit of all such laws; provided, however, that appraisalment of any of the Mortgaged Property located in the State of Oklahoma is hereby expressly waived or not, at the option of the Trustees, such option to be exercised prior to or at the time the judgment is rendered in any foreclosure hereof. The Mortgagor, for the Mortgagor and all who may claim through or under the Mortgagor, waives, to the extent that the Mortgagor may lawfully do so, any and all right to have the Mortgaged Property marshalled upon any foreclosure of the lien hereof, or sold in inverse order of alienation, and agrees that the Trustees or any court having jurisdiction to foreclose such lien may sell the Mortgaged Property as an entirety. If any law in this paragraph referred to and now in force, of which the Mortgagor or the Mortgagor's successor or successors

might take advantage despite the provisions hereof, shall hereafter be repealed or cease to be in force, such law shall not thereafter be deemed to constitute any part of the contract herein contained or to preclude the operation or application of the provisions of this paragraph.

5.8 Costs and Expenses. All costs and expenses (including attorneys' fees) incurred by the Trustees, the Agent or the Banks in protecting and enforcing their rights hereunder, shall constitute a demand obligation owing by the Mortgagor to the party incurring such costs and expenses and shall draw interest at the rate of ten percent (10%) per annum, all of which shall constitute a portion of the Indebtedness.

5.9 Sale of the Mortgaged Property in Texas. If any Note is not paid when due, whether by acceleration or otherwise, the Trustees are hereby authorized and empowered to sell any part of the Mortgaged Property located in the State of Texas at public sale to the highest bidder for cash at the door of the county courthouse of the county in Texas in which the Texas portion of the Mortgaged property or any part thereof is situated, as herein described, between the hours of 10:00 A.M. and 4:00 P.M. on the first Tuesday of any month, after advertising the time, place, and terms of said sale, and the portion of the Mortgaged Property to be sold, by posting (or by having some person or persons acting for Trustees post) for at least twenty-one (21) days preceding the date of the sale, written or printed notice of the proposed sale at the courthouse door of said county in which the sale is to be made; and if such portion of the Mortgaged Property lies in more than one county, one such notice of sale shall be posted at the courthouse door of each county in which such part of the Mortgaged Property is situated and such part of the Mortgaged Property may be sold at the courthouse door of any one of such counties, and the notice so posted shall designate in which county such property shall be sold. In addition to such posting of notice, the Bank or other holder of the Indebtedness shall, at least twenty-one (21) days preceding the date of sale, serve or cause to be served written notice of the proposed sale by certified mail on the Mortgagor and on each other debtor, if any, obligated to pay the Indebtedness according to the records of the Bank. Service of such notice shall be completed upon deposit of the notice, enclosed in a postpaid wrapper properly addressed to the Mortgagor and such other debtors at their most recent address or addresses as shown by the records of the Banks in a post office or official depository under the care and custody of the United States Postal Service. The affidavit of any person having knowledge of the facts to the

effect that such a service was completed shall be prima facie evidence of the fact of service. The Mortgagor agrees that no notice of any sale, other than as set out in this paragraph, need be given by the Trustees, the Agent, the Bank or any other person. The Mortgagor hereby designates as its address for the purpose of such notice, the address set out on the signature page hereof; and agrees that such address shall be changed only by depositing notice of such change enclosed in a postpaid wrapper in a post office or official depository under the care and custody of the United States Postal Service, certified mail, postage prepaid, return receipt requested, addressed to the Banks or other holder of the Indebtedness at the address for the Agent set out herein (or to such other address as the Banks or other holders of the Indebtedness may have designated by notice given as above provided to the Mortgagor and such other debtors). Any such notice of change of address of the Mortgagor or other debtors or of the Agent or the Banks or of other holders of the Indebtedness shall be effective three (3) business days after such deposit if such post office or official depository is located in the State of Texas, otherwise to be effective upon receipt. The Mortgagor authorizes and empowers the Trustees to sell the Texas portion of the Mortgaged Property in lots or parcels or in its entirety as the Trustees shall deem expedient; and to execute and deliver to the purchaser or purchasers thereof good and sufficient deeds of conveyance thereto by fee simple title, with evidence of general warranty by the Mortgagor, and the title of such purchaser or purchasers when so made by the Trustees, the Mortgagor binds itself to warrant and forever defend. Where portions of the Mortgaged Property lie in different counties, sales in such counties may be conducted in any order that the Trustees may deem expedient; and one or more such sales may be conducted in the same month, or in successive or different months as the Trustees may deem expedient.

5.10 Operation of the Mortgaged Property by the Trustees. Upon the occurrence of an event of default and in addition to all other rights herein conferred on the Trustees, the Trustees (or any person, firm or corporation designated by the Trustees) shall have the right and power, but shall not be obligated, to enter upon and take possession of any of the Mortgaged Property, and to exclude the Mortgagor, and the Mortgagor's agents or servants, wholly therefrom, and to hold, use, administer, manage and operate the same to the extent that the Mortgagor shall be at the time entitled and in his place and stead. The Trustees, or any person, firm or corporation designated by the Trustees, may operate the same without any liability to

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the Mortgagor in connection with such operations, except to use ordinary care in the operation of such properties, and the Trustees or any person, firm or corporation designated by the Trustees, shall have the right to collect, receive and receipt for all Hydrocarbons produced and sold from said properties, to make repairs, purchase machinery and equipment, conduct work-over operations, drill additional wells and to exercise every power, right and privilege of the Mortgagor with respect to the Mortgaged Property. When and if the expenses of such operation and development (including costs of unsuccessful work-over operations or additional wells) have been paid and the Indebtedness paid, said properties shall, if there has been no sale or foreclosure, be returned to the Mortgagor.

ARTICLE VI

Miscellaneous Provisions

6.1 Pooling and Unitization. The Mortgagor shall have the right, and is hereby authorized, to pool or unitize all or any part of any tract of land described in Exhibit A, in so far as relates to the Mortgaged Property, with adjacent lands, leaseholds and other interests, when, in the reasonable judgment of the Mortgagor, it is necessary or advisable to do so in order to form a drilling unit to facilitate the orderly development of that part of the Mortgaged Property affected thereby, or to comply with the requirements of any law or governmental order or regulation relating to the spacing of wells or proration of the production therefrom; provided, however, that any unit so formed for the production of oil shall not substantially exceed 160 acres, and any unit so formed for the production of gas shall not substantially exceed 640 acres, unless a larger area is required to conform to an applicable law or governmental order or regulation relating to the spacing of wells or to obtain the maximum allowable production under any applicable law or governmental order or regulation relating to the proration of production therefrom; and further provided that the Hydrocarbons produced from any unit so formed shall be allocated among the separately owned tracts or interests comprising the unit in proportion to the respective surface areas thereof. Any unit so formed may relate to one or more zones or horizons, and a unit formed for a particular zone or horizon need not conform in area to any other unit relating to a different zone or horizon, and a unit formed for the production of oil need not conform in area with any unit formed for the production of gas. Immediately after formation of any such unit, the Mortgagor shall furnish to the Trustees a true copy of the pooling

agreement, declaration of pooling or other instrument creating such unit, in such number of counterparts as the Trustees may reasonably request. The interest in any such unit attributable to the Mortgaged Property (or any part thereof) included therein shall become a part of the Mortgaged Property and shall be subject to the lien hereof in the same manner and with the same effect as though such unit and the interest of the Mortgagor therein were specifically described in Exhibit A. The Mortgagor may enter into pooling or unitization agreements not hereinabove authorized only with the prior written consent of the Trustees.

6.2 Successor Trustees. Any Trustee may resign in writing addressed to the Bank or be removed at any time with or without cause by an instrument in writing duly executed by the Bank. In case of the death, resignation or removal of a Trustee, a successor Trustee may be appointed by the Bank by instrument of substitution complying with any applicable requirements of law, and in the absence of any such requirement without other formality than appointment and designation in writing. Such appointment and designation shall be full evidence of the right and authority to make the same and of all facts therein recited, and upon the making of any such appointment and designation this conveyance shall vest in the named successor Trustee all the estate and title of the prior Trustee in all of the Mortgaged Property, and he shall thereupon succeed to all the rights, powers, privileges, immunities and duties hereby conferred upon the prior Trustee. All references herein to the Trustees shall be deemed to refer to the Trustees from time to time acting hereunder.

6.3 Advances. Each and every covenant herein contained shall be performed and kept by the Mortgagor solely at the Mortgagor's expense. If the Mortgagor shall fail to perform or keep any of the covenants of whatsoever kind or nature contained in this instrument, the Agent, the Banks, or the Trustees or any receiver appointed hereunder, may, but shall not be obligated to, make advances to perform the same in the Mortgagor's behalf, and the Mortgagor hereby agrees to repay such sums upon demand plus interest at the rate of ten percent (10%) per annum or, in the event any promissory note evidences such indebtedness, upon the terms and conditions thereof. No such advance shall be deemed to relieve the Mortgagor from any default hereunder.

6.4 Defense of Claims. The Mortgagor will notify the Trustees, in writing, promptly of the commencement of any legal proceedings affecting the lien hereof or the Mortgaged

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Property, or any part thereof, and will take such action, employing attorneys agreeable to the Trustees, as may be necessary to preserve the Mortgagor's, the Trustees' and the Agent's Banks' rights affected thereby; and should the Mortgagor fail or refuse to take any such action, the Trustees the Agent or the Banks may, upon giving prior written notice thereof to the Mortgagor, take such action in behalf and in the name of the Mortgagor and at the Mortgagor's expense. Moreover, the Agent, the Banks or the Trustees on behalf of the Banks, may take such independent action in connection therewith as they may in their discretion deem proper, the Mortgagor hereby agreeing that all sums advanced or all expenses incurred in such actions plus interest at the rate of ten percent (10%) per annum, will, on demand, be reimbursed.

6.5 The Mortgaged Property to Revert. If the Indebtedness shall be fully paid and the covenants herein contained shall be well and truly performed, then all of the Mortgaged Property shall revert to the Mortgagor and the entire estate, right, title and interest of the Trustees, the Agent and the Banks shall thereupon cease; and the Trustees in such case shall, upon the request of the Mortgagor and at the Mortgagor's cost and expense, deliver to the Mortgagor, proper instruments acknowledging satisfaction of this instrument.

6.6 Renewals, Amendments and Other Security. Renewals and extensions of the Indebtedness may be given at any time and amendments may be made to agreements relating to any part of such Indebtedness or the Mortgaged Property and the Banks may take or may now hold other security for the Indebtedness without notice to or consent of the Mortgagor. The Trustees or the Banks may resort first to such other security or any part thereof or first to the security herein given or any part thereof, or from time to time to either or both, even to the partial or complete abandonment of either security, and such action shall not be a waiver of any rights conferred by this instrument, which shall continue as a first lien upon the Mortgaged Property not expressly released until the Notes and all other Indebtedness secured hereby is fully paid.

6.7 Instrument an Assignment, etc. This instrument shall be deemed to be and may be enforced from time to time as an assignment, chattel mortgage, contract, deed of trust, financing statement, real estate mortgage, or security agreement, and from time to time as any one or more thereof.

6.8 Limitation on Interest. No provision of this instrument or of the Notes shall require the payment or permit the collection of interest in excess of the maximum permitted by law or which is otherwise contrary to law. If any excess of interest in such respect is herein or in the Notes provided for, or shall be adjudicated to be so provided for herein or in the Notes, the Mortgagor shall not be obligated to pay such excess.

6.9 Unenforceable or Inapplicable Provisions. If any provision hereof or of the Notes is invalid or unenforceable in any jurisdiction, the other provisions hereof or of the Notes shall remain in full force and effect in such jurisdiction, and the remaining provisions hereof shall be liberally construed in favor of the Trustees, the Agent and the Banks in order to effectuate the provisions hereof, and the invalidity of any provision hereof in any jurisdiction shall not affect the validity or enforceability of any such provision in any other jurisdiction. Any reference herein contained to a statute or law of a state in which no part of the Mortgaged Property is situated shall be deemed inapplicable to, and not used in, the interpretation hereof.

6.10 Rights Cumulative. Each and every right, power and remedy herein given to the Trustees, the Agent or the Banks shall be cumulative and not exclusive; and each and every right, power and remedy whether specifically herein given or otherwise existing may be exercised from time to time and so often and in such order as may be deemed expedient by the Trustees, the Agent or the Banks, as the case may be, and the exercise, or the beginning of the exercise, of any such right, power or remedy shall not be deemed a waiver of the right to exercise, at the same time or thereafter, any other right, power or remedy. No delay or omission by the Trustees, the Agent or the Bank in the exercise of any right, power or remedy shall impair any such right, power or remedy or operate as a waiver thereof or of any other right, power or remedy then or thereafter existing.

6.11 Waiver by the Trustees. Any and all covenants in this instrument may from time to time by instrument in writing signed by the Trustees be waived to such extent and in such manner as the Trustees may desire, but no such waiver shall ever affect or impair either the Trustees', the Agent's or the Banks' rights or liens hereunder, except to the extent specifically stated in such written instrument.

6.12 Action by Individual Trustee. Any Trustee from time to time serving hereunder shall have the absolute right, acting individually, to take any action and to give any

consent and to exercise any right, remedy, power, privilege or authority conferred upon the Trustees; and any action taken by either Trustee from time to time serving hereunder shall be binding upon the other Trustee and no person dealing with either Trustee from time to time serving hereunder shall be obligated to confirm the power and authority of such Trustee to act without the concurrence of the other Trustee. In this instrument, the term "Trustee" shall mean the Trustees hereinabove named, or either of them, as the context requires, and any successor Trustees.

6.13 Successors and Assigns. This instrument is binding upon the Mortgagor, the Mortgagor's successors and assigns, and shall inure to the benefit of the Trustees, their successors, and Agent and the Banks, their successors and assigns, and the provisions hereof shall likewise be covenants running with the land.

6.14 Article and Section Headings. The article and section headings in this instrument are inserted for convenience and shall not be considered a part of this instrument or used in its interpretation.

6.15 Execution in Counterparts. This instrument may be executed in any number of counterparts, each of which shall for all purposes be deemed to be an original, and all of which are identical except that, to facilitate recordation, in any particular counterpart portions of Exhibit A hereto which describe properties situated in parishes or counties other than the parish or county in which such counterpart is to be recorded may have been omitted.

6.16 Special Filing as Financing Statement. This Mortgage and Deed of Trust shall likewise be a Security Agreement and a Financing Statement and the Mortgagor hereby grants to the Banks, their successors and assigns, a security interest in all personal property, fixtures, accounts, contract rights and general intangibles described or referred to in Granting Clauses (a) through (f) herein and all proceeds from the sale, lease or other disposition of the Mortgaged Property or any part thereof. This Mortgage and Deed of Trust shall be filed for record, among other places, in the real estate records of each county in which the oil and gas leases described in Exhibit A hereto, or any part thereof, are situated, and, when filed in such counties shall be effective as a financing statement covering fixtures located on oil and gas properties (and accounts arising therefrom) which are to be financed at the wellhead of the wells located on the real estate described in Exhibit A attached hereto (and accounts arising therefrom).

6.17 Notices. Any notice, request, demand or other instrument which may be required or permitted to be given or served upon the Mortgagor shall be sufficiently given when mailed by First Class Mail, addressed to the Mortgagor at the address shown below the signatures at the end of this instrument or to such different address as the Mortgagor shall have designated by written notice received by the Agent, the Banks or the Trustees.

IN WITNESS WHEREOF, the Mortgagor has executed or caused to be executed this Mortgage, Deed of Trust, Assignment, Security Agreement and Financing Statement on the day, month and year first above written.

MORTGAGOR AND DEBTOR

GHK EXPLORATION COMPANY

By GHK Gas Corporation
General Partner
Larry A. Ray

By *Larry A. Ray*
Larry A. Ray
Vice-President

The address of the Mortgagor is:

6441 Northwest Grand Boulevard
Oklahoma City, Oklahoma 73316

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SECURED PARTIES

Laura L. Cavallo

Laura L. Cavallo

Trustee

Kurt Wegleitner

Kurt Wegleitner

Trustee

CONTINENTAL ILLINOIS NATIONAL BANK
AND TRUST COMPANY OF CHICAGO,
as Agent Patrick M. Goy

By Patrick M. Goy
Vice President

ATTEST:

Monique G. van-Nispen

Monique G. van-Nispen
Banking Officer

The address of the Secured Parties is:

231 South LaSalle Street
Chicago, Illinois 60693
Attention: Oil and Gas Group

This Instrument Was Prepared By:

Richard S. Brennan, Esq.
Mayer, Brown & Platt
231 South LaSalle Street
Chicago, Illinois 60604

STATE OF ILLINOIS)
) SS.
 COUNTY OF COOK)

BE IT REMEMBERED that I, Ruth B. Hock, a Notary Public duly qualified, commissioned, sworn and acting in and for the County and State aforesaid, hereby certify that, on this 5th day of April 1982, there appeared before me severally each of the following persons, each being either a Trustee or else the designated officer of the partnership, corporation or association set opposite his name, and each such Trustee, corporation and association being a party to the foregoing instrument:

Larry A. Ray, Vice President of GHK Gas Corporation, a General Partner of The GHK Company, an Oklahoma partnership, whose address is 6441 Northwest Grand Boulevard, Oklahoma City, Oklahoma 73116;

Patrick M. Gray Vice President and ~~Monique A. Van Alst~~ Banking Officer, of Continental Illinois National Bank and Trust Company of Chicago, a national banking association, whose address is 231 South LaSalle Street, Chicago, Illinois 60693; and

Laura L. Cavallo and Kurt Weckleitner whose addresses are 231 South LaSalle Street, Chicago, Illinois 60693, as Trustees.

OKLAHOMA

Before me on this day personally appeared the aforementioned persons, to me known to be the identical persons who subscribed the names of the respective makers thereof to the foregoing instrument in the capacities set forth opposite the names of such persons above, and each such person acknowledged to me that he executed the same as his free and voluntary act and deed and as the free and voluntary act and deed of the partnership, corporation or association set opposite his name (or of himself as Trustee, as the case may be) for the uses and purposes therein set forth.

TEXAS

Before me on this day personally appeared each such person, each of whom is known to me

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to be the person whose name is subscribed to the foregoing instrument, and known to me to be the designated officer of the partnership, corporation or association set opposite his name (or a Trustee, as the case may be) and each acknowledged to me that he executed said instrument for the purposes and consideration therein expressed, and as the act and deed of the partnership, corporation or association set opposite his name (or of himself as Trustee, as the case may be).

Ruth R. Hook
Notary Public



My commission expires:

My Commission Expires August 18th, 1965

FAILURE OF PENN SQUARE BANK

THURSDAY, SEPTEMBER 30, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The committee met, pursuant to call, at 9:35 a.m., in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the committee) presiding.

Present: Representatives St Germain, Minish, Annunzio, Vento, Barnard, Lowry of Washington, Stanton, Hansen, Leach, Weber, McCollum, and Wortley.

The CHAIRMAN. The committee will come to order.

Yesterday, the committee heard from some of the country's largest and most prestigious banks who fell victim to the Penn Square trap. This morning the committee's attention turns to yet another facet of the complex Penn Square mosaic—how Penn Square, often using the services of money brokers, lured millions of dollars in deposits not from large money center banks, but from comparatively small credit unions, savings and loans and banks throughout the country.

Through the final months of Penn Square's existence, and even up to the last day before the bank's doors were closed, in fact, just hours before the doors were closed, many small financial institutions were placing funds in this shopping center bank, reassured by a Peat, Marwick, Mitchell & Co. audit that some have said gave the bank a "clean bill of health."

So healthy did some find it that they put in sums well above the insured amounts—in many cases running into the millions of dollars from individual institutions. All told, credit unions alone lost \$111 million in uninsured funds in Penn Square—over 20 percent of the bank's deposits when it failed. The latest information we have is that four or five credit unions may require assistance in the wake of their Penn Square losses, and at least two S&L's have also encountered serious trouble.

How is it that these relatively small institutions found themselves engulfed by the failure of this bank? In large part these credit unions found Penn Square through money brokers, the middlemen in the CD market whose fees were paid not by the credit unions, but by Penn Square. Money brokers are not a new phenomenon. In a world in which volatile money has become a way of life for some financial institutions, brokers have devised ways to tap those sources of money that seek the highest rate around. Some of the practices of these brokers have attracted the attention of Federal regulatory authorities over the last decade, and from time to

time cries have arisen to regulate more closely the activities of these brokers.

With the demise of Penn Square, those cries have been heard again. One purpose of today's hearing is to learn more about how these brokers operate and how they established relationships with Penn Square and with investing credit unions and S&L's.

The credit unions and the savings and loans we have invited here today are not being singled out for criticism for their involvement in Penn Square. With so many institutions involved, we simply have to choose a few to relate to us the story that needs to be told. We appreciate the cooperation that all these institutions have shown by appearing here voluntarily today, and by working with our staff earlier in preparing for this hearing.

In addition, both of the money brokers testifying today, who had extensive involvement with Penn Square over a period of months, are appearing voluntarily and we appreciate that.

At this point, I insert in the record a letter I have received from the National Credit Union Administration describing their assessment of the impact of Penn Square's failure on the credit unions regulated by NCUA. I also insert a map showing the locations of federally insured credit unions with uninsured deposits in Penn Square.

[The material follows:]



— NATIONAL CREDIT UNION ADMINISTRATION —

WASHINGTON, D.C. 20456

September 29, 1982

Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This is in response to your letter of September 22 requesting further information concerning credit union losses in the Penn Square Bank failure. I am pleased to provide the following information.

The latest information indicates that 139 Federal credit unions had uninsured deposits of approximately \$111.5 million in Penn Square. While losses incurred in Penn Square certainly can contribute to a weakening in financial condition, it is impossible to attribute the overall financial condition of any credit union which may need assistance solely to losses resulting from Penn Square. We continue to evaluate credit union conditions and, at this point in time, it is possible that 4-5 credit unions with assets of \$204 million may require some form of NCUSIF Assistance.

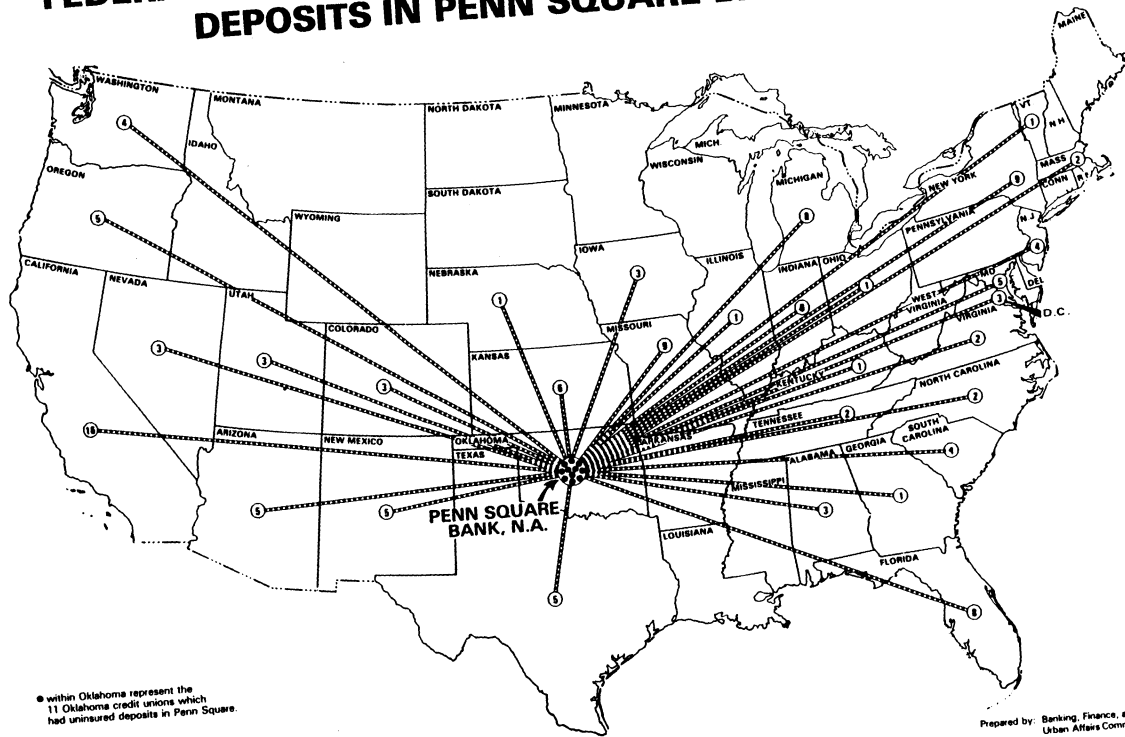
Additionally, we are closely monitoring 12-13 other credit unions with assets of \$534 million which experienced Penn Square losses. However, only 4 of these credit unions had their classification lowered since the closing of Penn Square and the remaining 8-9 credit unions were already under a special monitoring classification.

I hope that this information together with certain other information provided to your staff is responsive to your request.

Sincerely,

E. F. CALLAHAN
Chairman

FEDERALLY INSURED CREDIT UNIONS WITH UNINSURED DEPOSITS IN PENN SQUARE BANK, N.A.



● within Oklahoma represent the 11 Oklahoma credit unions which had uninsured deposits in Penn Square.

Prepared by: Banking, Finance, and Urban Affairs Committee Staff

Mr. BARNARD. Mr. Chairman, I notice in our folder this morning there is a chart. I would like to ask staff a question if I might.

The CHAIRMAN. Certainly.

[The chart referred to by Congressman Barnard follows:]

DEPOSITS OF FINANCIAL INSTITUTIONS IN PENN SQUARE BANK

The following information for this chart has been collected from FDIC documents and through conversations with FDIC personnel.

	<u>Credit Unions</u>	<u>Savings and Loans</u>	<u>Commercial Banks</u>
Number paid off by the FDIC	435	48	49
Total amount paid out as insured deposits	\$43,340,000	\$4,800,000	\$4,780,000
Number receiving and claiming FDIC receiver's certificates	140*	48	47
Total amount of these receiver's certificates (uninsured deposits)	\$107,720,116.30*	\$22,422,540.78	\$21,417,186.11

*These numbers reflect credit unions with receiver's certificates of over \$5,000.

Mr. BARNARD. Do I understand this form correctly to say that there were as many as 435 credit unions with deposits in Penn Square Bank; 48 savings and loan associations; and 49 commercial banks?

Mr. HOLLAR. Yes, Mr. Barnard, those figures are correct.

Mr. BARNARD. And the amount of money paid out as insured funds is \$43 million?

Mr. HOLLAR. That is correct. That is the amount already paid out by FDIC.

Mr. BARNARD. What does the last figure represent?

Mr. HOLLAR. The last figure is the amount of receiver's certificates. Those represent the uninsured deposits.

Mr. BARNARD. \$107 million?

Mr. HOLLAR. Yes.

Mr. BARNARD. \$107 million? Just to credit unions?

Mr. HOLLAR. That is right.

Mr. BARNARD. \$22 million in savings and loans and \$21 million in commercial banks?

Mr. HOLLAR. Yes, Mr. Barnard.

Mr. BARNARD. Thank you.

Mr. LOWRY. Mr. Chairman.

The CHAIRMAN. Mr. Lowry.

Mr. LOWRY. May I continue on that?

But of this \$107 million with credit unions, have they received \$107 million in receiver certificates?

Mr. Tow. Yes, that is correct.

Mr. LOWRY. They have received that in receiver certificates?

Mr. Tow. That is a combination of receiver certificates they have already received, and some claims for receiver certificates as well.

The CHAIRMAN. So that is not receiver certificates. That is the total amount, and for some of that they have received certificates, is that correct? Is that what you are saying?

Mr. Tow. Yes. The vast bulk of that amount has been received.

Mr. LOWRY. Is there a question on some of the claims as to whether there will be—

Mr. Tow. Claims represent a very small portion of the \$107 million.

Mr. LOWRY. So there either is or will be the \$107 million.

Mr. Tow. Yes.

Mr. LOWRY. Then they take those receiver certificates and go to the discount window; is that correct?

Mr. Tow. That is right.

Mr. LOWRY. They get what amount on that?

Mr. HOLLAR. My understanding, Mr. Lowry, is that they can borrow 90 percent of the 80 percent of face value at which these certificates are booked. In other words, they could borrow 72 percent of the face value of the receivership certificates at the discount window. I will check with the Federal regulators today and make sure of those figures.

Mr. BARNARD. Give us a figure then as to what you suggest are the losses people are going to experience. What will be the total losses depositors will experience?

Mr. HOLLAR. My understanding is that that has not been determined yet. Evaluation of assets takes a long period of time. For purposes of booking certificates, on the books of the various institutions, estimates so far have been to value assets at 80 percent of face value. Of course, that figure eventually could be lower. It could be higher, too.

Mr. BARNARD. I won't belabor the subject right now, but it appears to me that the Comptroller's estimate of necessary capital to keep this bank going is going to be much greater than the \$30 to \$40 million they were talking about.

Thank you.

The CHAIRMAN. Would all four of our first witnesses please stand. Mr. Sayres, Mr. Loiacona, Mr. Arnold, Mr. Mangan. [Witnesses sworn.] Our first witness this morning is Mr. William J. Sayres, general manager, IBM Poughkeepsie Employees Federal Credit Union, Poughkeepsie, N.Y.

Mr. Sayres.

TESTIMONY OF WILLIAM J. SAYRES, GENERAL MANAGER, IBM POUGHKEEPSIE EMPLOYEES FEDERAL CREDIT UNION, POUGHKEEPSIE, N.Y.; PHILIP LOIACONA, TREASURER AND MANAGER, BOLLING AIR FORCE BASE FEDERAL CREDIT UNION, WASHINGTON, D.C.; JOHN ARNOLD, MANAGER, SOUTHWEST CORPORATE FEDERAL CREDIT UNION, DALLAS, TEX.; AND JOHN MANGAN, EXECUTIVE VICE PRESIDENT, KILLEEN SAVINGS & LOAN ASSOCIATION, KILLEEN, TEX.

TESTIMONY OF WILLIAM J. SAYRES

Mr. SAYRES. Thank you, Mr. Chairman.

My name is Joe Sayres, and I am general manager of the IBM Poughkeepsie Employees Federal Credit Union in Poughkeepsie, N.Y., a post I have held since 1971.

IBM Poughkeepsie Employees Federal Credit Union was chartered in 1963. We are a full-service credit union, with over 100,000 member accounts and assets in excess of \$200 million.

While our services are extensive, our primary purpose—as I see it in the historical perspective of the credit union movement—is to lend deposits back to our members in the form of loans.

Since any funds that remain idle do not benefit the members, deposits in excess of loan demand are invested to produce additional income.

The credit union's board of directors has delegated investment decisions to a committee consisting of the treasurer, assistant treasurer and general manager. We adhere to guidelines set forth by our board and by the National Credit Union Administration. The guidelines in effect at the time of our Penn Square investment are attached to my testimony as addendum 1.

In evaluating investments, it's our practice to: request and evaluate the institution's most recent annual report and financial statements; review various ratios; and look at any increase or decrease in net worth, net income, deposits, assets, and reserve position.

Prior to using the investment consulting firm of Professional Asset Management, Inc., we were aware of it and acquainted with its vice president, William Goldsmith, through: his articles in the trade press; his authorship of the Investment Manual for Credit Unions published by the Credit Union Executives Society; and his participation in numerous conferences, including those of the League of IBM Credit Unions.

We were also aware that other credit unions were using his services.

In mid-1981 we had begun to receive from Professional Asset Management complimentary copies of the Capital Adequacy Reports which they published four times a year, as well as market updates in the form of a newsletter to "clients and friends." It was PAM's policy, as indicated to us, to emphasize safety first; institutions which did not meet their requirements were not even included in the Capital Adequacy Reports.

Those that did were monitored, and their financial reports were analyzed on a quarterly basis with the resultant data, including key operating ratios, included in the reports to clients and friends. This indepth analysis assisted us greatly.

Addendum 3 contains representative mailings from PAM. Indications were that Professional Asset Management monitored all trend areas carefully, following a 5-year trend analysis on key operating figures such as assets, deposits, loans, net worth, and profits of the institution. We also understood that personal visits were made to these institutions, and since we could not make such visits ourselves, this factor was instrumental in our decision to use PAM as an investment adviser.

A PAM update received in mid-1981 advised of two additions to PAM's list of approved institutions. That is included in addendum 4. It states:

Penn Square Bank, a national bank, has experienced outstanding growth in the past year with strong indications that this growth will continue.

Located in Oklahoma City, Penn Square has become the leading bank in the Southwest servicing the oil and gas industry. * * * Its total loan portfolio exceeds \$700 million, usually short term and all indexed to prime. * * * Penn Square acts as lead bank in joint loan ventures because its prime is normally 50 or more basis points higher than money center rates. As a result banks like Continental Illinois will earn more participating with Penn Square than by going it alone.

We are pleased to add these two fine institutions to our list of well capitalized banks and savings associations.

When Professional Asset Management contacted us in the fall of 1981, we had been experiencing an inflow of deposits, and sluggish loan activity, along with the previously mentioned reductions in savings and loan investments, so we were seeking alternative investment opportunities.

We made our first investment in Penn Square Bank on December 4, 1981. The deposit was in the amount of \$500,000 for 60 days at a rate of 13 percent.

At the time of this investment, we had \$39 million in our investment portfolio. Addendum 5 outlines our portfolio at the time of each Penn Square deposit.

In selecting any investment, we generally obtain a minimum of five bids and then perform an institution comparison based on financial statements and annual reports. At the time of our initial Penn Square deposit, we had rejected a higher rate from another institution because we had no statements or annual report on which to base our decision, nor was it listed in PAM's Capital Adequacy Report.

During the course of the next 6 months, we increased our total deposits in Penn Square Bank to \$3 million. We continued to supplement our own information with that provided by PAM and as recently as June 10, 1981, Penn Square showed a reserve position of 8.8 percent and a net worth to average deposit ratio of 9.95 percent.

We, along with many other investors, were completely shocked at the news of the bank's failure on July 5 of this year, since all indicators of which we were aware showed it to be a strong financial institution.

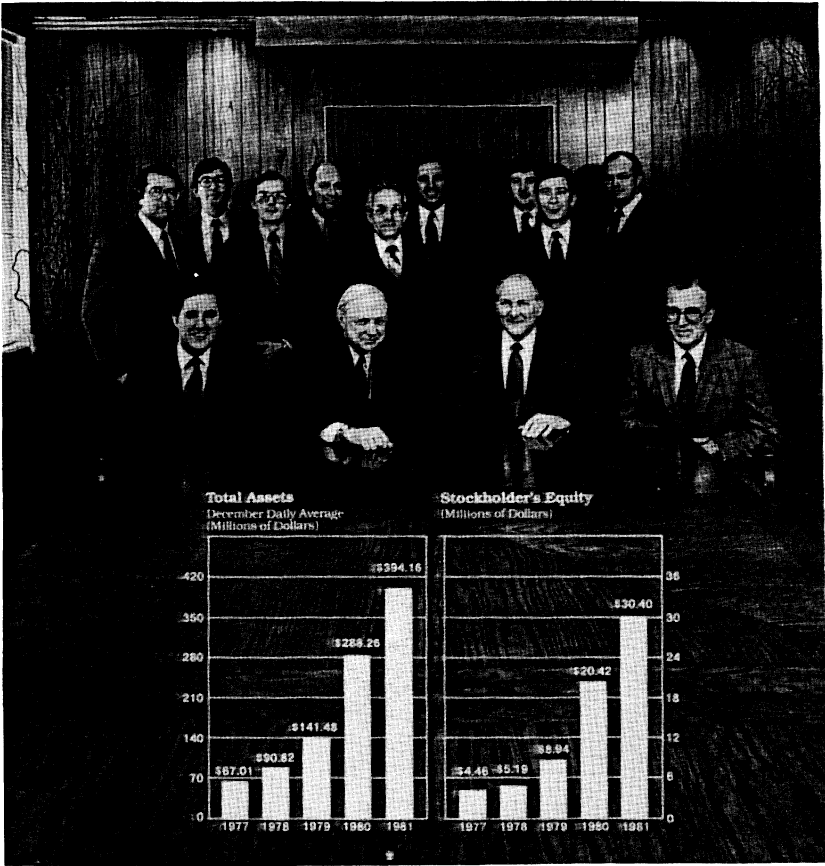
Mr. Chairman, I have with me copies of Penn Square's annual report and financial statements, and a Dun & Bradstreet report. With your permission, I would like to request that they be inserted in the hearing record.

The CHAIRMAN. Without objection, so ordered.

[The Penn Square Bank Annual Report, 1981, and financial statements, and the Dun & Bradstreet report referred to above, follow:]



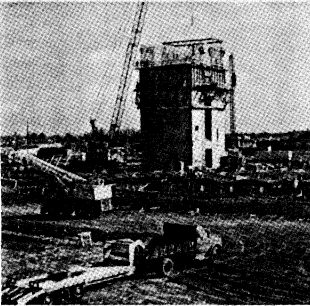
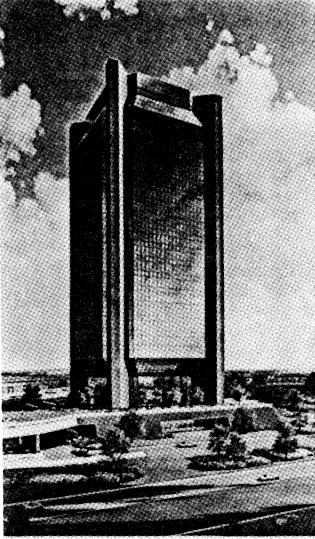
MEASURES OF OUR GROWTH



Penn Square Bank's top management team. Seated, left to right: Bill G. Patterson, Senior Executive Vice President; Bill F. Jennings, Chairman and Chief Executive Officer; Eldon L. Beller, President and Chief Administrative Officer; Frank L.

Murphy, Vice Chairman. Standing, left to right: Tony W. Williams, Ashburn H. Bywaters, Richard T. Dunn and Dennis Winget, Executive Vice Presidents; Robert C. Van Laanen, Harold D. Armstrong and Daniel W. Thompson, Senior Vice

Presidents; James J. Gunter, Executive Vice President, and John R. Preston, General Counsel. Top right: rendering of Pennbank Tower; Front cover and bottom right: Pennbank Tower under construction.



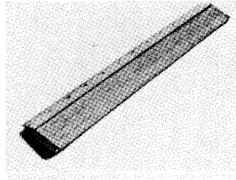
Energetic growth has become a recognized characteristic of Penn Square Bank over the past decade. This growth can be measured in many ways.

Since 1974 assets and stockholders' equity have increased more than tenfold, while deposits are more than twelve times their level of eight years ago.

Another measure of our growth has been the continued expansion of our facilities to accommodate increased activity and enable us to continue to provide superior customer service. Pennbank Tower, now under construction just east of our present location, is a tangible symbol that today Penn Square Bank is firmly established as one of the major banking organizations in Oklahoma.

Most importantly, managing this growth has meant broadening and strengthening our capabilities and services. In 1981, Penn Square Bank's emphasis has been on people. We have added to our management strength in every aspect of our business, creating a depth of experience at the top management level which is the equal of that found in institutions many times our size.

Banking in the 1980s will be characterized by the demand for more sophisticated financial services and increased competition from many new types of financial organizations. Penn Square Bank's growth has meant a corresponding growth in capability, in the form of both human and financial resources, to meet the changing needs of our customers.



CHAIRMAN'S MESSAGE

The year 1981 may well rank as one of the most significant periods in Penn Square Bank's growth. It was a year of visible progress in many areas.

We reported solid growth in assets, loans and deposits. An infusion of \$7 million in stockholders' equity greatly strengthened our capital structure. Earnings increased 10% over last year's record results notwithstanding the high cost of expansion into temporary facilities, the large increase in personnel necessitated by our growth, and the continuation of our policy of maintaining a strong capital position and loan loss reserve.

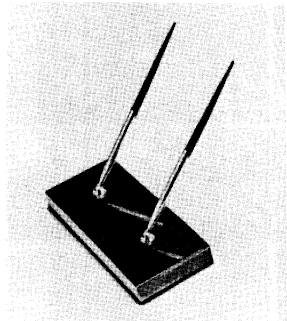
We were also able to implement our long range plans to provide Penn Square Bank with adequate facilities for future growth. The 22-story Pennbank Tower began construction at mid-year and is due to be ready for occupancy in 1983.

Our customer list continues to grow, a fact we believe attests to the strong reputation for performance Penn Square Bank has established in the community.

Moreover, we are particularly proud of the progress we have made in expanding our human resources during the past twelve months. Our continuing objective is to attract the highest caliber of professionals to our senior management staff and board of directors. During 1981 this effort was especially fruitful.

Beginning with the election of Eldon Beller as President and Chief Administrative Officer of the bank, we have expanded and strengthened our top management team with key additions in many areas. The extensive banking experience represented by these new people gives us a breadth and depth of knowledge unusual for an institution of our size.

In looking to the future, we must take note of the conditions prevailing in our industry and in the national economy. Two overriding concerns are continuing inflation and the national recession which so far, fortunately, has not seriously affected Oklahoma's booming economy. Changing conditions, new banking laws and regulations have also heightened competition within the banking industry and from other financial institutions.



To meet these challenges, our long range plans for growth are aggressive, flexible, yet realistic. We are dedicated to increasing our capabilities to cope with rapidly changing technology and the need for a broader range of more sophisticated services to serve our customers in the 1980s. We realize that adequate management of the rapid growth Penn Square Bank has enjoyed makes it incumbent upon management to provide the financial solidarity, the expanded facilities, the technology and the quality people who can continue to provide a superior level of services for our banking customers.



Bill P. Jennings
Chairman



Bill P. Jennings, Chairman
and Chief Executive Officer (left)
and Eldon L. Beller, President
and Chief Administrative Officer

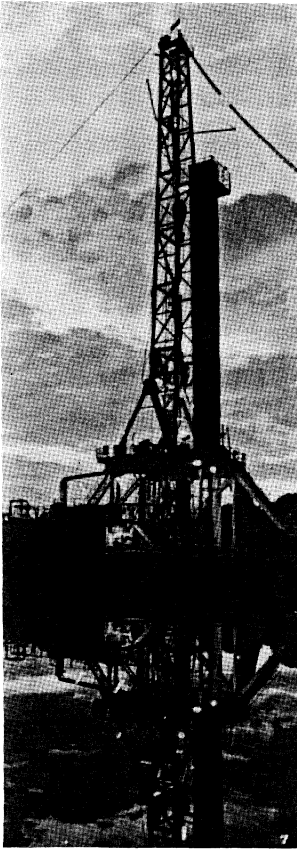
GROWING WITH ENERGY



Penn Square Bank's Energy Division serves an excellent group of independent oil producers. Among them: 1. An-Son Corporation's Carl Anderson Jr., center, with other top company executives, left to right, Ruben Osborn, Fred Standigler,

Jack Moore, Pat Colton and Carl Anderson III. 4. Robert L. Hefner III heads GHK Corporation, a pioneer in the Deep Anadarko Basin area. 7. Continental Drilling Company provides contract drilling services. Energy Division executives: 2. Russell B. Bainbridge, Phil G. Busey, James R. Karcher

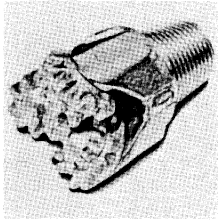
and Gregory A. Odean. 3. Seated, left to right: Dennis Winget, Bill G. Patterson, Janelle Cates. Standing: Ashburn Bywaters and Tom Suenneford. 5. Janelle Cates, Dewayne Horton, Bill Kingston. 6. Bill G. Patterson.



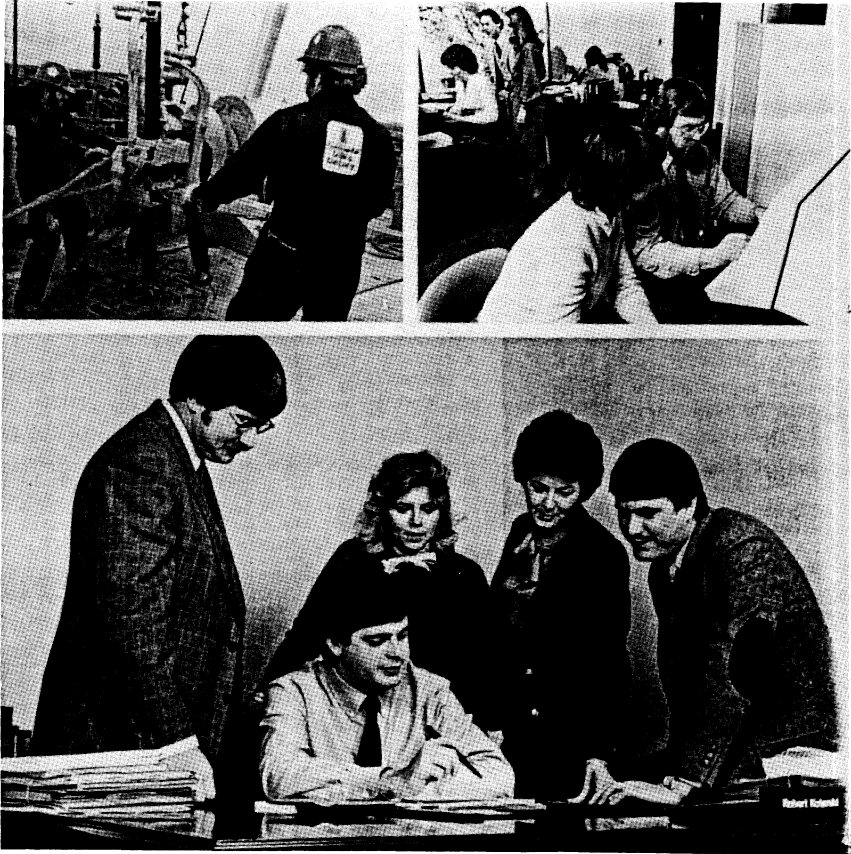
The oil and gas industry continues to be a major factor in Oklahoma's burgeoning economy. Currently, one-fifth of all the rotary rigs active in this country are drilling in Oklahoma.

Oil and gas lending activities have been a prime source of growth for Penn Square Bank. Our oil and gas lending division ranks among the most active in the state. Working in participation with five of the largest oil and gas lending banks in the country, and others, Penn Square Bank presently handles more than \$2 billion in oil and gas loans and commitments.

These loans are originated and monitored by a staff of more than 80 people, headed by Senior Executive Vice President Bill G. Patterson. The customers served by Penn Square Bank represent one of the strongest groups of independent oil producers and operators in the Southwest. We provide these customers with a wide range of services, including loans on production, drilling funds, equipment and oil and gas leases.



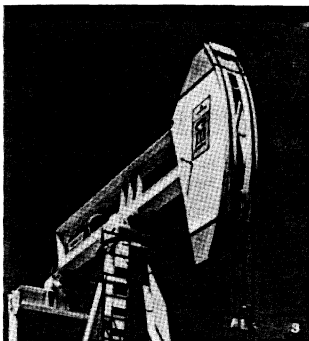
FINANCING THE SEARCH FOR ENERGY



1. Continental Drilling rig in action. 2. Penn Square Bank's Petroleum Engineering Department. Foreground: Lucy Reed and John Madison. Background, left to right: Annie Tegmeier,

Larry Herd, Leah Smith, Marilyn Cook. 3. Oil well pumping unit manufactured by CMF Corporation, a Penn Square Bank customer. 4. Correspondent Banking. Left to right, Randy

Smith, Bob Kotarski (seated), Jan Kiser, Billie Dean, Barry Rudy, Petroleum Engineers Mike Gilbert and Jeff Callard.

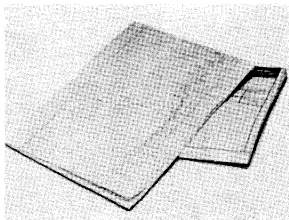


Penn Square Bank works closely with its oil and gas customers and its correspondent banks to provide the financing needed to search out new supplies of energy.

The bank utilizes the most modern monitoring/evaluation techniques in the banking industry to evaluate the oil and gas reserves securing these loans. Its petroleum engineering department includes two full-time petroleum engineers, plus engineering assistants. Computer and microfiche records give this staff access to detailed information on every producing well in Oklahoma and eleven surrounding states. Producing wells in loan portfolios are closely monitored to compare estimated to actual production.

The Correspondent Banking Department also is actively involved in this effort. Penn Square Bank and its large correspondent banks reach dual credit decisions, in many instances, to provide bank consortium loans to oil and gas customers.

The bank maintains firm ties to more than 50 banks in Oklahoma and other parts of the country. These relationships provide Penn Square Bank's oil and gas customers with access to the capital resources they need for their exploration and development activities.



HELPING BUSINESSES GROW



Among the many businesses Penn Square Bank has helped grow are several pictured on these pages: 1. CMF Corporation, manufacturers of heavy roadmaking equipment; 2. Jon Orenstein of Creative Cookery; 3. and 4. Henson Cargill and his new western showplace, Henson's & Air Center at Wiley

Post Airport. Working closely with businesses are these members of Penn Square Bank's staff: 5. Phillip E. Foss and Robert C. Van Laanen, Commercial Loan Department; 6. Harold D. Armstrong, Commercial Real Estate Department; 7. Bill R. Blackstein and Charice Guhery, Real Estate and

Construction; 8. Richard T. Dunn and Robert Williams, Loan Administration; 9. John Battiloin, Frankie Burnsworth and Jean Peterson, Loan Administration; 10. Bill W. Coy and Don Chappell, Installment Loan Department.

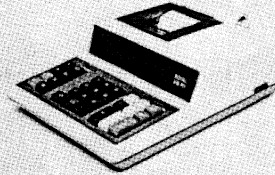


Business and consumer lending have always been important activities at Penn Square Bank. In 1981, we greatly strengthened our staff capabilities in this area with the addition of a number of experienced loan officers in real estate, industrial, commercial, construction and consumer lending.

Penn Square Bank serves a wide variety of retail, industrial and real estate enterprises. Together, these customers represent a major source of employment for residents in the Oklahoma City metropolitan area. We help these customers grow by providing many types of financing services, including equipment, accounts receivable and inventory loans.

In these days of high interest rates, a new service offered by a subsidiary, First Penn Leasing Corporation, is also of benefit to our business and professional customers. This subsidiary provides leasing services for business, medical, construction and industrial equipment, usually at lower monthly rates than the customer would pay for a loan to purchase the equipment. This is particularly beneficial to customers who do not need the tax credits available from depreciation.

We also offer consumer lending services to our individual customers, including new car loans and home improvement loans.



EMPHASIZING CUSTOMER CONVENIENCE



1. Motor Bank: Ada Carrithers, Max Ellis, Gelene Shannon.
 2. Financial Services: Ray Hicks, Norma Babb, Jim Gunter,
 Arlyn Hill. 3. M. Robert Barton, Operations, and Kim Hall.
 4. Jerry Pandy, Administrative Services. 5. Tony Williams.

Executive Vice President of Bank Administration. 6. The Motor
 Bank's consumer lobby draws many customers. 7. New Accounts:
 Carol Stewart, Cleda Owens, Tom Harrison. 8. Wire desk:
 Renea Springer, Margaret Bonfield. 9. Dan Thompson.

Operations Department. 10. Jim Pitts, Corinna Lipson with Proc-
 Department in background. 11. Susan Bolger, Bill McCain,
 and Paula Tharp, Operations.



Superior service begins by providing customer convenience. One of our primary objectives is making sure our customers — companies and individuals — find it convenient to do business with Penn Square Bank.

Our motor bank, with its drive-through service and convenient consumer and commercial lobbies, is one of our most popular customer areas. We provide a wide array of services at both our motor bank and main banking facility.

Recent changes in banking laws have given rise to many new services for consumers, particularly in the area of checking and savings accounts. These include the new Individual Retirement (IRA) accounts, NOW accounts and All-Savers Certificates as well as regular savings accounts and certificates of deposit.

The Beep Machine, located at the Motor Bank, provides automated teller service 24 hours a day, 7 days a week. Customers can withdraw cash or make deposits or handle other transactions by computer. Safe deposit boxes, for the storage of valuable papers, art objects and silver hollow and flat ware, are another consumer service offered by the bank.

Excellence in customer service begins behind the scenes, with our operations staff. Currently, our operations division employs one-third of our total work force. Automation has played a major role in the ability of our operations division to provide support services for banking functions in an efficient manner. During the past year Penn Square Bank became the first bank in the state to automate its draft collection system. We have also increased our transfer capacity by 100% over the past twelve months.

In the final analysis, however, we know that people and attitude are the vital factors in providing quality service. We are proud of the reputation our employees have established for prompt and courteous service to our customers.



THE MANY PHASES OF BANKING SERVICES



1. Business Development: Lisa Smith, Patricia R. McPartlin.
2. Trust Division: John H. Miller, Carolyn B. Jones. 3. Harold
D. Armstrong participated in Oklahoma City's Easter Seal
telethon. 4. The Motor Bank was winner of a 1981 Oklahoma

City Beautiful award. 5. Among events Penn Square Bank
sponsors is the Oklahoma City Junior Symphony Festival
Run. 6. Personnel: Geraldine Neary, Elaine Duke. 7. Marketing:
Karen Martin, Carol Gasaway, Linda Bell. 8. One of many

seminar sessions sponsored in 1981 by Penn Square Bank.
9. General Counsel John Preston, right, and Marsha Hickman.
Black and white photo of McEnroe by Terry Sims.

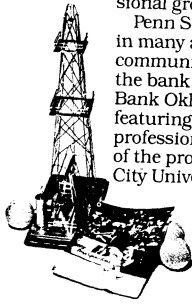


Serving the needs of our customers takes many forms at Penn Square Bank.

One important aspect is the full range of trust and financial advisory services provided by our Trust Division. This division is headed by two highly respected professionals, John H. Miller and Carolyn B. Jonas. The Trust Division provides financial and estate planning, estate management, investment and management of funds, establishment and management of many different types of trusts, pension plans and profit-sharing programs, and many other services for individuals and businesses.

Another important function is provided by our Marketing Division. It is this division's task to anticipate changing customer needs and make new products and services available. Changing regulations in the banking industry will make research and development of new products and services an even more important function of banking during the 1980s. This division also sponsors a series of financial planning seminars each year, keyed to the needs of various groups served by the bank. These have ranged from seminars for businesswomen to sessions on tax shelters for various professional groups.

Penn Square Bank also becomes involved in many activities that benefit the community. Among events sponsored by the bank was a recent Penn Square Bank Oklahoma Cup tennis match featuring the Number One ranked tennis professional, John McEnroe, with a portion of the proceeds benefiting the Oklahoma City University tennis program.



STATEMENT OF CONDITIONAt the Close of Business December 31, 1981 and 1980
(December Daily Averages)

ASSETS	1981	1980
Cash and due from banks.....	\$ 45,075,000	\$ 32,095,000
U. S. Treasury securities.....	13,111,000	8,861,000
State and municipal securities.....	34,397,000	30,124,000
Stock in Federal Reserve.....	541,000	235,000
Federal funds sold.....	9,855,000	8,082,000
Loans, net of reserve.....	264,594,000	197,815,000
Bank premises and equipment.....	3,679,000	2,812,000
Other assets.....	22,906,000	8,235,000
Total assets.....	\$394,158,000	\$288,259,000
LIABILITIES		
Demand deposits.....	\$147,924,000	\$107,238,000
Time and savings deposits.....	206,859,000	151,485,000
Total deposits.....	354,783,000	258,723,000
Federal funds purchased.....	4,760,000	7,182,000
Other liabilities.....	4,211,000	1,932,000
Total liabilities.....	363,754,000	267,837,000
STOCKHOLDERS' EQUITY		
Capital stock.....	1,000,000	1,000,000
Surplus.....	17,516,000	10,500,000
Retained earnings.....	11,888,000	8,922,000
Total stockholders' equity.....	30,404,000	20,422,000
Total liabilities and stockholders' equity.....	\$394,158,000	\$288,259,000

STATEMENT OF INCOME

Years Ended December 31

	1981	1980
REVENUE FROM EARNING ASSETS:		
Interest and fees on loans	\$50,929,000	\$24,650,000
Investment securities:		
U. S. Securities	1,597,000	300,000
State and municipal subdivisions	2,204,000	1,308,000
Other	41,000	10,000
Interest on Federal Funds sold	676,000	283,000
Total revenue from earning assets	55,447,000	26,551,000
INTEREST EXPENSE:		
Deposits	28,807,000	12,820,000
Interest on federal funds purchased	2,949,000	739,000
Other interest expense	1,132,000	135,000
Total interest expense	32,888,000	13,694,000
Net revenue from earning assets	22,559,000	12,857,000
Provision for possible loan losses	6,343,000	1,408,000
Net revenue from earning assets after provision for possible loan losses	16,216,000	11,449,000
OTHER REVENUES:		
Deposit fees	1,119,000	687,000
Other operating income	370,000	211,000
Total other income	1,489,000	898,000
OTHER EXPENSES:		
Salaries and employee benefits	5,124,000	2,339,000
Occupancy and equipment expense	1,376,000	619,000
Other expense	4,204,000	2,383,000
Total other expense	10,704,000	5,341,000
INCOME BEFORE INCOME TAXES AND SECURITIES GAINS OR LOSSES ..	7,001,000	7,006,000
Provision for income taxes	2,295,000	2,721,000
NET INCOME	\$ 4,706,000	\$ 4,285,000



Penn Square Bank Directors, left to right:
Row 1: Bill P. Jennings, Frank L. Murphy,
Eldon L. Beller, Bill G. Patterson,
John R. Preston.
Row 2: Richard T. Dunn, Ronald H. Burks,
Eltzabeth Merrick Coe, Gary M. Cook,
J. C. Crauens.
Row 3: Richard C. Haugland, Ken L. Kenworthy,
C. F. "Tag" Kimberling, Marvin K. Margo,
H. Mead Norton.
Row 4: James G. Randolph, Jerry Richardson,
W. A. "Dub" Ross.
Row 5: Gene Smelser, Bill Stubbs, Carl W. Swan.

Directors

Bill P. Jennings
Chairman
Frank L. Murphy
Vice Chairman
Eldon L. Beller
President
Bill G. Patterson
Senior Executive Vice President
Richard T. Dunn
Executive Vice President
John R. Preston
Secretary and General Counsel
Ronald H. Burks
Chairman,
Burks Investments, Inc.
Elizabeth Merrick Coe
President,
The Merrick Foundation
Gary M. Cook
Chairman,
Thru Construction Corporation
J.C. Cravens*
Investments
Richard C. Haugland
Vice President,
Citizens National Bank, Muskogee
Ken L. Kenworthy
Vice President, Director
Secretary, Treasure
CMI Corporation
C.F. "Tag" Kimberling
Real Estate
Marvin K. Margo, M.D.
McBride Clinic, Inc.
H. Mead Norton*
President,
Norton Investment Co.
James G. Randolph
President,
Kerr-McGee Coal Corporation
Jerry Richardson
President,
Dab Richardson Ford, Inc.
W.A. "Dab" Ross
President,
Dab Ross Company
Gene Sreisher
President,
Val Gene's Food Service, Inc.
Bill Stubbs
Real Estate
Carl W. Swan
Independent Oil Producer
*Advisory Director

Officers

Bill P. Jennings,
Chairman and
Chief Executive Officer
Frank L. Murphy,
Vice Chairman
Eldon L. Beller,
President and
Chief Administrative Officer
Bill G. Patterson,
Senior Executive Vice President
Executive Vice Presidents
Tony W. Williams
James J. Gunter
Richard T. Dunn
Ashburn H. Bywaters
Dennis Winget
ENERGY DIVISION
Bill G. Patterson,
Senior Executive Vice President
Executive Vice Presidents
Ashburn H. Bywaters
Dennis Winget
Thomas D. Swineford,
Senior Vice President
Vice Presidents
Russell B. Bainbridge
Janette R. Cates
Phil G. Busey
James R. Karcher
Gregory A. Odean
Assistant Vice Presidents
Robert S. Lockard
Randy Allison
Dewayne Horton
Shari L. Mitchell
Rex M. Lind
Banking Officers:
Jan Stratz
Joy C. Loranice
Diana D. Swift
Sharon Gutierrez
Shirley Turner
ENGINEERING DEPARTMENT
Petroleum Engineers
Jeff G. Callard
Michael R. Gilbert
John Madison,
Assistant Vice President
**CORRESPONDENT
BANKING DEPARTMENT**
Robert D. Kotarski,
Senior Vice President
Vice Presidents
Billie J. Dean
Barry A. Rudy
Randal W. Smith
R. Jan Kiser,
Assistant Vice President

**COMMERCIAL AND
CONSUMER LOAN DIVISION**

**COMMERCIAL LOAN
DEPARTMENT**
Robert C. Van Laanen,
Senior Vice President
Vice Presidents
Phillip E. Foss
D. Patrick McCoy
Robert T. Laing,
Assistant Vice President
**INSTALLMENT LOAN
DEPARTMENT**
Bill W. Cox,
Senior Vice President
Dory R. Chappell,
Vice President

**COMMERCIAL REAL ESTATE
DEPARTMENT**
Harold D. Armstrong,
Senior Vice President
**REAL ESTATE AND
CONSTRUCTION**
Bill R. Blacksten,
Vice President
Charcie M. Guthey,
Administrative Officer

**LOAN ADMINISTRATION
DIVISION**
Richard T. Dunn,
Executive Vice President
Vice Presidents
John C. Baldwin
Jean A. Peterson
Robert J. Williams, Jr.

Assistant Vice Presidents:
Frankie L. Burnworth
Cheryl Lemmon
Loan Review Officers:
Garvin M. Chandler
M. Joseph Vercher
Joseph D. Anselmo
Banking Officers:
Daniel C. Glaspy
Becky L. Smith

**BANK ADMINISTRATION
DIVISION**
Tony W. Williams,
Executive Vice President

OPERATIONS DEPARTMENT
Daniel W. Thompson,
Senior Vice President
James W. Pitts,
Vice President and Cashier
Vice Presidents:
M. Robert Barton
Tom Harrison
Celene Shannon

Assistant Vice Presidents:
William M. McBain
Cleda C. Owens
Carol J. Stewart
Max Ellis

Operations Officers:
Ada Carithers
Cortina Lipton
Shirley A. Vint
Karilyn J. Inman
E. Buddy McIntosh
JoAnn Callaway

ADMINISTRATIVE SERVICES
Jerry Pendry,
Banking Officer
Michael H. Mahoney,
Operations Officer
Wayne L. Hurstman,
Purchasing Officer

TRUST DIVISION

John H. Miller,
Vice President and Trust Officer
Carolyn B. Jones,
Vice President and Trust Officer

FINANCIAL SERVICES DIVISION

James J. Gunter,
Executive Vice President
Raymond L. Hicks,
Senior Vice President and Controller
Bert Davis, III,
Senior Vice President

Vice Presidents:
Mark T. White
Arlyn C. Hill

MARKETING DIVISION

Linda B. Bell,
Vice President

PERSONNEL DIVISION

Elaine Dake,
Vice President
Ceraldine Yearley,
Assistant Vice President

**BUSINESS DEVELOPMENT
DIVISION**

Patricia R. McFarlin,
Vice President

AUDITOR

Norma L. Babb
Frances L. Gray,
Auditing Officer

GENERAL COUNSEL

John R. Preston
Richard D. Forshee,
Assistant

Officers

Bill F. Jennings, Chairman and Chief Executive Officer
 Frank J. Murphy, Vice Chairman
 Eldon L. Belzer, President and Chief Administrative Officer
 Bill C. Patterson, Senior Executive Vice President
 Executive Vice Presidents
 Tom W. Williams, James J. Gunter, Richard T. Dunn
 Ashburn H. Bywaters, Dennis Winget

OIL AND GAS LOAN DIVISION

Bill C. Patterson, Senior Executive Vice President
 Executive Vice Presidents
 Ashburn H. Bywaters, Dennis Winget
 Thomas D. Swinford, Senior Vice President
 Vice Presidents
 Russell B. Dalbridge, James R. Cole, Robert J. Williams, Jr.
 Robert J. Lockard, Assistant Vice President
 Frankie L. Burroughs, Assistant Vice President
 Randy Allison, Assistant Vice President
 Dewey Barton, Assistant Vice President
 Stuart L. Mitchell, Banking Officer
 Jay C. Loran, Administrative Officer

ENGINEERING DEPARTMENT

Petroleum Engineers
 Ed G. Cahill, Michael R. Gilbert

CORRESPONDENT BANKING DEPARTMENT

Robert B. Kulinski, Senior Vice President
 Harold W. Smith, Vice President
 Billie J. Dean, Assistant Vice President
 R. Dan Kiser, Assistant Vice President

COMMERCIAL AND CONSUMER LOAN DIVISION

Vice President
 Philip E. Foss, Ed Patrick McVay, Robert C. Van Lauren
 INSTALLMENT LOAN DEPARTMENT
 Harold O. Armstrong, Senior Vice President
 Bill W. Cox, Senior Vice President, Bill R. Blackston, Vice President
 Don R. Chappell, Vice President, Charles M. Guthrie, Administrative Officer

CREDIT ADMINISTRATION DEPARTMENT

Richard T. Dunn, Executive Vice President
 John C. Baldwin, Vice President
 Jean A. Peterson, Vice President, Loan Closing
 Garvin M. Chandler, Loan Closing Officer
 Cheryl Lemmon, Assistant Cashier
 Becky L. Smith, Banking Officer, Loan Closing
 Daniel C. Chespy, Banking Officer, Loan Closing

OPERATIONS DIVISION

Tore W. Williams, Executive Vice President
 Daniel W. Thompson, Senior Vice President
 James W. Pitts, Vice President and Cashier
 Vice Presidents
 Tom Harrison, Celene Shannon
 M. Robert Barton, Assistant Vice President

William M. McBain, Kelda C. Overton, Carol J. Stewart
 Operations Officers
 Michael H. Mahoney, Audrey A. Vint, Corinna Lpton
 Max Ellis, Ada Cartledge, Carolyn J. Tamm
 Jerry Dindry, Security Officer

TRUST DIVISION

John H. Miller, Vice President and Trust Officer
 Carolyn B. Jones, Trust Officer

FINANCIAL PLANNING DIVISION

James J. Griffin, Executive Vice President
 Raymond L. Hicks, Vice President

PERSONNEL DIVISION

Blaine Duke, Vice President
 Geraldine Yeates, Assistant Vice President

FACILITIES MANAGEMENT

Jim Brand, Vice President
 Wayne L. Harman, Purchasing Officer

MARKETING DIVISION

Linda B. Bell, Vice President

BUSINESS DEVELOPMENT

Patricia R. McFarlin, Vice President

AUDITOR

Norma L. Dabo

GENERAL COUNSEL

John K. Preston

Growing with Energy

Penn Square Bank, N.A.

Member F.D.I.C.

Pennsylvania and NW Expressway
 Oklahoma City
 942-7441

Statement of Condition

At the Close of Business September 30, 1981

	September 30, 1981	September 30, 1980
ASSETS		
Cash and time from banks	\$ 34,871,000	\$ 26,890,000
U. S. Treasury securities	13,169,000	3,178,000
State and municipal securities	35,329,000	25,967,000
Stock in Federal Reserve	540,000	210,000
Federal funds sold	47,000,000	0
Loans, net of reserve	255,237,000	174,182,000
Bank premises and equipment	3,878,000	2,344,000
Other assets	18,267,000	6,079,000
Total assets	\$408,289,000	\$238,650,000
LIABILITIES		
Demand deposits	\$114,568,000	\$ 8,924,000
Time and savings deposits	256,661,000	132,806,000
Total deposits	371,229,000	215,510,000
Federal funds purchased	2,350,000	6,585,000
Other liabilities	4,709,000	2,226,000
Total liabilities	378,288,000	224,301,000
STOCKHOLDERS' EQUITY		
Capital stock	1,000,000	1,000,000
Surplus	17,000,000	6,000,000
Undivided profits	12,001,000	7,349,000
Total stockholders' equity	30,001,000	14,349,000
Total liabilities and stockholders' equity	\$408,289,000	\$238,650,000

Directors

Bill P. Jennings
 Chairman
Frank L. Murphy
 Vice Chairman
Eldon L. Beller
 President
Bill G. Patterson
 Senior Executive Vice President
Richard T. Dunn
 Executive Vice President
John R. Preston
 Secretary and General Counsel
Ronald H. Burks
 Chairman of the Board,
 Burns Investments, Inc.
Elizabeth Merrick Coe
 President,
 The Merrick Foundation

Gary M. Cook
 Chairman,
 Trend Construction Corporation
J. C. Cravens*
 Investments
Richard C. Haugland
 Vice President,
 Citizens National Bank, Muskogee
Ken L. Kenworthy
 Vice President, Director,
 Secretary Treasurer,
 CMI Corporation
C. F. "Tag" Kimberling
 Real Estate
Marvin K. Margo, M.D.
 McBride Clinic, Inc.
H. Mead Norton*
 President,
 Norton Investment Co.

James G. Randolph
 President,
 Kerr-McGee Coal Corporation
Jerry Richardson
 President,
 Dub Richardson Ford, Inc.
W. A. "Dub" Ross
 President,
 Dub Ross Company
Gene Smelser
 President,
 Val Gene's Food Service, Inc.
Bill Stubbs
 Real Estate
Carl W. Swan
 Independent Oil Producer

*Advisory Director

Officers

Earnings, Chairman and Chief Executive Officer
Frank L. Murphy, Vice Chairman
Beller, President and Chief Administrative Officer
Patterson, Senior Executive Vice President

Executive Vice Presidents
W. Williams James J. Gunter
ard T. Dunn Dennis Winget
Harold D. Armstrong

ENERGY DIVISION

G. Patterson, Senior Executive Vice President
Dennis Winget, Executive Vice President
Thomas D. Swineford, Senior Vice President

Vice Presidents

I. B. Bainbridge James R. Karcher
cliff R. Cates Gregory A. Odean
H. G. Busey Peter D. Crawford

Assistant Vice Presidents

rt S. Lockard Shari L. Mitchell
ndy Allison Rex M. Linn
ayne Horton D. Keith McFall

Banking Officers

an Stratz Sharon S. Gullerres
C. Lorance Shirley P. Turner
na D. Switt Daniel C. Seely

Engineering Department

Petroleum Engineers
Callard David Curry Terri Smith
John Madison, Assistant Vice President

Correspondent Banking Department

Robert D. Rotarski, Senior Vice President

Vice Presidents

ean Barry A. Rudy Randi W. Smith
K. Alan Kiser, Assistant Vice President

COMMERCIAL LOAN DIVISION

Richard T. Dunn, Executive Vice President

Metropolitan Department

Robert C. Van Laanen, Senior Vice President

Vice Presidents

Phillip E. Foss D. Patrick McCoy
Robert T. Laing, Assistant Vice President

Consumer Loan Department

Bill W. Coy, Senior Vice President
Don R. Chappell, Vice President

Industrial and Leasing Department

Vice Presidents
ammon Robert L. Oliver Jerry L. Ford

REAL ESTATE DIVISION

Commercial Real Estate Department

old D. Armstrong, Executive Vice President

Real Estate and Construction

Bill R. Blacksten, Vice President
harlie M. Guthery, Administrative Officer

LOAN ADMINISTRATION DIVISION

John C. Baldwin, Vice President
Hoppy E. Heidelberg, Loan Administration Officer
Vice Presidents:

Jean A. Peterson Robert J. Williams, Jr.

Assistant Vice Presidents:

Frankie L. Burnworth A. Cheryl Lemon

Joseph D. Anselmi

Banking Officers

Carvin M. Chandler Daniel C. Glaspy

M. Joseph Vercher Becky L. Smith

BANK ADMINISTRATION DIVISION

Tony W. Williams, Executive Vice President

Operations Department

James W. Pitts, Vice President and Cashier

Vice Presidents

M. Robert Barton Tom Harrison Celene Shannon

Assistant Vice Presidents

Cleda C. Owens Carol J. Stewart Max Ellis

Operations Officers

Ada Carthier Karolya J. Inman

Corinna Upton E. Buddy McIntosh

JoAnn H. Callaway

Administrative Services

Jerry Pendry, Banking and Security Officer

Wayne L. Huntman, Purchasing Officer

TRUST DIVISION

John H. Miller, Vice President and Trust Officer

Carolyn B. Jones, Vice President and Trust Officer

FINANCIAL SERVICES DIVISION

James J. Gunter, Executive Vice President

Raymond L. Hicks, Senior Vice President and Controller

Bert Davis III, Senior Vice President

Daniel W. Thompson, Senior Vice President

Vice Presidents

Mark T. White Arlyn C. Hill Tim W. Rice

William M. McCain, Assistant Vice President

Shirley A. Vint, Banking Officer

Keith King, Banking Officer

MARKETING DIVISION

Linda B. Belt, Vice President

PERSONNEL DIVISION

Elaine Dake, Vice President

Gerakline Yearley, Assistant Vice President

BUSINESS DEVELOPMENT DIVISION

Patricia R. McFarlin, Vice President

AUDITING

Norma L. Babb, Auditor

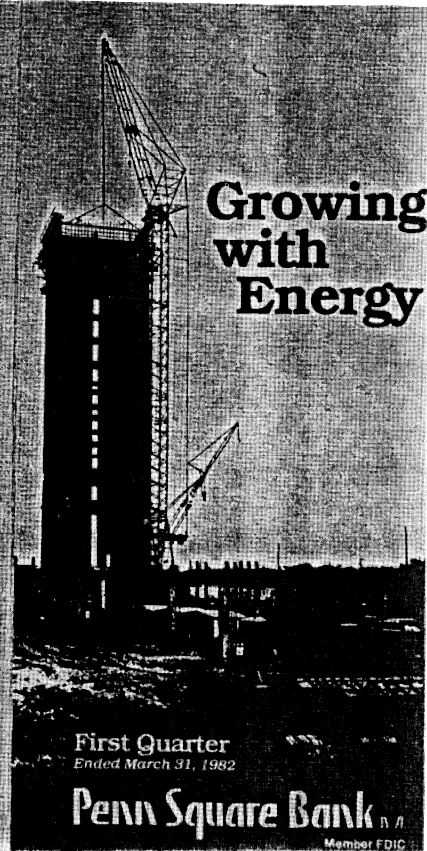
Frances L. Gray, Auditing Officer

GENERAL COUNSEL

John R. Preston

Richard D. Forshue, Assistant

Michael H. Maloney, Risk Management Officer



Growing with Energy

First Quarter
Ended March 31, 1982

Penn Square Bank

Member FDIC

Directors

Bill P. Jennings
Chairman
Frank L. Murphy
Vice Chairman
Eldon L. Beller
President
Bill G. Patterson
Senior Executive Vice President
Richard T. Dunn
Executive Vice President
John R. Preston
Secretary and General Counsel
Ronald H. Burks
Chairman
Burks Investments, Inc.
Elizabeth Merrick Coe
President
The Merrick Foundation
Gary M. Cook
Chairman
Trend Construction Corporation
J. C. Craven*
Investments
Richard C. Haugland
Vice President
Citizens National Bank, Muskogee
Ken L. Kenworthy
Vice President, Director
Secretary-Treasurer
CMJ Corporation
C. F. "Tag" Kimberling
Real Estate
Marvin K. Margo, M.D.
McBride Clinic, Inc.
H. Mead Norton*
President
Norton Investment Co.
James G. Randolph
President
Kerr-McGee Coal Corporation
Jerry Richardson
President
Dub Richardson Ford, Inc.
W. A. "Dub" Ross
President
Dub Ross Company
Gene Smelser
President
Yat Gene's Food Service, Inc.
Bill Stubbs
Real Estate
Carl W. Swan
Independent Oil Producer

*Advisory Director

Statement of Condition

At the Close of Business March 31, 1982 and March 31, 1981

	1982	1981
ASSETS		
Cash and due from banks	\$ 38,728,000	\$ 30,794,000
U. S. Treasury securities	14,024,000	13,041,000
State and municipal securities	32,903,000	34,057,000
Stock in Federal Reserve	600,000	345,000
Loans, net of reserve	323,475,000	218,943,000
Bank premises and equipment	4,091,000	3,073,000
Other assets	22,672,000	11,329,000
Total assets	\$436,491,000	\$311,582,000
LIABILITIES		
Demand Deposits	\$127,281,000	\$ 92,202,000
Time and savings deposits	262,757,000	187,272,000
Total deposits	390,038,000	279,474,000
Federal funds purchased	9,650,000	6,200,000
Other liabilities	3,752,000	4,639,000
Total liabilities	403,440,000	290,313,000
STOCKHOLDER'S EQUITY		
Capital stock	10,000,000	1,000,000
Surplus	10,000,000	10,500,000
Retained earnings	13,051,000	9,769,000
Total stockholder's equity	33,051,000	21,269,000
Total liabilities and stockholder's equity	\$436,491,000	\$311,582,000



Dun & Bradstreet

DBD a company of
The Dun & Bradstreet Corporation

NN SQUARE BANK NA
 19 PEHN SQUARE
 LAHONIA CITY OK 73118 J HOFFMAN
 RST PENN CORPORATION

PREPARED FOR
 SUB: 000-00000

DATE 07/27/82
 NET INTEREST INCOME:
 18,826,000
 EQUITY: 31,597,000
 IND. ASSETS:
 100 MIL. - 1 BILL.
 FISCAL

NS 00-486-8659
 C 6020

FISCAL
 STATEMENT FIGURES ARE IN THOUSANDS
 DEC. 31, 1981 (1601 ESTAB.)

		% CH.	%	IND. %
ARTED 1960				
PLOYS 246				
SH & EQUIVALENT.....	87,465	46.7	18.1	11.8
CURITIES.....	48,056	12.7	9.9	26.5
DERAL FUNDS SOLD.....	53,000	231.3	10.9	5.6
T LOANS.....	270,944	37.6	55.9	51.5
XED ASSETS.....	3,803	55.5	0.8	2.1
HER ASSETS.....	21,221	159.9	4.4	2.5
TAL ASSETS.....	484,489	48.7	100.0	100.0
HAND DEPOSITS.....	234,689	64.5	48.4	22.8
HE & SAVINGS DEP.....	213,085	39.7	44.0	61.4
REIGN DEPOSITS.....	-	-	-	0.1
D FUNDS PURCHASED.....	900	38.5	0.2	5.6
AB-BORROWED MONEY....	-	-	-	0.5
HER LIABILITIES.....	4,218	9.0	0.9	1.9
BORD NOTES & DEBENT.	-	-	-	0.4
UITY CAPITAL.....	31,597	56.7	6.5	7.3
TAL LIAB & EQUITY...	484,489	48.7	100.0	100.0
TAL EARNING ASSETS...	376,925			
LOAN SCHEDULE				
AL ESTATE LOANS.....	50,805	72.6	18.8	39.2
MIERCIAL LOANS.....	185,116	27.0	68.3	37.0
NSUMER LOANS.....	20,628	54.2	7.6	26.4
HER LOANS.....	20,658	74.6	7.6	1.8
EARNED INCOME (-)	2,122	44.6	0.8	3.3
LOW FOR POSS LOSS(-)	4,141	106.5	1.5	1.1
T LOANS.....	270,944	37.6	100.0	100.0

FISCAL
 STATEMENT FIGURES ARE IN THOUSANDS
 DEC. 31, 1980 (1418 ESTAB.)

		% CH.	%	IND. %
	59,626	130.9	18.3	11.3
	42,627	85.5	13.1	26.9
	16,000	999.9	4.9	5.4
	196,925	86.1	60.4	52.3
	2,445	27.6	0.8	2.0
	8,166	184.9	2.5	2.1
	325,789	103.0	100.0	100.0
	142,682	80.0	43.8	27.6
	158,164	126.0	48.5	57.7
	-	-	-	0.1
	650	62.5	0.2	4.6
	-	-	-	0.8
	3,871	104.6	1.2	1.5
	-	-	-	0.4
	20,422	128.5	6.3	7.3
	325,789	103.0	100.0	100.0
	255,562			
	29,433	111.5	14.9	39.3
	145,755	99.0	74.0	35.2
	13,375	(22.4)	6.8	28.2
	11,834	388.4	6.0	1.8
	1,467	(22.8)	0.7	3.4
	2,005	100.1	1.0	1.1
	196,925	86.1	100.0	100.0

FISCAL
 STATEMENT FIGURES ARE IN THOUSANDS
 DEC. 31, 1979 (1258 ESTAB.)

		%	IND. %
	25,818	16.1	11.3
	22,983	14.3	25.5
	1,100	0.7	4.7
	105,793	65.9	54.7
	1,916	1.2	2.0
	2,866	1.8	1.8
	160,476	100.0	100.0
	79,270	49.4	29.6
	69,978	43.6	56.0
	-	-	0.2
	400	0.2	4.1
	-	-	0.9
	1,892	1.2	1.7
	-	-	0.4
	8,936	5.6	7.1
	160,476	100.0	100.0
	129,876		
	13,917	13.2	39.3
	75,123	71.0	33.4
	17,232	16.3	30.3
	2,423	2.3	1.7
	1,900	1.8	3.6
	1,002	0.9	1.1
	105,793	100.0	100.0

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Dun & Bradstreet

a company of
The Dun & Bradstreet Corporation

DATE 07/27/82

N SQUARE BANK NA
9 PENN SQUARE
AHOHA CITY OK

STATEMENT FIGURES ARE IN THOUSANDS
73118 DEC. 31, 1981 (1601 ESTAB.)

		STATEMENT FIGURES ARE IN THOUSANDS		
		% CH.	%	IND. %
AL OPERATING INCOME	56,952	107.5	100.0	100.0
INTEREST INCOME**	18,826	33.0	33.1	39.1
IV FOR LOSSES (-)...	6,343	350.5	11.1	2.1
INTEREST INCOME...	7,443	728.8	13.1	6.2
INTEREST EXP (-)...	10,702	100.4	10.8	26.9
ES (-).....	2,295	(15.7)	4.0	1.5
OME BEFORE SEC G/L.	4,725	10.3	8.3	8.3
INCOME.....	4,725	10.3	8.3	7.8
DIVIDENDS.....	1,050	250.0	1.8	3.2
CHARGE-OFFS.....	(4,206)			
TAX. EQUIV. ADJ....	2,204			

STATEMENT FIGURES ARE IN THOUSANDS
DEC. 31, 1980 (1418 ESTAB.)

		STATEMENT FIGURES ARE IN THOUSANDS		
		% CH.	%	IND. %
	27,449	116.3	100.0	100.0
	14,151	96.6	51.6	45.4
	1,408	128.9	5.1	2.4
	898	98.7	3.3	6.9
	5,341	75.6	19.5	30.6
	2,721	155.7	9.9	2.2
	4,285	110.2	15.6	9.9
	4,285	111.1	15.6	9.7
	300	7.1	1.1	3.5

STATEMENT FIGURES ARE IN THOUSANDS
DEC. 31, 1979 (1258 ESTAB.)

		STATEMENT FIGURES ARE IN THOUSANDS	
		%	IND. %
	12,689	100.0	100.0
	7,199	56.7	49.6
	615	4.8	2.5
	452	3.6	7.2
	3,041	24.0	32.9
	1,064	8.4	2.7
	2,039	16.1	11.1
	2,030	16.0	10.9
	280	2.2	3.8

		STATEMENT FIGURES ARE IN THOUSANDS			
		% CH.	UQ	MED	LQ
IOS					
SOLVENCY					
ILITY TO ASSETS.....	6.5	3.2	8.1	7.1	6.2
ILITY TO LOANS.....	11.7	12.5	16.8	13.6	11.4
NS TO DEPOSITS.....	60.5	(7.6)	54.9	61.7	68.5
NS TO ASSETS.....	55.9	(7.5)	45.6	52.3	58.2
EARNINGS QUALITY					
INTEREST MARGIN...	5.0	(9.1)	5.9	5.1	4.3
INCOME.....	2.0	600.0	1.0	0.7	0.5
REHEAD.....	2.8	33.3	2.8	3.4	4.2
PERATING EFFICIENCY..	40.7	14.6	51.5	59.8	67.7
LOAN QUALITY					
CHARGE-OFFS/LOANS..	1.6	708.0	0.2	0.3	0.5
IV FOR LOSS/LOANS...	2.3	228.6	0.2	0.4	0.6
OW FOR LOSS/LOANS..	1.5	50.0	1.2	1.0	0.9
PROFITABILITY					
URN ON ASSETS.....	1.0	(23.1)	1.2	0.9	0.7
URN ON EQUITY.....	15.0	(28.6)	16.5	13.1	9.8
DIVIDEND YIELD.....	22.2	217.1	24.7	37.0	51.9

		STATEMENT FIGURES ARE IN THOUSANDS			
		% CH.	UQ	MED	LQ
	6.3	12.5	8.0	7.0	6.2
	10.4	23.8	16.2	13.3	11.3
	65.5	(7.6)	55.7	62.2	67.9
	60.4	(8.3)	47.2	53.1	58.6
	5.5	0.0	5.8	5.0	4.4
	0.4	33.3	1.0	0.7	0.5
	2.1	(6.7)	2.7	3.3	4.1
	35.5	(10.6)	51.5	58.5	65.4
	0.2	0.0	0.2	0.3	0.5
	0.7	16.7	0.2	0.4	0.6
	1.0	11.1	1.2	1.0	0.8
	1.3	0.0	1.2	1.0	0.7
	21.0	(7.9)	16.3	13.4	10.9
	7.0	(68.9)	23.3	34.0	45.4

		STATEMENT FIGURES ARE IN THOUSANDS		
		UQ	MED	LQ
	5.6	8.0	6.9	6.0
	8.4	15.1	12.5	10.5
	70.9	58.1	64.9	70.5
	65.9	49.7	56.0	61.0
	5.5	5.6	4.9	4.4
	0.3	0.9	0.6	0.4
	2.3	2.7	3.2	3.9
	39.7	51.4	58.0	64.1
	0.2	0.1	0.2	0.4
	0.6	0.2	0.3	0.5
	0.9	1.2	1.0	0.8
	1.3	1.2	1.0	0.8
	22.8	16.0	13.7	11.5
	13.7	23.9	33.2	43.4

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Mr. SAYRES. Since July, we have tried to reconstruct what happened and why. And we have tried to determine how to avoid the recurrence. Personally, I cannot help but feel that the Federal agencies were remiss in allowing Penn Square to perform business as usual.

We now understand that the Office of the Comptroller of the Currency warned Penn Square as early as 1980 that the bank lacked sufficient capital and liquidity, had loan problems, and had violated banking laws. And in June 1981 the Federal examiners apparently uncovered \$40 to \$50 million in loan losses—enough to wipe out the bank's capital and render it insolvent. Why was this allowed to continue?

I believe that banks should be required to include a schedule of delinquency as part of their financial statement. When a bank is diagnosed as a troubled institution, it should be required to generate more frequent reports to the appropriate agencies and it should not be permitted to accept deposits in excess of the insured limits.

Since Penn Square, we have supplemented our previous information sources such as Merrill Lynch and our Corporate Central with the Dun & Bradstreet report. The investment committee has also lowered the ceiling on new certificates of deposit with other financial institutions from \$3 million to \$1 million, with the exception again of Empire Corporate Central.

The committee also recommended, and the board established, a special reserve account as a "reserve for loss contingencies," with 10 percent of investment earnings transferred into it quarterly until it totals 5 percent of our investment portfolio. This is in addendum 7.

While this will reduce our exposure, I am still concerned that even with the knowledge of Penn Square's failure, when I look now at the information available to me then I have to conclude that I would make the same investment. There was nothing conclusive even in the D&B report to point to the collapse. How, then, can we invest with safety and certainty?

If I apply more rigid standards to current ratings, even our largest banks don't look secure. Even a credit union as large and sophisticated as ours cannot perform the intensive studies required to reveal critical weaknesses in these institutions. I have to conclude therefore that the kind of information available to the regulatory agencies and Comptroller of the Currency must be made available to potential investors in some form to help us assess a bank's strength and help us make a more informed investment decision. It is not only the stability of my credit union that concerns me, but the stability of the entire economic fabric of this country.

Thank you, Mr. Chairman.

[Mr. Sayres' prepared statement on behalf of the IBM Poughkeepsie Employees Federal Credit Union, and the referred-to addenda and other pertinent material follow:]

Testimony
of
William J. Sayres

Thank you, Mr. Chairman.

My name is Joe Sayres, and I am General Manager of the IBM Poughkeepsie Employees Federal Credit Union in Poughkeepsie, New York, a post I've held since 1971. I joined the credit union as Office Manager in 1968 following ten years with Beneficial Finance.

I also serve as an Assistant Treasurer of the credit union and am a member of the Investment Committee.

The credit unions represented here today differ in size and services, so I'd like to give you a thumbnail sketch of our organization to help you put us in perspective.

IBM Poughkeepsie Employees Federal Credit Union was chartered in 1963 to serve employees and retirees of IBM Corporation in Dutchess County NY, and the members of their families. Approximately 80% of our membership is concentrated in Dutchess and the four surrounding counties.

Currently we have over 100,000 member accounts and assets in excess of \$200 million.

We are a full-service credit union, offering regular share accounts, share drafts, trust and custodial accounts, five different types of certificates, Individual Retirement Accounts, ATM service and supermarket banking centers, and a wide range of loans, including secured and unsecured consumer loans, first and second mortgages, five different education loans, and VISA. We also offer a range of supplementary services such as money orders, travelers checks, consumer literature and free educational seminars.

While our services are extensive, our primary purpose, as I see it in the historical perspective of the credit union movement, is to lend our deposits back to our members in the form of loans for "provident and productive purposes." Since any funds that remain idle do not benefit the membership, deposits in excess of loan demand are invested to produce additional income.

The credit union's Board of Directors has delegated investment decisions to an Investment Committee comprised of the Treasurer and Assistant Treasurer (both directors) and the General Manager, who also serves as an Assistant Treasurer. The Investment Committee adheres to guidelines set forth by the Board of Directors and the National Credit Union Administration.

The guidelines in effect at the time of our Penn Square investment are attached as Addendum 1.

The Investment Committee has further delegated certain responsibilities to the General Manager for action on a daily basis or as required. These include the movement of monies in and out of day-of-deposit to day-of-withdrawal accounts, and the investment or renewal of certificates-of-deposit to a maximum aggregate of \$3 million at any one institution with the exception of Empire Corporate Central Federal Credit Union. To justify this exception, the investment policies of Empire Corporate Central and the purpose of the U.S. Central are included as Addendum 2.

In evaluating any prospective investment, it is our practice to request the institution's most recent annual report and financial statement, review various ratios, and look at any

increase or decrease in net worth, net income, deposits, assets and reserve position.

Just prior to our involvement with Penn Square Bank, in the latter part of 1981, we were scaling down our investments in Savings-and-Loan Associations because of their widely publicized instability, and we were attempting to diversify our investment portfolio.

We were, at this time, aware of the investment consulting firm of Professional Asset Management Inc. (PAM) and acquainted with its Vice President, William Goldsmith, through his articles in the trade press, his authorship of the Investment Manual for Credit Unions which was published by the Credit Union Executives Society, and his attendance at and participation in numerous conferences, including those of LICU--the League of IBM Credit Unions. We were also aware that other credit unions, some of them within LICU, were using his services.

In mid-1981 we had begun to receive from Professional Asset Management complimentary copies of the Capital Adequacy Reports which they published four times a year, as well as market updates in the form of a newsletter to "clients and friends." It was PAM's policy, as indicated to us, to emphasize safety first; institutions which did not meet their requirements were not even included in the Capital Adequacy Reports. Those that did were monitored, and their financial reports were analyzed on a quarterly basis with the resultant data, including key operating ratios, included in the reports to clients and friends. This in-depth analysis assisted us greatly.

Addendum 3 contains representative mailings from PAM.

Indications were that Professional Asset Management monitored all trend areas carefully, following a five-year trend analysis on key operating figures such as assets, deposits, loans, net worth, and profits of the institution. We also understood that personal visits were made to these institutions, and since we could not make such visits ourselves, this factor was instrumental in our decision to use PAM as an investment advisor.

In issuing their Capital Adequacy Reports and market updates, PAM stated that they had a commitment to offer certificates-of-deposit from solid performers with capital adequacy far above minimum regulatory requirements. One update, which we received in mid-1981, advised of two additions to PAM's list of approved institutions, one of which was Penn Square Bank. That mailing included a report indicating that Penn Square had increases from 5/31/80 to 5/31/81 of 89% in assets, 68% in earnings, 88% in deposits, and 148% in capital, with a net income increase of 65%. A copy of that mailing is included as Addendum 4, and it states that "Penn Square Bank, a national bank, has experienced outstanding growth in the past year with strong indications that this growth will continue.

"Located in Oklahoma City, Penn Square has become the leading bank in the Southwest servicing the oil and gas industry. Its total loan portfolio exceeds \$700 million, usually short term and all indexed to prime. Penn Square acts as a lead bank in joint loan ventures because its prime is normally 50 or more basis points higher than money center rates. As a result banks like Continental Illinois will earn more participating with Penn Square than by going it alone.

"We are pleased to add these two fine institutions to our list of well capitalized banks and savings associations."

When Bill Goldsmith of Professional Asset Management contacted us in the Fall of 1981, we had been experiencing an inflow of deposits, and sluggish loan activity, along with the previously mentioned reductions in Savings-and-Loan investments, so we were seeking alternative investment opportunities. Based on his recommendations and information provided by PAM, including the indicators appearing on the Capital Adequacy Report, we made our first investment in Penn Square Bank on December 4, 1981. The deposit was in the amount of \$500,000 for 60 days at a rate of 13%.

At the time of this investment, we had \$39 million in our investment portfolio, the balance of it distributed as follows: \$14.5 million (38%) in Savings-and-Loans, \$3 million (8%) in other commercial banks, \$9 million (23%) in Empire Corporate Central FCU.

Addendum 5 charts our deposit history with Penn Square Bank and provides this dollar and percentage breakdown from our first investment on December 4, 1981 to our last on June 18, 1982.

In selecting an investment, we generally obtain a minimum of five bids and then perform an institution comparison based on financial statements and annual reports. The Investment Committee guidelines require investment at the highest rate provided all other criteria have been met; when the highest rate is not selected, an explanation is required.

In the case of our December 4, 1981 deposit with Penn Square, we had obtained seven quotes. The 13% quote from Penn Square considerably exceeded local institutions but was lower than that from Southern California Savings, which quoted 13.75%. We took Penn Square over Southern California because we did not have sufficient financial data on the latter on which to base a decision; that is, we had no annual report or financial statements, nor was Southern California Savings included in PAM's Capital Adequacy Report.

During the course of the next six months we increased our total deposits in Penn Square Bank from the initial \$500,000 to an aggregate of \$3 million, with the final investment in the amount of \$500,000 made on June 18, 1982 for 180 days at 15-1/8%. Addendum 6 represents copies of the bid sheets for every investment made at Penn Square Bank, reflecting the comparative rates at all institutions contacted on the date of investment.

During the period of December 4, 1981 through July 5, 1982, the date on which Penn Square was closed, we had continued to supplement our own information with that provided to us by Professional Asset Management. There were no indications that the bank's financial position had changed as late as June 10, 1982, when it showed a reserve position of 8.8% and a net worth to average deposit ratio of 9.95%.

We, along with many other investors, were completely shocked at the news of the bank's failure on July 5 of this year, since all indicators of which we were aware showed it to be a strong financial institution.

At that time and in the intervening months we've asked the same questions that prompted you to hold these hearings: "What happened and why? How can a recurrence be avoided?"

Personally, I can't help but feel that the federal agencies were remiss in allowing this bank to perform business-as-usual when other indicators available to them showed that it was in trouble. We now understand that the Office of the Controller of the Currency warned Penn Square as early as 1980 that the bank lacked sufficient capital and liquidity, had loan problems, and had violated banking laws. And in June 1981 the federal examiners uncovered \$40 to \$50 million in loan losses--enough to wipe out the bank's capital and render it insolvent. Why was Penn Square permitted to continue perpetuating its problems with funds attracted from institutions like IBM Poughkeepsie Employees Federal Credit Union?

I believe the system that allowed this to happen needs some improvements. Banks should be required, for instance, to include a schedule of delinquency as part of their financial statement, and when a bank has been diagnosed as a troubled institution, it should not be permitted to receive deposits in excess of the insured limits; there should also be more frequent reports generated to the appropriate agencies, and if an investor goes beyond the insured limits data should be provided with sufficient indicators to reveal that the bank has problems.

Since Penn Square's failure, we have supplemented our previous information sources such as Merrill, Lynch and our Corporate Central with the Dun & Bradstreet Report to provide additional

data on which to base investment decisions. Also, our Investment Committee has lowered the investment ceiling on new certificates-of-deposit with other financial institutions from \$3 million to \$1 million, with the exception again of Empire Corporate Central. The committee also recommended, and the Board established, a special reserve account as a "Reserve for Loss Contingencies," with 10% of investment earnings transferred into it quarterly until the account total represents 5% of our total investment portfolio.

Addendum 7 documents these changes.

A primary concern of mine is that, even with the knowledge of Penn Square's failure, when I review now the information that was available to me then, I have to conclude that there was nothing definitive to point to the coming collapse. Even the Dun & Bradstreet Report on Penn Square, which I obtained following the bank's failure, presented no conclusive evidence.

Mr. Chairman, I have with me copies of Penn Square's annual report and financial statements, and the Dun & Bradstreet Report on Penn Square, and with your permission I'd like to request that they be inserted in the hearing record at this time.

Given these circumstances, how are we to analyze with any degree of certainty the safety of our investments in other financial institutions? Everything I now read casts doubt on the stability of even the largest banks. As recently as September 20, the Credit Union Information Service Newsletter reported that a study of debt and other ratios conducted by T. J. Holt & Co., an investment advisor, revealed that "all

15 of America's biggest banks rank among the country's 100 weakest."

Even a credit union as large and sophisticated as ours cannot perform the in-depth studies on every potential investment as would have been required to detect Penn Square's weakness. I have to conclude, therefore, that the kind of information that was available to the regulatory agencies and the Controller of the Currency must be made available to potential investors in some form, to help us assess a bank's strength and make an informed investment decision.

It is not only the stability of my credit union that concerns me, but the stability of the entire economic fabric of this country.

Thank you for the opportunity to address you today.



Addendum No. 1

AGENDA ITEM

☐ IBM POUGHKEEPSIE EMPLOYEES FEDERAL CREDIT UNION SOUTH ROAD / P.O. BOX 1750 / POUGHKEEPSIE / NEW YORK 12601

July 10, 1980

TO: Board of Directors
 RE: Recommendations: Credit Union Investment Policy/Guidelines
 FR: Sherman L. Prosser, Treasurer

At our July 10th meeting, the Committee reviewed the current Investment Committee Guidelines dated August 4, 1977 and CUMS Ins. Society's request for Credit Union Investment Guidelines on certain investments. The purpose of the guidelines is to encourage the Credit Union Board of Directors to avoid investment practices which are risky, speculative, unsafe and unsound.

In reviewing the current Investment Committee Guidelines, the Committee felt that further Policy/Philosophy should be acted on by the Board. Therefore, regarding Policy/Philosophy, the following is recommended for action at the July 16th Board meeting:

1. FUNCTION:

- a. Provide for adequate liquidity.
- b. Permit the Credit Union optimal use of its residual funds, those not currently being used in the loan portfolio. These funds should produce the maximum level of income consistent with both the highest degree of safety and the satisfaction of the liquidity needs.
- c. Provide a source of pledgeable assets to secure deposits.

2. RESPONSIBILITY:

- a. The Board has delegated control of all investments, other than loans to members, to the Investment Committee.

Telephone (Area Code 914) 463-3987 or 463-3992

2. RESPONSIBILITY: (continued)

- b. The Investment Committee further delegates the following responsibilities to the General Manager:

(1) To move monies in/out of such accounts as listed:

From Checking Accounts into D-D/D-W Accounts

From D-D/D-W Accounts into Checking Accounts

Renew and/or placing into New Certificate of Deposits

Regarding C/D's: A minimum of three (3) bids must be obtained from financial institutions prior to final disposition.

Monies should be placed at the highest available rate, if not, an explanation must be submitted to the Committee.

(2) Accounts such as: Savings Accounts and Day-of-Deposit/Day-of-Withdrawal Accounts. These accounts should be kept at a minimum so that excess monies can be invested.

- c. 'Requests From Other Credit Unions' either for loans or share deposits, shall be brought to the Committee. The Committee shall maintain the concept of helping other credit unions at possibly a lower than prevailing rate.
- d. Government Securities will be considered at the recommendation of the General Manager to the Committee.
- e. The Committee will use all means to audit and confirm that policy is followed as stated.

(The above on 'Responsibility' is a carry-over from the 8/4/77 Investment Comm. Guidelines with minor word changes for updating)

- f. Liquidity position and portfolio changes should be reviewed by the Investment Committee no less than quarterly.

- * g. The Investment Committee shall provide the Board with a written report at the regular Board meetings.

As part of the Investment Policy of this Credit Union the Committee is recommending that the Board adopt the following resolution: (words underscored denotes 'Definitions' that are attached)

1. To establish a "buy and hold" philosophy in which the credit union buys investment securities with the intention of holding them until they mature or until they are needed to provide liquidity.

2. As part of any decision to enter into a cash forward agreement to buy, all of the following conditions must be met:
- a. Settlement period does not exceed 120 days from the trade date.
 - b. Information evidencing the credit union's liability to purchase must appear on the credit union's financial statement
 - c. If the delivery of the security is to be made beyond 30 days from the trade date, then a written cash flow projection evidencing available cash to purchase the security must be made and retained in file.
 - d. The credit union must plan to take delivery of the security and hold it for at least 6 months except under adverse cash flow conditions.
 - e. The security must be an authorized investment for the CU.
3. A Board policy prohibiting cash forward agreements to sell.
 4. A Board policy prohibiting standby commitments.
 5. A Board policy prohibiting adjusted trades.
 6. A Board policy prohibiting short sales.
 7. A Board policy prohibiting futures trading.
 8. A Board policy permitting reverse repurchase transactions with the following restrictions:
 - a. No more than 40% of the funds so obtained may be used to purchase securities.
 - b. The investments/deposits made with funds obtained through a reverse repurchase transaction or securities collateralizing that transaction must have a maturity date not later than the settlement date for the reverse repurchase transaction and in no case greater than ³⁰ days.
 - c. A plan should be in place to insure necessary funds are on hand to effect repurch.
 9. Repurchase transactions are divided into "investment type" and "loan type". Investment type repos are permitted. To qualify as an investment type repurchase transaction, there must be unrestricted transfer of ownership of the security by the vendor to the credit union or its safekeeping agent. There must be written "bailment for hire" contract with the safekeeping agent.

All other repos are considered "loan type" repos and may only be made to members, other credit unions and credit union organizations.

I have also attached for your review Section 703.3 of the Regulations.

Sherman L. Prosser
 Sherman L. Prosser
 Treasurer

DEFINITIONS

1. *Security* means a "direct" investment. It excludes certificates of deposit or deposit with, or loans to another credit union, savings and loan or bank.
2. *Standby commitment* means an agreement to purchase or sell a security at a future date, whereby the buyer is required to accept delivery of the security at the option of the seller.
3. *Cash forward agreement* means an agreement to purchase or sell a security, at a future date, that requires mandatory delivery and acceptance. The contract for the purchase or sale of a security for which delivery of the security is made in excess of thirty (30) days but not exceeding one hundred and twenty (120) days from the trade date shall be considered to be a cash forward agreement.
4. *Repurchase transaction* means a transaction in which a credit union agrees to purchase a security from a vendor and to resell a security to that vendor at a later date. A repurchase transaction may be of two types:
 - a. "*Investment-type repurchase transaction*" means a repurchase transaction where:
 - 1) The credit union purchasing the security takes physical possession of the security, or receives written confirmation of the purchase and a custodial or safekeeping receipt from a third party bank or other financial institution under a written bailment for hire contract identifying a specific security in its possession as owned by the credit union;
 - 2) There is no restriction on the transfer of the security purchased by the credit union; and
 - 3) The credit union is not required to deliver the identical security to the vendor upon resale.
 - b. "*Loan-type repurchase transaction*" means any repurchase transaction that does not qualify as an investment-type repurchase transaction. A loan-type repurchase transaction represents a lending transaction.
5. *Reverse repurchase transaction* means a transaction whereby a credit union agrees to sell a security to a purchaser and to repurchase the same security from that purchaser at a future date, irrespective of the amount of consideration paid by the credit union or the purchaser. A reverse repurchase transaction represents a borrowing transaction.
6. *Futures* means a standardized contract for the future delivery of commodities, including certain government securities, sold on designated commodities exchanges.
7. *Trade date* means the date a credit union originally agreed, whether verbally or in writing, to enter into the purchase or sale of a security with a vendor.
8. *Settlement period* means the date(s) originally agreed to by a credit union and a vendor for settlement of the purchase or sale of a security, without any modification or extension of that/those date(s).
9. *Maturity* means the date on which a security matures, and shall not mean the call date or the average life of the security.
10. *Adjusted trading* means any method or transaction used to defer a loss whereby a credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from that vendor another security above its current market price.
11. *Bailment for hire contract* means a contract whereby a third party bank or other financial institution for a fee agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.
12. *Short sale* means the sale of a security not owned by the seller.

CREDIT UNION INVESTMENT GUIDELINES

The Board of Directors of _____ Credit Union agree to adopt the following guidelines as a part of the *Investment Policy* of the credit union.

1. To pursue either (a) or (b):
 - a. To establish a "buy and hold" philosophy in which the credit union buys investment securities with the intention of holding them until they mature or until they are needed to provide liquidity.
 - b. To buy each security with the intention of holding it at least six months except for maturities, equities and unusual circumstances related to liquidity. In connection with this option, a turnover of less than 25% each year in investment securities (maturing in excess of one year) would be appropriate.
2. As part of any decision to enter into a cash forward agreement to buy, all of the following conditions must be met:
 - a. Settlement period does not exceed 120 days from the trade date.
 - b. Information evidencing the credit union's liability to purchase must appear on the credit union's financial statement.
 - c. If the delivery of the security is to be made beyond 30 days from the trade date, then a written cash flow projection evidencing available cash to purchase the security must be made and retained in file.
 - d. The credit union must plan to take delivery of the security and hold it for at least six months except under adverse cash flow conditions.
 - e. The security must be an authorized investment for the credit union.
3. A Board policy prohibiting *cash forward agreements to sell*.
4. A Board policy prohibiting *standby commitments*.
5. A Board policy prohibiting *adjusted trades*.
6. A Board policy prohibiting *short sales*.
7. A Board policy prohibiting *futures trading*.
8. A Board policy permitting *reverse repurchase transactions* with the following restrictions:
 - a. No more than 40 percent of the funds so obtained may be used to purchase securities.
 - b. The investments or deposits made with funds obtained through a reverse repurchase transaction or securities collateralizing that transaction must have a maturity date not later than the settlement date for the reverse repurchase transaction and in no case greater than 180 days.
9. Repurchase transactions are divided into "investment type" and "loan type." Investment type repos are permitted. To qualify as an investment type repurchase transaction, there must be unrestricted transfer of ownership of the security by the vendor to the credit union or its safekeeping agent. There must be written "bailment for hire" contract with the safekeeping agent.

All other repos are considered "loan type" repos and may only be made to members, other credit unions and credit union organizations.

Date

Pres., Board of Directors Chairperson

Walter J. Morgan
6010
Manager

§703.1 Certificates of Deposit.

(a) A Federal credit union may invest in or make a deposit evidenced by a time certificate of deposit issued by any of those institutions enumerated in section 107(7)(D) and 107(8) of the Federal Credit Union Act: Provided,

(1) That such Federal credit union itself makes the investment or deposit for which the certificate is issued; and

(2) That no consideration is received from a third party in connection with the making of the investment or deposit.

(b) A Federal credit union may contract with the issuing institution for payment of the whole or a portion of a certificate of deposit before maturity.

(c) Certificates of deposit issued by those state chartered financial institutions enumerated in §107(8) of the Federal Credit Union Act may be obtained by a Federal credit union provided such institutions are operating in accordance with the laws of a state in which the Federal credit union maintains a facility. For the purposes of the paragraph, the word "facility" means the home office of a Federal credit union or any suboffice thereof, including but not necessarily limited to a wire service, telephonic station or mechanical teller station.

(d) Negotiable certificates of deposit purchased under this authority may be sold by a Federal credit union to a third party before maturity subject to the appropriate regulations governing the issuing institution involved.

(e) The purchase of a certificate of deposit that does not meet the above provisions is not authorized for Federal credit unions.

§703.2 Investment in loans to nonmember credit unions.

(a) A Federal credit union may invest in loans to other nonmember credit unions including loans extended under a line of credit agreement, provided:

(1) The aggregate amount of all loans and credit limits established to nonmember credit unions does not exceed 25 per centum of the investing Federal credit union's paid-in and unimpaired capital and surplus;

Part 703**Investments and Deposits**

(2) The maximum amount of a line of credit shall be stated in the line of credit agreement between the investing and borrowing credit unions;

(3) The terms and maturities of outstanding loans and the schedule of payments of principal balances outstanding under a line of credit do not exceed one year; and

(4) The investment is approved by the board of directors, or its authorized executive or investment committee.

(b) Prior to making a loan or extending a line of credit, and annually in the case of an established line of credit, the investing Federal credit union shall obtain and retain on file the following documents from the borrowing credit union:

(1) A current financial and statistical report;

(2) A certified copy of the resolution of the board of directors or executive committee authorizing such borrowing; and

(3) A written statement from the secretary of the borrowing credit union that the persons negotiating the loan or line of credit and executing the note or agreement are officers of the credit union and are authorized to act on its behalf and that the amount of loan or line of credit does not exceed the maximum borrowing authority of the borrowing credit union.

§703.3 Investment Activities.

(a) Definitions.

(1) "Security" means any investment or deposit authorized for a Federal credit union pursuant to sections 107(7) and 107(8) of the Act. For the purpose of this section, the definition of

a security shall not mean loans to members or loans authorized under sections 701.21-6 and 701.21-8 of the rules and regulations.

(2) "Standby commitment" means an agreement to purchase or sell a security at a future date, whereby the buyer is required to accept delivery of the security at the option of the seller.

(3) "Cash forward agreement" means an agreement to purchase or sell a security, at a future date, that requires mandatory delivery and acceptance. The contract for the purchase or sale of a security for which delivery of the security is made in excess of thirty (30) days but not exceeding one hundred and twenty (120) days from the trade date shall be considered to be a cash forward agreement.

(4) "Repurchase transaction" means a transaction in which a Federal credit union agrees to purchase a security from a vendor and to resell a security to that vendor at a later date. A repurchase transaction may be of two types:

(i) "Investment-type repurchase transaction" means a repurchase transaction where:

(A) The Federal credit union purchasing the security takes physical possession of the security, or receives written confirmation of the purchase and a custodial or safekeeping receipt from a third party bank or other financial institution under a written bailment for hire contract identifying a specific security in its possession as owned by the Federal credit union;

(B) There is no restriction on the transfer of the security purchased by the Federal credit union; and

(C) The Federal credit union is not required to deliver the identical security to the vendor upon resale.

(ii) "Loan-type repurchase transaction" means any repurchase transaction that does not qualify as an investment-type repurchase transaction. A loan-type repurchase transaction represents a lending transaction and is subject to the limitations of section 107(5) of the Act.

(5) "Reverse repurchase transaction" means a transaction whereby a Federal credit union agrees to sell a security to a purchaser and to repurchase the same security from that purchaser at a future date, irrespective of the amount of consideration paid by the Federal credit union or the purchaser. A reverse repurchase transaction represents a borrowing transaction and is subject to the limitations of section 107(9) of the Act.

(6) "Futures contract" means a standardized contract for the future delivery of commodities, including certain government securities, sold on designated commodities exchanges.

(7) "Trade date" means the date a Federal credit union originally agreed, whether verbally or in writing, to enter into the purchase or sale of a security with a vendor.

(8) "Settlement date" means the date originally agreed to by a Federal credit union and a vendor for settlement of the purchase or sale of a security, without any modification or extension of that date.

(9) "Maturity date" means the date on which a security matures, and shall not mean the call date or the average life of the security.

(10) "Adjusted trading" means any method or transaction used to defer a loss whereby a Federal credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from that vendor another security above its current market price.

(11) "Bailment for hire contract" means a contract whereby a third party bank or other financial institution for a fee agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

(12) "Short sale" means the sale of a security not owned by the seller.

(13) "Market price" means the last established price at which a security is sold.

(b) Limitations.

(1) A Federal credit union may contract for the purchase or sale of a security authorized by section 107(7) of the Act, provided that the delivery of the security is to be made within thirty (30) days from the trade date.

(2) A Federal credit union may not enter into a standby commitment to purchase or sell a security.

(3) A Federal credit union may enter into a cash forward agreement to purchase a security provided that the period from the trade date to the settlement date does not exceed one hundred and twenty (120) days and the credit union has written cash flow projections evidencing its ability to purchase the underlying security. A Federal credit union may not enter into a cash forward agreement to sell a security unless it presently owns the security. All cash forward agreements must be settled on a cash basis at the settlement date.

(4) A Federal credit union may not enter into an investment-type repurchase transaction unless all the conditions cited in subsection 703.3(a)(4)(i) are met. Any repurchase transaction that does not meet such requirements constitutes a loan-type repurchase transaction subject to the limitations of section 703.3(b)(5). The purchase price of a security obtained under an investment-type repurchase transaction must be at the market price.

(5) A Federal credit union may enter into a loan-type repurchase transaction only with its own members, other credit unions, or approved credit union organizations that are defined in section 701.27-2 of the rules and regulations.

(6) A Federal credit union may enter into a reverse repurchase transaction, provided that the funds obtained are not invested under section 107(7)(I) of the Act. Furthermore, either any investment or deposit made under sections 107(7)(B), (D), (E), (F), (G), (H) or 107(8) of the Act

or any security collateralizing the reverse repurchase transaction must have a maturity date not later than the settlement date for the reverse repurchase transaction. The maximum amount of funds that may be borrowed under a reverse repurchase transaction for investment or deposit is 10 percent of paid-in and unimpaired capital and surplus.

(7) A Federal credit union may not buy or sell a futures contract unless the purchase or sale is specifically authorized by a regulation issued by the Administration.

(8) A Federal credit union may not engage in adjusted trading as defined in section 703.3(a)(10).

(9) A Federal credit union may not engage in a short sale as defined in section 703.3(a)(12).

(10) All purchases and sales of securities by a Federal credit union by means of a cash transaction under section 703.3(b)(1) or a cash forward agreement under section 703.3(b)(3) must be at the market price.



EMPIRE CORPORATE CENTRAL FEDERAL CREDIT UNION

1211 WESTERN AVENUE
ALBANY, NEW YORK 12203 (518) 482-8891

August, 1982

Dear Member,

In recent weeks, we have received a number of inquiries concerning the "safety" of funds at Empire Corporate, Empire's investment policies, even U.S. Central's investment policies, all no doubt motivated by the Penn Square Bank failure. The questions raised are those which should be addressed in every investment decision. We are only too happy to respond to them here.

EMPIRE'S INVESTMENT POLICIES

Empire Corporate incorporates two very conservative funds management practices right into its investment policies to assure the safety of your deposits. These are: the "MATCHED BOOK", and a "HIGH INVESTMENT QUALITY EMPHASIS".

The MATCHED BOOK approach to managing funds basically dictates that the maturity structure of Empire's assets is always "matched" (i.e. identical with) the maturity structure of its deposits and certificates. Another way of looking at this is that your maturity decision is preserved in our reinvestment. Matching protects Empire (and your credit union) from the earnings and liquidity risks imbedded in all rate sensitive mismatching strategies.

The QUALITY EMPHASIS insures that all funds invested by Empire-- either directly or through U.S. Central-- are diversified into high quality, well researched institutions-- at the expense of higher yields. Such quality standards afford strong protection to Empire (and your credit union) from the risk of default.

We have enclosed pertinent excerpts from our policies plus a more detailed explanation for your review (this literature was originally sent out in the fall of 1981).

EMPIRE'S INVESTMENT PORTFOLIO

Currently, about 99% of our investable funds are being invested through U.S. Central Credit Union (the hub of the Corporate Network). The other 1% is held in other (quality) banks.

Since we concentrate funds at U.S. Central, some information on their purpose, investment policies, and practices is in order.

U.S. CENTRAL CREDIT UNION

As the hub of the Corporate Network, U.S. Central is the point at which credit union surplus funds are concentrated and invested in the marketplace. U.S. Central has a full time investment staff which does the necessary research and analysis and the investing. The benefits of this approach to you are related to economies of scale: better rates for larger blocks of funds, shared costs of investment analysis, monitoring, etc.

Like Empire, U.S. Central incorporates conservative funds management right into its policies. And like Empire, these policies are available for review.

- U.S. Central makes use of the "Matched Book" approach to funds management to insulate the Network from interest rate risk.
- U.S. Central places a strong emphasis on investment quality. U.S. Central limits its investment possibilities basically to the top 50 domestic banks and top 80 world banks (ranked by deposits). These possibilities are then researched (and analyzed continuously) with particular attention to (i) financial position and results-- the numbers, (ii) use of funds-- investment and loan portfolio quality, and (iii) management quality. As an example, U.S. Central is currently using only 14 of the country's top 20 banks. Several commercial rating agencies are used to obtain this information.
- U.S. Central diversifies its investments extensively by type of institution as well as within type of institution.
- U.S. Central constantly publishes its financial statements and portfolio structure.

In essence, by concentrating funds at Empire, your credit union accesses this high quality, diversified portfolio.

A CONSERVATIVE STANCE

Although we have received criticism in the past by some credit unions who feel that we should assume more risk to get-- and give-- better yields, we feel that safety must remain the top priority in our investment considerations. Credit unions who desire a higher return must book the investments (and take the risk) themselves. U.S. Central has always held a similar attitude. Penn Square's failure affirms the value of this approach.

As a closing note, consider this: U.S. Central's policies and operations are so sound that they resulted in the highest possible commercial paper ratings from both Standard & Poor's and Moody's. Only one other financial institution, Morgan Guaranty Trust Company, currently has as high a rating.

We hope that these comments plus the enclosures have been helpful in reassuring you and your board of the safety of your credit union's funds. If not, please contact us with your questions. We remain confident that we will have the right answers.

Sincerely,

The Board of Directors and Management
Empire Corporate Central F.C.U.



EMPIRE CORPORATE CENTRAL FEDERAL CREDIT UNION

1211 WESTERN AVENUE
ALBANY, NEW YORK 12203 (518) 482-8891

Dear Member:

Recently, the growing number of reports detailing large deposit outflows and substantial operating losses at some financial institutions, as well as two spectacular institutional defaults, have increased credit union concerns over the safety of invested funds. We thought it would be appropriate — and reassuring — to address this issue of safety with respect to your deposits with Empire Corporate.

EMPIRE CORPORATE'S DEPOSIT INSURANCE COVERAGE

Your credit union's aggregate deposits with Empire are insured by NCUA for the first \$100,000. Amounts in excess of \$100,000 are not so insured.

Empire Corporate's insurance coverage is, of course, no different than that of other insured financial institutions in this respect.

SAFETY VERSUS INSURANCE COVERAGE

In spite of (or perhaps because of) all the recent press on troubles in some sections of the industry, **safety** is now equated by some with **insurance coverage**. This is unfortunate because the two are not synonymous. The lack of insurance coverage on deposits exceeding \$100,000 is not an indication that these funds are not "safe". Nor is the presence of coverage on the first \$100,000 an absolute guarantee that such funds are "safe" — **it by "safe" we mean the assurance of timely return of full deposit principal and earnings**. Concern for the **safety** of your funds is always well founded and should be addressed in every investment decision regardless of deposit insurance.

THE SAFETY OF FUNDS AT EMPIRE

Empire Corporate was specifically designed and chartered to provide liquidity management services to the credit unions of New York. These services include deposit/investment options (on the liability-side) and various loans (on the asset side).

In using these services, depositing credit unions implicitly pool their surpluses at Empire Corporate to make funds available to borrowing credit unions of New York. Funds at Empire not used for loans to member credit unions are made available to credit unions in other states via the Corporate Central System, or finally, invested by U.S. Central Credit Union in high quality market instruments.

Obviously, the statewide and nationwide pooling of credit union surpluses (for credit union use) would be quickly defeated by \$100,000 aggregate deposit limits if dictated by account insurance coverage.

Equally obvious, however, is the need for strong assurance that the deposits are made completely safe.

The necessary assurance — or "insurance" — is provided by Empire Corporate's management philosophy which is deliberately risk averse ("safety" oriented). This philosophy assumes substance in two major funds management policies: a **quality emphasis** and a **matched book approach**.

The Quality Emphasis:

1) In investing credit union deposits, Empire Corporate adheres to the **SLY Principle**. SLY refers to a particular ordering of the three major investment characteristics:

1st priority: Safety
2nd priority: Liquidity
3rd priority: Yield

The high priority placed upon investment safety by Empire Corporate is emphasized in Empire's policies, which greatly restrict the legal investment options to a much more select group of allowable investment options, and which require **credit analysis** and **suitable diversification** (either at Empire or through U.S. Central). That priority is illustrated by the fact that Empire Corporate currently has no investments — either directly or through US Central — in savings and loans or savings banks. The SLY approach is well recognized as a very conservative approach to placing funds.

2) In lending to other credit unions, Empire Corporate relies upon **strict credit standards** and **constant monitoring** to reduce the risk exposure of the funds so placed. As a last resort, Empire is protected by credit priority.

The Matched Book Approach:

Whether lending or investing, Empire Corporate matches the maturity/yield of the use of funds (loans/investments) to maturity/cost of the source of funds (deposit), locking in a small, positive spread. This protects depositors from adverse moves in interest rates by assuring both principal return and dividend coverage at deposit maturity. More specifically:

- The depositor is assured that at maturity, he will be able to receive deposit principal because of a simultaneous investment maturity.
- The depositor is assured that at maturity, full earnings will be available since those earnings are locked-in at the time of funds commitment.
- The depositor is further assured that earnings on other accounts (such as the Daily Account) will not suffer for certificate dividends, since the Matched Book broadly insulates Empire Corporate from "interest rate risk".
- The depositor is finally assured that because of the marginal pricing capabilities inherent in the Matched Book approach, the coverage of reserve costs and operating expenses can be maintained on an ongoing basis without overcharging.

The **Matched Book Approach** to managing assets and liabilities is generally considered to be the most risk averse possible. Indeed, asset/liability management strategies which do not match maturities are often labeled "Risk-Books".

These two important policies are employed by Empire Corporate (and by U.S. Central) because of their suitability to a corporate credit union's special (wholesale) function as a liquidity management vehicle for its member credit unions. They form the real "insurance" for your deposits on both sides of the \$100,000 government insurance limit.

THE QUESTIONABLE "SAFETY" OF INSURED DEPOSITS

Deposit insurance provides no guarantee of "safety" for funds covered by the \$100,000 limit (using the definition of "safety" set forth above). In the event of liquidation, **the insurance coverage protects only the insured portion of the deposit principal**. It does not protect earned interest income, nor provide earnings during a protracted claim settlement. Further, it definitely does not protect the credibility of the investor who placed the funds. To rephrase this point, deposit insurance is not an adequate substitute for credit analysis — that is, determining the safety of every investment.

THE "VOTE" FROM EMPIRE'S MEMBERS

A large number of Empire's members consider Empire a safe haven for their surplus funds. The current average balance per credit union is over \$400,000. Further, several credit unions have well over \$10 million each on deposit.

THE "VOTE" FROM NCUA

Empire Corporate received a "Code-One" rating from NCUA in its most recent examination (Dec. 1981). Special mention was made of its financial health and strength. Empire Corporate also received an Unqualified Opinion from Ernst and Whinney in its annual audit.

We hope that the information provided here has sufficiently addressed questions concerning the safety of funds placed at Empire Corporate. If you have any additional questions or comments, please feel free to contact our office.

Sincerely,



Raymond A. Johnson
President
Empire Corporate Central FCU



EMPIRE CORPORATE CENTRAL FEDERAL CREDIT UNION

1211 WESTERN AVENUE
ALBANY, NEW YORK 12203 (518) 482-8891

EXCERPTS FROM EMPIRE CORPORATE CENTRAL'S POLICIES*

V. ASSET - LIABILITY MANAGEMENT

General Statement of Policy

Asset management, or funds usage, should be consistent with liability management or commitments made in acquiring funds. This is particularly true in wholesale funds management (as exists at a corporate central).

The principal tenet underlying the asset-liability policy of this credit union is that the individual member (natural person) is the participant in the "Credit Union Financial System" with the primary authority to dictate the parameters of asset management. For all other tiers of the financial system, asset management policies should preserve the integrity of this financial authority — as vested in the time/rate commitments of credit union liabilities.

VI. LIABILITY MANAGEMENT

A. Sources of Funds — Members

Empire Corporate offers a full array of investment options to its (primary) members to enhance their flexibility in liquidity management, as well as to encourage substantial inflows of (surplus) funds in order to build a strong and stable financial foundation for itself and for the entire system. Member credit unions are encouraged to provide Empire Corporate with the opportunity to bid on all investable funds.

B. Other Sources of Funds

Empire Corporate may borrow funds from any source in aggregate amount not exceeding fifty per centum (50%) of its paid-in and unimpaired capital and surplus. These funds may be borrowed with or without security and under other such terms and conditions prevailing at the time of borrowing as deemed financially prudent by the Board or designated management.

Empire Corporate's credit-worthiness is in large part established by its risk-averse posture in the use of funds. In particular, its credit standing benefits from limited exposure to:

- Market risk (Interest rate risk) through the utilization of the matched portfolio concept.
- Loan default risk through both credit analysis and the rights of creditor priority/pledge of assets by borrowing members.
- Investment default risk through policies designed to assure quality, diversification and prudent investigation.

In addition, it has been Empire's experience that creditors consider loans to Empire Corporate as loans to its members (risk diversification). These factors combine to minimize creditor risk in lending to Empire Corporate.

VII. ASSET MANAGEMENT

A. Loans To Members

Empire Corporate's loan policies are designed to accomplish the equitable distribution of available funds and related costs based on member needs, with consideration of member commitment in assisting Empire Corporate in meeting those needs while minimizing risk. To qualify for any type of loan, a member credit union must:

*Approved January, 1981.

1. Complete all necessary documentation.
2. Provide financial information including but not limited to balance sheets, income/expense statements and statistical reports as established by the Board and/or Credit Committee.

B. Investments

Overview

The investment policies of Empire Corporate Central FCU begin with the fundamental premise that the priority in utilizing the resources entrusted to it is in meeting liquidity requirements of members. Consequently, investments form a secondary or reciprocal use of funds.

The investment policies of Empire Corporate emphasize the concept of matching the maturities of sources and uses of funds, and in so doing, give implicit recognition to the following:

1. As a wholesale financial intermediary, Empire Corporate is subject to, and must insulate itself from a large degree of volatility in its sources of funds. Empire must be able to assure the liquidity of those sources of funds to its members.
2. As a credit union, Empire does not have, nor will it ever have the accumulated reserves required to prudently manage a "risk-book" of business. Empire must avoid the earnings risks inherent in an unmatched source/use structure in order to assure its dividends to members.

Exceptions to the matched investment concept are limited, and may collectively be termed "Portfolio Investments." Portfolio investments are made to cover:

1. Seasonal, short-term maturity extensions of daily sources.
2. Purchase date/maturity date variations for anticipated loan demand and/or share withdrawals.

The investment policies of Empire Corporate further emphasize the important function that a corporate central plays in concentrating credit union surpluses within the Corporate Central System by recognizing U.S. Central as a primary resource for investments, and by always providing U.S. Central first opportunity to bid on all investable funds. The recognition of U.S. Central as a primary resource presumes its adherence to the matched-book concept on an on-going basis.

The investment policies of Empire Corporate finally and most importantly prioritize the safety of principal and interest in all investment decisions.

Maximum Risk Postures

Subject to change, and to be reviewed at least annually by the Board of Directors are the following maximum risk postures to be assumed by Empire Corporate:

Market Risk: With the exceptions noted in "Portfolio Investments" above, Empire Corporate shall not assume market (or interest-rate) risk in an attempt to increase return. Exposure to one form of market risk — changes in the term structure of interest rates — is to be limited by adherence to the "matched book" concept. Exposure to the other form of market risk — changes in the absolute levels of interest rates — is to be limited by the avoidance of attempts to anticipate rate level changes (i.e., "time the market").

Default Risk: Empire Corporate shall not assume significant default risk in an attempt to enhance return. Legal limitations have been established under the Federal Credit Union Act to define an investment universe of acceptable securities in terms of tolerable default risk (section 107-8 of the Federal Credit Union Act). Empire Corporate shall comply with the letter of the federal law regarding acceptable investments. In addition, to further reduce the risk of default, Empire Corporate shall observe the following parameters in its investment activity . . .

To the extent practicable, management shall undertake to obtain and analyze financial statements and other relevant information to ascertain and further reduce default risk.

Return Risk: Empire Corporate shall invest only in term investments of "fixed income" form. That is, those with return characteristics determinable prior to purchase.

Liquidity Risk: Empire Corporate shall not assume significant liquidity risk in order to enhance return.



ANOTHER CAUTION FOR CREDIT UNION INVESTORS
(Reprinted from statement mailing, February, 1982)

In a time of deepening economic distress, it becomes imperative that you affirm the quality of all investment purchases.

We realize that you have heard this message from us many times before-- so much so that it probably has come to sound annoyingly repetitive and self-serving. Our purpose though is not to "cry wolf", but simply to remind you of the tremendous responsibilities that you have assumed in managing your members' money.

How do you assure the quality of your investment purchases? By doing your homework. For each institution you entrust with your credit union's funds, you should know (by your own investigation):

- THE INSTITUTION'S PRESENT FINANCIAL CONDITION.
Capital to asset, debt to equity, liquidity ratios are good indicators. So too are the results of current period operations-- including income, expenses and net income. This type of analysis requires a current, complete financial statement.
- RECENT TRENDS IN THE INSTITUTION'S CONDITION AND PERFORMANCE.
These are as important as current information in determining safety and stability. This requires some historical information.
- USE OF ASSETS.
The institution's use of assets is extremely important-- and typically not to be found on the statements. Is the institution locked into low yielding assets and/or investing in high risk assets with which it has no experience? Find out!
- CREDIT RATING.
What is the credit rating? Has it changed recently?

If you are unable to obtain this information or are uncertain about the indications, don't invest.

To most of you the above caution is nothing new; yet in some cases it is ignored. Why? Here are some ill-conceived reasons...

"The yield is so good." Yield is a function of time and risk. In investing you "don't get something for nothing." Rates which are out-of-line with the market should be a red flag that with the yield premium comes a great deal of risk. (Do you really want to bet your credit union that your opinion is right while the rest of the marketplace is wrong in its risk assessment?)

"I need to diversify." The purpose of diversification is to reduce risk. Rote diversification without regard to the risk of what you're diversifying into or what you're diversifying out of is nothing more than a handy excuse to chase yield.

"The investments are insured." Deposit insurance is structured to reassure the natural person depositor-- who is assumed to be ignorant of the means of risk assessment. It is not meant for money managers (who should know better). Nor is it meant to cover a large number of institution failures should such a thing occur. Even if your principal is insured, your credit union might not be able to withstand the loss of credibility in the event of a default.

The bottom line in calling these reasons "ill-conceived" is that ultimately you bear the risk and responsibility for all of your investment choices. You cannot defer these to a regulator, auditor, or insurance fund. If your members ever lose confidence in their credit union because of your investment practices, excuses such as "But we got an extra 125 basis points...", "We had to diversify...", or "Don't worry, the investments are insured..." will only hasten their flight.

Addendum No. 3



**PROFESSIONAL
ASSET
MANAGEMENT
INC.**

221 15th Street, Del Mar, California 92014 800/854-2160 Continental U.S.
714/755-6661 California, Alaska, Hawaii

THE P.A.M. PLEDGE

We are frequently asked "why should I buy certificates of deposit using P.A.M. for assistance when I can buy them myself by going direct to a savings and loan or bank?"

You can do it yourself, but if you do you will be missing out on a valuable service we offer - paid for not by you but by the savings and loan or bank from which you buy the CD - a service at which our staff works full time. Do you have a staff who can devote full time to reviewing and analyzing information concerning savings and loans and banks from which you buy CDs? And, no matter what the size of your staff, can you persuade the savings and loans and banks from which you purchase CDs to pay for your staff?

Let me explain how our service works and why money brokers have become important to many of the nation's banks and savings and loans.

But first allow me to clear up what I perceive to be a common misconception that only small, obscure banks and savings and loans need and use money brokers.

Today almost all of the nation's largest 100 banks and largest 100 S & Ls, in addition to smaller institutions, use a variety of sources to attract deposits. These sources include financial conglomerates such as Merrill Lynch to specialists like Professional Asset Management.

The need to use non-traditional sources for deposits has grown as the traditional sources of deposits have diminished. Since the late 1970's, as regulation Q was circumvented by money market funds, more than \$200 billion in traditional pass book savings left the nation's banks and S & L's for more favorable money market rates. At the same time, the asset base of the country's banks and S & Ls has grown substantially. As each bank's and S & L's local assets (loans) increased while their local market deposits declined, the need for a broader deposit base grew. In fact, just as a substantial portion of major bank loans are made to foreign borrowers - usually long term - substantial portions of major bank deposits come from foreign lenders - usually short term.

REGISTERED INVESTMENT ADVISOR

Enter Merrill Lynch, Professional Asset Management and other money brokers. There is growing evidence that when Regulation Q is finally phased out completely, banks and S & L's will need to rely even more on money brokers for deposits.

Finally, all banks and S & L's have a cost of attracting deposits whether they do so internally through a branch system or a money desk operation or externally through brokers. Some use all three. When money brokers are used this cost is paid as fees. I would like to add, parenthetically, that some major brokers buy CDs from banks and S & L's for their own inventory, receive a fee and then sell these CDs at a premium resulting in a larger total fee for themselves and a smaller yield for the depositor. When you use the services of P.A.M. you wire your funds directly to the CD issuer, paying no premium to P.A.M. Our only fee is paid by the bank or savings and loan.

Now, why use Professional Asset Management?

We seek out strong, financially sound regional independent banks (from the more than 14,000 nationally) and savings associations (from the more than 3800 in the U.S.) who use external sources for raising deposits. Then, before we add a bank or S & L to our universe, we do a five-year trend analysis of capital adequacy and performance. We use, for analytical purposes, statistical reports from Alex Sheshunoff who publish semi-annual financial data on all commercial banks in the U.S. on a state basis and similar reports from Kaplan & Smith who publish data on all S & L's in the U.S. on a state by state basis.

Then we review actual annual financials, 10K's, 10Q's and interim reports from each institution and the auditor's opinions of the annual reports.

In addition, we review documents required by Federal regulatory agencies of each institution: call reports for banks and FHLB reports for savings associations.

In other words, before adding a bank or S & L to our universe, we review every report available to the public and include this information in our analysis.

We also monitor widely read business and trade publications such as the American Banker and Wall Street Journal.

After we have collected, reviewed and analyzed all of this information, we capsulize it in our well known and widely circulated Capital Adequacy Reports. We measure for each savings & loan and bank on our list, total assets, deposits, net worth, net income, return on average assets, return on average net worth, net worth/average deposits, net worth/average assets, year-to-date changes in assets, deposits, net worth and net income, and five year growth in assets, deposits and net worth.

But we don't use just that information as the basis of our report on a particular institution. Before we add any institution to our report, we send the institution our own carefully designed financial questionnaire, and review the institution's response.

What else do we do? Simple. We repeat all of this work every quarter. And, to the best of our ability, we visit each savings & loan or bank which wants to be on our recommended list. As best we can, we visit each institution at least once a year.

All of this work by us - none of it paid for by you - all of it paid for by the institutions who want to be in our report - gets those institutions in our report if they meet the standards which we apply to the information we have analyzed. [The standards are the ratio averages for their institutional peers--if they are equal to or are in excess of those of the peers, we recommend.]

Then, each morning, our traders contact each of the institutions on our list for their daily CD rates, EURO deposit rates and BA inventory rates. We make these rates immediately available to any of our more than 1000 clients who wish to contact any of our team of highly skilled and trained investment officers.

In addition to doing all of the information gathering and analysis that I have described in this Pledge, we calculate

interest accrued on your investment, monitor your maturities, track wires from your account to the receiving bank or savings & loan, make certain that your account is credited promptly, monitor your investment in an attempt to assure efficient return of interest and principal when requested, and attempt to eliminate interest loss through effective cash management techniques that ensure immediate investment of idle cash.

If you want to work with us, just one call to P.A.M. will provide you with daily rates from numerous banks and savings associations with whom we work.

Can you do what we do? Certainly - if you want to spend an equal amount of time and effort doing it, and if you want to pay for it. But all that time, effort and money won't get you any better rates. It will take you longer to do it. It will increase your costs. And, because you will have to devote your own staff and time to doing what we do at the expense of someone other than yourself, it will lower your effective yield and could slow your ability to invest.

Sure you can do what we do, but we believe we can do it better because it's a substantial portion of our business. After all, we do it for over 1000 clients who at last count had utilized our services in connection with their investment of more than \$2 billion. We can do the same for you.

Cordially,



Bill Goldsmith
Executive Vice President

BG/bw



**PROFESSIONAL
ASSET
MANAGEMENT
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22110 Ventura Boulevard Woodland Hills, California 91364 800/423-5877 Continental U.S.
213/888-2100 California, Alaska, Hawaii

**AN OPEN LETTER TO CLIENTS and
FRIENDS OF PROFESSIONAL ASSET MANAGEMENT:**

On Tuesday, May 19, 1981, an article appeared in the Wall Street Journal announcing the failure of Economy Savings of Chicago. At the time of the article Economy had assets of \$88 million.

The article went on to say that this was the first time in ten years that the FSLIC had to rescue a failing savings association and only the 14th time in the 45 year history of the corporation.

While failures have been a rare occurrence, this letter is written in the hope of bringing into focus the need in these times for more than just a cursory analysis of any investment.

My urging for caution and the need to be conservative in the investment arena is not new to those of you who know me. As recently as September, 1980, I published an article in Credit Union Management magazine (see enclosed reprint) drawing attention to what I perceived to be a potential danger.

For the past several years I have repeatedly advised in various articles, in speeches at credit union gatherings and in Board of Directors' meetings with management the need for a sound investment policy on the part of all credit unions. Now, more than ever, this need is apparent. But fiscal integrity for your credit union is not limited to investments alone. It also includes asset liability management, spread management and pricing your services.

What happened in Chicago can happen in L.A., New York or Des Moines. What happened to Economy Savings & Loan can happen to your credit union.

As Vice President of Investments for two major Wall Street firms for more than ten years, I counseled dozens of credit unions throughout the country. Now as Vice President of my own consulting firm, I have fewer time constraints. Consequently, I am available to those of you who may require my assistance.

Our policy has and will continue to emphasize safety first. Toward this end, we monitor on a quarterly basis, financial reports from many institutions. We analyze these reports and send you pertinent statistical data to complete your own analysis. Institutions that do not meet our requirements are not included in the report.

We will make every effort to help you make the right decisions. But more importantly, perhaps, we make it top priority to keep you from making the wrong decisions.

I hope we get to talk soon. Until then,

With warmest regards,

Bill

Bill Goldsmith
Vice President

THE FIRM

Professional Asset Management, Inc. is an investment consulting firm specializing in certificates of deposit investments within the financial community. Our goal is to assist you in placing funds in federally-insured financial associations at the most advantageous interest rates for the desired terms with the greatest degree of safety and liquidity. We have devised a unique network to gather rate data from financial institutions nationwide to assure you of the most accurate and up-to-the-minute information.

In addition, as a full service financial advisor, **Professional Asset Management** provides you with investment strategy and arbitrage assistance.

THE PRINCIPALS

James C. Chaffee, President, Professional Asset Management, is a graduate of Northrop Institute of Technology and California State University, Northridge with degrees in Aeronautical Engineering and Mathematics. He was previously Vice President, Investments for a world wide, NYSE member, investment firm where he acted as investment advisor to selected corporations, credit unions, and employee benefit accounts. He has also been active in the real estate investment field.

William Goldsmith, Vice President, Professional Asset Management, earned his BA at Indiana University and worked on his Masters in Economics at Northwestern University. He is considered to be one of the most knowledgeable advisors on investments in the credit union industry. Mr. Goldsmith has conducted numerous seminars on investment practices from cash and liquidity management to issues dealing with the economy and regulations. He has been a frequent speaker at chapter meetings, educational conferences, and annual conventions throughout the country. His articles appear regularly in credit union periodicals and most recently authored the Investment Manual for Credit Unions published by CUES.

Ronald P. James, Vice President, Professional Asset Management, is a graduate of the University of Georgia in accounting and finance. He was previously Investment Advisor for a Los Angeles based investment firm providing financial services to institutional and private investors nationwide. Prior to his association with the financial community, Mr. James was Manager of the Technical Assistance Group for the California Credit Union League (a trade association of 1800 credit unions). In addition, he was an International Financial Consultant and Senior Auditor for a Fortune 100 company. In this capacity, he provided companies in approximately 30 different countries with valuable financial advice.

Stephen L. Roe, Vice President, Professional Asset Management, is a Certified Public Accountant and is a member of the American Institute of Certified Public Accountants and the California Society of Certified Public Accountants. Prior to his association with Professional Asset Management, Mr. Roe was President and General Partner of Roe, O'Rourke and Clark Accountancy Corporation, a firm which specializes in auditing and consulting services for over 250 credit union clients throughout the country. He was also associated with a leading Big "8" accounting firm in San Francisco. Mr. Roe received a Bachelor of Science degree from San Jose State in 1970, and did graduate study at Stanford University in Business Administration.



PROFESSIONAL ASSET MANAGEMENT INC.

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It's no secret that the nation's savings and loan industry is in deep trouble. Even Richard Pratt, head of the FHLB, recently stated that every day another institution sinks to zero net worth.

Now having a zero net worth is quite a bit different from having no cash flow. Those associations with a steady cash flow from monthly mortgage payments could ride out negative net worth until interest rates decline and net worth corrected itself. The associations in most trouble are those that ventured beyond their traditional forms of financing (buying Ginnie Maes on margin, for example) into riskier forms of finance. The Wall Street Journal in a recent editorial questioned whether or not the "news" was placed to influence legislation beneficial to the industry.

Now savings associations come in many sizes and shapes. From the giant Home with assets near \$15 BILLION to tiny Equitable with assets less than \$4 million. While the industry may be in trouble there are many well managed individual associations that are doing very well. The California S & L's for the most part are strong because of their relative large size, their very strong balance sheets (with generally excellent net worth to asset ratios) and the fact that for many years they have been net sellers of loans while eastern institutions were net buyers.

In spite of this, many portfolio managers are scaling down their deposits in S & L's and are now "reaching" for yield in the nation's banking system. Both actions, again, with little or no investigation of the income statements or balance sheets of the S & L's avoided or the banks used.

Now I'm not making a case for either the S & L's or for banks. *I am* making a case for intelligent investigation *before* making an investment. We produce this capital adequacy report to assist in *your* investigations. We at Professional Asset Management were among the first to speak out on the need for caution. We are aware of our responsibilities to you and will continue to monitor even more closely those institutions included on our "approved" list. We produce our report quarterly and will include only institutions that meet our rigid requirements. This new issue was produced to make it easier for you to make comparisons. The report should not replace your own internal investigations. Use it as a guide. If you need our help with your own work we will be happy to assist.

While we observe some 150 ratios we closely watch only a few "Key" ratios. We are concerned first with safety. As a result we consider size. A minimum total asset base of \$400 to \$500 million if the bank or S & L has a strong deposit base (very little foreign money). We look for net worth to assets of no less than 4% to 5%. A few S & L's wholly owned by large publically listed corporations are looked at on a case by case basis. We look for an adequate return on assets and equity. Temporary losses are not too significant in and of themselves, unless the losses are of significant size to impair net worth. The use or extent of borrowed money (leverage) is watched. In all areas we monitor trends carefully. For our internal use we follow a five year trend analysis. For purposes of the report we reflect a year to year trend. Here we look at assets, deposits, loans, net worth, profit.

A deterioration in key liquidity or equity ratios or a significant change in an otherwise successful trend will force us to drop the institution from our approved list.

One intangible that is difficult to quantify, but one which we watch closely, is our assessment of management. We know, and visit regularly with top management of every bank or S & L on our list. Through this close personal contact we feel we get to "know" the institution and better interpret data taken from their published reports.

Once an institution has been approved we recommend the following guides: **Limit your investment to no more than 1% of their total assets or 5% of their net worth and no more than 10% of your total portfolio in any one institution.**

If you find any improvement we can make in publishing this report, we solicit your suggestions. We will be happy to assist with any of your investment questions.

Cordially,

Bill Goldsmith
Vice President

Capital Adequacy Report ENDING 6-30-81 (IN THOUSANDS)

PEER GROUP STATISTICS YEAR ENDING 6-30-81

	TOTAL ASSETS	DEPOSITS	NET ¹ WORTH	NET INCOME	ON ² AVERAGE ASSETS	RETURN ON AVERAGE ² NET WORTH	% CHANGE FROM PERIOD ENDING 6-30-80				% CHANGE NET INCOME	ALL FELIC INSURED S & L's ¹	RETURN ON AVERAGE ASSETS	RETURN ON AVERAGE NET WORTH	NET WORTH AVERAGE ASSETS	
							LEVERAGE	NET WORTH PERCENT ASSETS	% CHANGE ASSETS	% CHANGE DEPOSITS						% CHANGE NET WORTH
ALLSTATE SAVINGS & LOAN(a)	3,134,195	2,255,415	164,503	(9,802)	--	--	17.57	5.60%	13.6%	6.7%	- 4.0%	--	\$100 TO \$250 MILLION (722 Associations)	.10%	1.9%	5.5%
AMERICAN CITY BANK(b)	410,932	349,198	20,723	1,049	.60%	12.00%	21.10	5.70%	31.0%	29.0%	52.0%	- 29.0%	\$250 MILLION & OVER (497 Associations)	.15%	2.5%	6.6%
AMERICAN NATIONAL BANK	329,638	283,540	25,258	2,142	1.40%	16.80%	14.00	8.40%	22.0%	26.0%	45.0%	82.0%				
BARCLAYS BANK OF CALIFORNIA(c)	900,857	714,503	57,581	NA	--	--	13.40	7.60%	13.0%	19.0%	5.0%	NA	CALIFORNIA ASSOCIATIONS ²			
BENTWOOD SAVINGS & LOAN(d)	1,085,372	841,092	43,285	(3,244)	--	--	20.57	4.80%	54.0%	57.0%	- .8%	-120.0%				
CALIFORNIA FIRST BANK	3,751,251	3,283,717	150,505	9,015	.05%	12.50%	24.90	4.20%	9.2%	10.6%	9.2%	7.3%	\$1 BILLION & OVER (24 Associations)	.29%	4.8%	5.2%
CAPITAL BANK, NA	876,428	677,411	45,550	2,869	.80%	13.60%	18.35	5.90%	30.0%	28.0%	17.0%	- 4.0%	\$500 MILLION TO \$1 BILLION (16 Associations)	.35%	5.2%	5.3%
CENTRAL BANK	852,171	759,983	45,722	2,626	.60%	12.00%	18.40	5.70%	15.0%	14.0%	12.0%	5.0%				
CENTRAL FEDERAL SAVINGS & LOAN	1,391,490	925,623	61,044	478	.08%	1.60%	20.30	5.00%	52.0%	16.0%	3.0%	155.0%				
COMMUNITY BANK	583,376	409,458	32,492	2,452	1.00%	16.00%	17.20	6.20%	27.0%	16.0%	16.0%	10.0%				
FAR WEST SAVINGS & LOAN	1,011,588	724,626	57,822	1,434	.03%	5.20%	16.40	6.30%	23.0%	16.7%	6.9%	47.0%				
GIBRALTER SAVINGS & LOAN	3,249,000	2,481,000	190,000	3,800	.26%	4.00%	16.00	6.20%	16.0%	15.5%	2.0%	- 70.0%				
GOLDEN STATE BANK(e)	779,666	661,057	52,476	NA	--	--	17.86	7.00%	10.0%	6.0%	71.0%	NA				
GUARANTEE SAVINGS & LOAN	1,679,858	1,115,471	69,783	613	.08%	1.8%	23.50	4.30%	9.7%	-12.6%	4.3%	- 70.0%				
HIBERNIA BANK	883,043	752,035	67,231	570	1.60%	2.40%	16.00	9.00%	44.0%	39.0%	158.0%	- 43.0%				
HOMESTEAD SAVINGS & LOAN	555,918	335,882	23,089	152	.06%	1.20%	20.18	4.70%	33.0%	12.0%	- 8.0%	- 96.0%				
IMPERIAL BANK	1,121,510	970,719	52,815	8,663	1.80%	37.90%	20.60	5.60%	46.0%	41.0%	36.0%	53.0%				
MERCURY SAVINGS & LOAN	820,490	585,057	30,396	(2,179)	--	--	24.40	4.40%	18.5%	20.0%	- 6.6%	-240.0%				
PACIFIC FEDERAL SAVINGS & LOAN(g)	1,311,786	866,890	58,617	(6,726)	--	--	22.40	4.50%	--	--	--	--				
PENN SQUARE BANK, NA	364,760	314,029	26,513	3,140	1.80%	31.40%	14.14	9.40%	82.0%	71.0%	98.0%	68.0%				
SOUTHWEST SAVINGS & LOAN	502,390	369,460	27,004	(1,202)	--	--	16.20	6.00%	26.0%	22.0%	- 6.0%	-128.0%				
STATE SAVINGS & LOAN(h)	2,466,816	1,764,832	88,754	6,910	.80%	19.80%	26.28	4.80%	103.0%	87.0%	72.0%	103.0%				
UNION FEDERAL SAVINGS & LOAN	718,438	485,426	32,000	56	--	.03%	19.65	4.90%	24.0%	13.0%	- 6.0%	- 96.0%				
UNIVERSITY SAVINGS & LOAN(i)	1,941,227	1,546,849	63,155	4,536	.60%	14.60%	28.00	3.60%	26.0%	23.0%	5.0%	- 44.0%				
VALLEY FEDERAL SAVINGS & LOAN	1,494,847	1,085,692	57,135	(3,451)	--	--	23.90	4.20%	22.0%	17.0%	1.0%	-200.0%				

1 = Figures taken from FHLB combined financial statement
2 = Figures supplied by Kaplan & Smith, S & L Analysts

PEER GROUP STATISTICS YEAR ENDING 12-31-81

	RETURN ON AVERAGE ASSETS	RETURN ON AVERAGE NET WORTH	NET WORTH AVERAGE ASSETS
ALL FEDERAL RESERVE MEMBER BANKS ³			
ASSETS FROM \$1 TO \$5 BILLION (125 Banks)	.81%	12.98%	5.89%
ASSETS FROM \$50 MILLION TO \$1 BILLION (112 Banks)	.93%	12.93%	6.82%
ASSETS FROM \$300 TO \$500 MILLION (114 Banks)	.96%	13.63%	7.04%
CALIFORNIA BANKS ⁴			
\$100 TO \$500 MILLION (43 Banks)	1.09%	15.19%	7.00%
\$500 MILLION & OVER (14 Banks)	.64%	14.18%	4.50%

3 = Figures supplied by controller of currency
4 = Figures supplied by California Department of Banking

NA = Not Available
1 NET WORTH = PAID IN CAPITAL + SURPLUS + RETAINED EARNINGS
2 ANNUALIZED

- (a) Wholly owned subsidiary of Sears Roebuck
- (b) American City acquired by \$3.5 Billion United Overseas Bank
- (c) Wholly owned subsidiary of \$68 Billion Barclays Bank Ltd.
- (d) Wholly owned subsidiary of Jim Walter Corporation
- (e) Wholly owned subsidiary of \$70 Billion Sanwa Bank Ltd.
- (f) Wholly owned by Guarantee Financial
- (g) Pacific Federal acquired Santa Fe Federal 5/15/81. Prior figures not meaningful
- (h) Wholly owned by Financial Corporation of America
- (i) Wholly owned subsidiary of Entex Corporation

1980
1975-80

933

GLOSSARY

DEPOSITS	Time deposits (including savings accounts) and demand deposits plus deposits in excess of \$100,000 will total 100%.
NET INCOME	Net current operating income after minority interest and taxes but before securities gains and losses (if any) and preferred dividends.
RETURN ON AVERAGE ASSETS	Net operating income available for common (net operating income minus preferred dividends) divided by average assets. For purposes of our illustrations period ending June 30, 1980 and June 30, 1981 assets are averaged.
LEVERAGE	Average assets divided by average net worth.
NET WORTH	Total of paid in capital, surplus and retained earnings.
RETURN ON NET WORTH	Net operating income divided by average net worth. For purposes of our illustration period ending June 30, 1980, and June 30, 1981 net worth figures are averaged.



**PROFESSIONAL
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November 12, 1981

Since the publication of our last CAPITAL ADEQUACY REPORT much has changed in the capital and money markets. The prime rate has dropped from a near record 20.5% to a current 16.5% (a 19.5% decline), Federal Funds have declined from 17.5% to 13.25% (a 24% drop) and 30 to 90 day CDs are now trading at 14.5% from 19.5% (a decline of 25.6%).

The long term (capital) markets have improved dramatically too, with the popular Treasury 13.875% of 2001 at 104.15 up from 91.15, an improvement of 14.3%.

Inflation has moved out of the double digit range down to an annual rate of 7.5% in the third quarter while unemployment is up to 8% and heading higher.

The large demands on the market by government financing are presently being more than offset by an economy much weaker than earlier estimates. This will probably result in rates continuing to drop gradually for the next six months or so. But the deepening recession (which reduces revenues and adds to spending), coupled with continuing heavy demands by the Treasury to finance past deficits with a federal deficit for fiscal 1982 currently estimated to reach a record \$70 to \$80 billion, plus a continued tight money policy by the Federal Reserve, could well build a floor under both capital and money market rates at a relatively high level. If the economy begins to move upward in the second half of 1982 and/or if the resolve of the Administration, Congress and the Fed to fight inflation weakens, interest rates could move to new record levels in the second half of 1982.

Currently there is definitely a three tier market in the CD arena. Rates paid by well capitalized S & L's are 100 to 150 basis points higher than those paid by strong regional independent banks. The law of supply and demand has not been repealed.

While hardly a day passes without another scare story concerning the S & L industry recent actions by Congress and the Administration will provide breathing room until falling interest rates and improved portfolios of mortgages return money-losing S & L's to a period of growth and prosperity long enjoyed by the industry.

"... there is food for contrarian thought in all this woe. S & L's will not become wildly profitable anytime soon, but there will not be a massive collapse," says Allan Sloan in his October 26, 1981, issue of FORBES.

"The key element has been the ability of the FSLIC ... to protect its \$6.7 billion insurance fund ... it's doing that with accounting adopted by the FHLB Board and a gimmick the FSLIC snuck into the 1981 Tax Act to make some S & L takeovers more attractive. The thrifts have two problems, capital adequacy and liquidity. Capital adequacy can be more or less ignored during the current problems as long as an institution is basically sound."

Sloan continues: "To help solve both liquidity and capital problems the FHLB Board hit upon a neat method of accounting. It will let S & L's sell mortgage loans at a loss and allow them to charge the loss to capital over the life of the loan rather than all at once. As an example: An S & L sells a \$50,000 10% mortgage with 20 years remaining for \$40,000. Normally the \$10,000 loss would be charged to capital at once. Under the new rules the S & L can charge off just \$500 a year for 20 years. The S & L uses the \$40,000 for a new 16% loan. The loan produces more interest than the old one: \$6,400 a year compared with \$5,000. That \$1,400 covers the annual \$500 charge to capital with \$900 left over. Is the loss real? Yes. Is the S & L better off? Of course.

A second action allows S & L's to trade a package of low yielding loans to Freddie Mac in return for a Freddie Mac guaranteed certificate, both at market rates. The new Freddie Mac certificate has properties the individual loans do not have: They can be used in an arbitrage strategy to increase the return or they can be used as collateral to raise money through the sale of repos.

"Major S & L's whose problems can't be solved by portfolio sales may be attractive takeovers, thanks to Section 244 of the 1981 Tax Act. That clause, pushed through by the FSLIC while no one was looking enabled the FSLIC to unload two of its biggest problems — West Side Federal of New York City and Washington S & L of Miami."

Capital Adequacy Report

	ENDING 9-30-81 (IN THOUSANDS)				PERIOD ENDING 9-30-81								PEER GROUP STATISTICS YEAR ENDING 9-30-81			
	TOTAL ASSETS	DEPOSITS	NET WORTH ¹	NET INCOME	RETURN ON AVERAGE ASSETS ²	RETURN ON AVERAGE NET WORTH ²	NET WORTH AVERAGE DEPOSITS	NET WORTH AVERAGE ASSETS	% CHANGE ASSETS	CHANGE DEPOSITS	CHANGE NET WORTH	% CHANGE NET INCOME	ALL FS LIC INSURED S & L'S ¹	RETURN ON AVERAGE ASSETS	RETURN ON AVERAGE NET WORTH	NET WORTH AVERAGE ASSETS
ABILENE NATIONAL BANK	333,746	269,498	26,772	4,384	2.30%	31.20%	12.40%	10.40%	83.60%	67.00%	151.00%	126.70%	\$100 TO \$250 MILLION (722 Associations)	.10%	1.9%	5.5%
ALLSTATE SAVINGS & LOAN(a)	3,226,000	2,289,000	156.5	(17,744)	NM	NM	5.90%	5.10%	10.80%	2.50%	-9.00%	NM	\$250 MILLION & OVER (497 Associations)	.15%	2.5%	6.6%
AMERICAN CITY BANK	411,930	302,780	18,039	(2,932)	NM	NM	6.40%	4.8%	21.20%	16.90%	24.30%	NM	CALIFORNIA ASSOCIATIONS ²			
AMERICAN NATIONAL BANK	357,137	309,343	27,734	3,363	1.40%	19.10%	10.10%	8.80%	30.30%	28.50%	44.90%	62.00%	\$1 BILLION & OVER (24 Associations)	.29%	4.8%	5.2%
BARCLAYS BANK OF CALIFORNIA(b)	803,478	705,552	57,899	1,168	.20%	2.70%	8.9%	7.50%	11.20%	15.50%	4.40%	-18.20%	\$500 MILLION TO \$1 BILLION (16 Associations)	.35%	5.2%	5.3%
BREITWOOD SAVINGS & LOAN(c)	1,086,000	818,000	40,000	(7,000)	NM	NM	5.90%	4.50%	53.00%	52.60%	-4.80%	NM				
CALIFORNIA FIRST BANK	3,867,236	3,305,402	182,565	12,631	.40%	10.40%	5.90%	5.00%	11.80%	9.00%	29.00%	-6.20%				
CAPITAL BANK	811,819	638,448	52,419	4,200	.70%	12.13%	6.80%	8.80%	15.70%	15.60%	31.40%	-6.00%				
CENTRAL BANKING SYSTEM	880,574	781,571	42,764	4,129	.60%	13.40%	5.70%	5.10%	11.2%	11.00%	9.70%	-3.9%				
COMMUNITY BANK	610,328	419,088	33,668	4,000	.90%	17.00%	8.50%	5.90%	16.40%	12.80%	15.60%	33.30%				
EMPIRE SAVINGS(d) S/L	1,250,000	1,198,000	52,000	(4,700)	NM	NM	4.70%	4.50%	15.30%	16.40%	-7.10%	NM				
FIRST NATIONAL BANK & TRUST TULSA, OKLAHOMA	1,106,721	846,666	78,372	5,959	.70%	10.60%	9.70%	7.40%	10.30%	11.20%	10.50%	43.90%				
GOLDEN STATE SANWA BANK(e)	796,200	468,800	56,800	998	.1%	3.00%	9.30%	8.00%	27.20%	22.30%	21.9%	-25.00%				
GUARANTEE SAVINGS & LOAN(f)	1,697,000	1,151,000	68,254	(971)	NM	NM	6.00%	4.20%	8.00%	1.50%	-0.60%	NM				
HERBERTIA BANK(g)	889,382	771,773	47,356	1,504	.30%	4.30%	7.10%	6.20%	41.80%	37.70%	3.40%	-50.00%				
HOMESTEAD SAVINGS & LOAN	562,596	318,230	23,256	818	.20%	4.40%	7.20%	4.60%	21.00%	-2.40%	-11.70%	-6.80%				
HONOLULU FEDERAL SAVINGS & LOAN, HONOLULU, HAWAII	1,422,000	925,000	61,000	(5,000)	NM	NM	6.90%	4.60%	18.6%	13.37%	10.52%	NM				
IMPERIAL BANK	1,251,000	1,060,000	61,000	13,500	1.40%	36.40%	6.80%	5.80%	36.00%	35.00%	47.00%	57.00%				
LIBERTY NATIONAL BANK	1,937,954	1,478,885	82,331	11,590	.70%	15.10%	6.60%	4.70%	25.00%	36.60%	15.0%	22.00%				
PACIFIC FEDERAL SAVINGS & LOAN(h)	1,775,000	1,215,000	80,000	(1,500)	NM	NM	6.70%	4.8%	17.70%	18.90%	-11.10%	NM				
PENNY SQUARE NATIONAL BANK	408,289	371,229	30,000	4,129	1.70%	24.80%	10.20%	9.30%	71.00%	72.00%	109.00%	52.30%				
SOUTHWEST SAVINGS & LOAN	511,000	365,000	24,000	(4,000)	NM	NM	7.10%	5.10%	18.60%	17.00%	4.30%	NM				
STATE SAVINGS & LOAN(i)	3,020,949	2,206,727	94,722	12,569	.70%	22.40%	5.10%	4.20%	106.80%	108.90%	71.70%	64.50%				
UNION FEDERAL SAVINGS & LOAN	714,100	484,142	28,066	2,484	NM	NM	6.00%	4.16%	12.80%	9.30%	-13.70%	NM				
UNIVERSITY SAVINGS ASSOCIATION(j) S/L	2,015,311	1,561,984	63,411	256	.02%	.54%	4.20%	3.30%	10.60%	7.20%	.40%	-72.00%				
VALLEY FEDERAL SAVINGS & LOAN(k)	1,578,950	1,099,212	50,380	(10,361)	NM	NM	4.90%	3.50%	20.00%	13.60%	-11.00%	NM				
WESTLANDS BANK	196,708	176,616	12,163	860	.60%	12.70%	7.10%	6.50%	11.40%	7.80%	107.60%	50.80%				

GIBRALTAR SAVINGS & LOAN: Is in process of being spun-off from its parent, Imperial Corporation of America, is currently in registration and will shortly be listed on the NYSE. As a result, public disclosure of current financial information not permitted.

- (a) Wholly owned subsidiary of Sears Roebuck
- (b) Wholly owned subsidiary of \$68 Billion Barclays Bank Ltd.
- (c) Wholly owned subsidiary of Jim Walter Corporation
- (d) Wholly owned subsidiary of Baldwin United
- (e) Wholly owned subsidiary of \$70 Billion Sanwa Bank Ltd.
- (f) Wholly owned by Guarantee Financial
- (g) Hibernia acquired by Security National Bank, Walnut Creek, CA.
- (h) Pacific Federal merged with Santa Fe Federal and Oceanside Federal before 9/30/81. Prior figures not meaningful.
- (i) Wholly owned by Financial Corporation of America
- (j) Wholly owned subsidiary of Entox Corporation
- (k) Applied for change to a Stock Company from a Mutual Company

- 3 = Figures supplied by controller of currency
- 4 = Figures supplied by California Department of Banking

NM = Not Meaningful
¹ NET WORTH = PAID IN CAPITAL + SURPLUS + RETAINED EARNINGS
² ANNUALIZED

Section 244 allows a healthy S & L who acquires a sick one to deduct the S & L's operating losses for tax purposes but does not require them to count FSLIC payment as income. For example, if you buy an S & L losing \$100 million a year with a guarantee that the FSLIC will cover the loss you can't lose . . . You shell out the \$100 million loss, get a \$46 million refund from the IRS and then get \$100 million from the FSLIC. Net cash flow: \$46 million.

"With deals like this available . . . buying troubled S & L's should be a growth business for the next few years" says Sloan.

Congress is also considering a bill to permit banks to buy S & L's across state lines. This may be the next chapter which leads to interstate banking and the end of the McFadden Act. Keep tuned in. When the FSLIC is finished there will be far fewer but sounder S & L's.

As we warned in the September, 1980, issue of CREDIT UNION MANAGEMENT investing in S & L CD's can be prudent if you invest only in the larger, better capitalized institutions. We continue to believe in the viability of the S & L industry. We continue to stress safety, diversification and capital adequacy.

Our thanks to the many of you who have told us how much you appreciate our CAPITAL ADEQUACY REPORT. We will continue to publish it quarterly with increased dedication. Again, if there are any improvements or additions you'd like to see in the REPORT please let us know.

Cordially,



Bill Goldsmith

The information included in this report is taken from financial statements published by the various institutions included herein. Copies of the actual Statement of Conditions are available on request from PAM or from any of the institutions whose figures are included in this report.

GLOSSARY

DEPOSITS	Time deposits (including savings accounts) and demand deposits plus deposits in excess of \$100,000 will total 100%.
NET INCOME	Net current operating income after minority interest and taxes but before securities gains and losses (if any) and preferred dividends.
RETURN ON AVERAGE ASSETS	Net operating income available for common (net operating income minus preferred dividends) divided by average assets. For purposes of our illustrations period ending June 30, 1980 and June 30, 1981 assets are averaged.
LEVERAGE	Average assets divided by average net worth.
NET WORTH	Total of paid in capital, surplus and retained earnings.
RETURN ON NET WORTH	Net operating income divided by average net worth. For purposes of our illustration period ending June 30, 1980, and June 30, 1981 net worth figures are averaged.



PROFESSIONAL ASSET MANAGEMENT INC.

22110 Ventura Boulevard Woodland Hills, California 91364 800/423-5877 Continental U.S.
213/888-2100 California, Alaska, Hawaii

December 30, 1981

*in compliance
with 1060 Rev'd*

Dear Friends:

A very happy holiday season to all.

Since the publication of our Capital Adequacy Report on November 12, 1981, we have brought into the fold five new institutions:

*NAD
BKS*

- State Bk - ND* (State Street Bank - Boston, Massachusetts - *ND*)
- Heritage Bank - Anaheim, California
- Bank of Newport - Newport Beach, California
- First National Bank and Trust - Lincoln, Nebraska
- Financial Federation - Los Angeles, California

You will notice from the enclosed analysis that they all meet the rigid criteria we require for any institution we represent.

In addition we are studying three more national banks. If our analysis confirms our early studies, we will bring them on board and send you the results of our analysis as soon as possible.

One special note. Financial Federation is an eleven association holding company. Consequently certificates are insured up to \$1.1 million. If you have any questions, please call.

Cordially,

Bill Goldsmith
Vice President

BG/jr/wcp
Encl.

CAPITAL ADEQUACY REPORT (additions)
For nine months ending 9-30-81 (in thousands)

	Total Assets	Deposits	Net Worth	Net Income	Return On Avg. Net Assets	Return On Avg. Net Worth	Net Worth/ Avg. Deposits	Net Worth/ Avg. Assets
Bank of Newport	\$ 192,125	\$ 156,440	\$ 14,153	\$ 1,899	1.4	19.3	9.9	8.2
Financial Federation	2,383,673	1,956,901	167,557	(20,290)	NM	NM	8.5	7.1
✓ First Ntl. Bank & Trust	695,669	456,522	49,147	5,750	1.1	16.5	10.8	6.9
Heritage Bank	212,261	195,493	11,599	1,554	1.1	20.8	6.9	6.3
✓ State Street Bank	3,131,484	2,077,783	158,283	18,717	.8	16.8	8.5	5.3



PROFESSIONAL ASSET MANAGEMENT INC.

22110 Ventura Boulevard Woodland Hills, California 91364 800/423-5877 Continental U.S.
213/888-2100 California, Alaska, Hawaii

Registered Investment Advisor

March 10, 1982

Dear Investor,

To hear many tell it, the S & L industry is dead. Others are holding the wake BEFORE the funeral. To steal a line from another generation, reports of this demise are greatly exaggerated. However, I think it is safe to say that 1981 was a very difficult year for most S & L's.

You may have noticed that this report includes fewer S & L's and more banks than previous reports. The extent of the industry's difficulties are further underscored by the number of S & L's requiring mouth to mouth resuscitation. Even the best managed institutions sustained substantial losses and the FHLB reduced its minimum reserve requirements from 4% of average assets to 3%.

Hardly a day passes without an article in one or more local or national publications telling of the plight of the S & L industry and the fact that almost daily another institution sinks to zero net worth. What isn't reported is that having a zero net worth is quite different than having no cash flow. Those associations with a steady cash flow from monthly mortgage repayments could ride out a zero net worth or even a negative net worth until interest rates decline and the net worth corrected itself.

We at Professional Asset Management continue to believe in the viability of the S & L industry even though we recognize over the near term additional surveillance and extreme caution are top priorities. Consequently, even though we have reduced the NUMBER of S & L's on our approved list, the QUALITY of the specific institutions we follow remains extremely high. In these difficult times SAFETY and CAPITAL ADEQUACY have no substitutes. Only those banks and S & L's that continue to meet our rigid quality standards are included in this capital adequacy report.

Philosophically it could be argued that since the regulators have relaxed their merger requirements easing the way for interstate mergers and inter-institution mergers, the possibility of failure for all but the smallest S & L has been reduced significantly. It could be argued further that since Congress rescued Lockheed and Chrysler with bailout loans, can it do any less for a large troubled thrift?

Since these are political decisions it is difficult to know with precision what this new political environment or an election year will bring. Therefore we will not speculate in the realm of probability and consider only the land of reality, those factors that reliably measure relative strength and capital adequacy. You will note that the banks and S & L's we have included in this report are very profitable or at the very least possess capital adequacy that is more than adequate in spite of recent losses. The banks continue to reflect both profitability and strong capital adequacy positions.

The continuing relative weakness on the part of even the strongest S & L and the strength of banks in general has created a fairly pronounced two-tier market in the bidding for CD's. Yield differentials favoring S & L's have increased to 75 to 100 basis points in many cases. This differential implies a greater risk plus an element of fear inherent in an S & L investment. Is the additional premium paid by an S & L worth whatever real or imagined risk one perceives in such an investment? This is a decision you will be forced to make with increasing frequency as this year unfolds. That is precisely the reason Professional Asset Management brings you this report. It allows you to study 40 institutions, carefully comparing many of the key elements of safety and capital adequacy before you make an investment.

We will not include in this report any bank or S & L whose capital adequacy do not meet rigid minimum standards. We will augment this analysis with personal visits to each institution and personally interview top management as part of our in-depth analysis.

Separately much has been said and written of late about expanding investment regulations to permit credit unions to buy bankers acceptances, Euro dollar CD's and commercial paper. Additional avenues for investments are needed, of that there is little doubt. But I was around in the early 70's when many of you reading this entered the world of Ginnie Mae's after learning only to spell the name. But at least Ginnies are guaranteed by the U.S. government. And still because of a gross lack of knowledge and information many lost a bundle of dollars. You're going to have to know much more than how to spell the names to be able to invest intelligently in BA's, Euros or commercial paper. Sadly the loudest spokesmen for increased investment opportunities are many of the same voices who bought heavily into Ginnies and Freddie's a while back. Nothing takes the place of information. Investigate before you invest is an axiom as current today as when it was first uttered years ago. I will discuss BA's, Euros and commercial paper more fully in a subsequent report. However feel free to call on me any time for assistance.

**CAPITAL ADEQUACY REPORT
FOR YEAR ENDING DECEMBER 31, 1981**

Balance

	TOTAL ASSETS	DEPOSITS	NET WORTH	NET INCOME	RETURN ON AVERAGE ASSETS	RETURN ON AVERAGE NET WORTH	NET WORTH AVERAGE DEPOSITS	NET WORTH AVERAGE ASSETS	ASSETS	DEPOSITS	NET WORTH	NET INCOME	5 YEAR GROWTH 12/31/77 - 12/31/81		
	(IN T H O U S A N D S)												ASSETS	DEPOSITS	NET WORTH
Ablene Natl. Bank	424,377	376,804	27,230	5,477	1.7%	26.7%	9.5%	8.5%	94.0%	90.0%	96.5%	90.0%	764.0%	745.0%	687.0%
Allstate S&L ³	3,260,475	2,269,918	150,846	(25,299)	NM	NM	6.6%	4.8%	7.9%	(2.0%)	(14.4%)	(625.0%)	150.0%	130.0%	85.0%
American City Bank	396,444	349,906	17,308	(1,653)	NM	NM	5.2%	4.5%	5.2%	5.2%	14.5%	(213.0%)	175.0%	159.6%	118.5%
American Natl. Bank	385,751	336,716	26,748	5,017	1.4%	19.5%	8.4%	7.8%	11.8%	9.0%	51.4%	71.0%	65.0%	108.0%	108.0%
Bank of Newport	212,824	176,911	14,649	2,014	1.0%	14.4%	8.9%	7.4%	16.3%	15.6%	10.2%	(17.0%)	116.0%	103.0%	176.0%
Barclays Bank ⁴	819,326	723,474	56,731	100	NM	1.7%	8.1%	7.0%	4.9%	5.7%	(2.2%)	(96.0%)	NM	NM	NM
California First Bank	4,620,000	3,497,000	184,300	2,680	0.7%	1.6%	5.5%	4.5%	27.6%	(11.1%)	27.5%	(15.5%)	61,464	64.0%	52.0%
Capital Bank, NA	921,550	716,364	53,713	5,228	.6%	11.0%	8.0%	6.2%	14.0%	15.5%	30.7%	(14.4%)	NM	NM	NM
Central Bank	916,442	823,963	45,650	7,189	.8%	16.7%	5.9%	5.2%	7.7%	12.9%	13.2%	30.2%	NM	NM	NM
Community Bank	681,547	445,164	34,694	4,654	.75%	14.4%	7.8%	5.3%	25.0%	17.4%	15.5%	11.3%	147.0%	94.0%	89.0%
Empire S&L ⁵	1,319,753	959,712	57,549	(5,743)	NM	NM	6.4%	4.7%	18.7%	15.3%	1.2%	(230.0%)	155.0%	135.0%	93.0%
Far West S&L	1,038,805	736,300	65,175	(1,890)	NM	NM	9.4%	6.7%	14.3%	13.5%	(5.6%)	(216.7%)	59.3%	48.7%	31.9%
Financial Federation	2,436,805	2,059,344	137,692	(32,824)	NM	NM	6.8%	5.6%	4.0%	2.8%	(19.6%)	(119.0%)	NM	NM	NM
First Natl-Amarillo	797,564	631,085	52,814	8,560	1.2%	17.4%	9.1%	7.3%	22.7%	19.4%	16.8%	24.7%	NM	NM	NM
First Natl-Midland	1,642,752	1,348,228	84,270	21,543	1.5%	28.7%	6.2%	5.9%	35.8%	29.3%	28.3%	49.5%	218.7%	190.9%	133.6%
First Natl-of Oklahoma	2,745,700	2,009,306	40,000	19,298	.76%	12.6%	8.7%	6.2%	48.5%	50.0%	6.0%	(14.0%)	NM	NM	NM
First Natl-Tulsa	1,294,723	1,014,403	78,641	11,002	.9%	14.7%	8.2%	6.1%	19.0%	12.8%	10.4%	15.5%	NM	NM	NM
First Penn Bank, NA	5,257,234	3,525,395	216,828	(4,500)	NM	NM	6.1%	4.0%	(.4%)	(.3%)	.05%	97.0%	NM	NM	NM
Fuji Bank, N.Y.	1,800,000	1,380,000	75,000	5,800	.4%	10.17%	6.5%	5.3%	71.0%	47.9%	92.3%	65.7%	NM	NM	NM
Gibraltar S&L H ⁶ ston	3,445,086	2,552,124	167,523	(8,928) ¹	NM	NM	6.9%	4.9%	3.0%	6.5%	(11.8%)	(240.0%)	NM	NM	NM
Golden State Sanwa Bk. ⁶	860,000	720,000	60,000	2,100	.26%	4.6%	8.9%	7.6%	19.3%	11.4%	86.4%	(21.6%)	344.0%	313.0%	462.0%
Guarantee S&L ⁷	1,693,073	1,164,892	62,283	(6,945)	NM	NM	5.4%	3.8%	5.0%	1.5%	(10.4%)	(223.2%)	NM	NM	NM
Heritage Bank	264,464	242,600	12,381	2,121	.1%	20.2%	5.9%	5.5%	41.0%	39.0%	43.0%	39.0%	519.0%	567.0%	151.0%
Hibernia Bank	897,339	766,406	47,158	1,089	.4%	2.3%	8.5%	7.2%	45.0%	39.4%	3.0%	(.75%)	103.0%	95.0%	26.0%
Homestate S&L	1,651,880	1,211,229	21,471	533	.1%	2.3%	7.0%	5.0%	10.5%	2.8%	2.3%	(92.3%)	100.0%	43.0%	105.0%
Honolulu Federal S&L	1,464,748	969,283	56,963	(9,000)	NM	NM	6.2%	1.1%	10.9%	10.9%	(13.7%)	(60.8%)	124.0%	87.8%	48.9%
Imperial Bank	1,397,317	1,172,761	65,717	18,151	1.5%	33.8%	6.5%	5.5%	41.4%	36.4%	57.2%	39.3%	195.0%	285.0%	240.5%
Liberty Natl. Bank	2,266,840	1,740,164	106,414	14,240	.7%	15.8%	7.0%	5.3%	30.0%	39.0%	43.0%	35.0%	128.0%	125.0%	127.0%
Pacific Federal S&L	1,717,853	1,249,203	70,382	(24,625)	NM	NM	6.7%	4.9%	3.0%	0.0%	(26.0%)	(477.0%)	150.0%	155.0%	44.5%
Penn. Square Bank, NA	394,158	363,754	30,404	4,705	1.4%	18.5%	9.0%	8.9%	36.7%	40.6%	48.9%	9.8%	601.0%	605.0%	611.0%
Southwest S&L	462,518	322,007	25,227	418	.0%	1.2%	7.2%	5.0%	24.0%	19.1%	9.0%	(69.0%)	152.0%	78.0%	37.0%
State S&L ⁸	3,662,590	2,747,716	98,944	18,009	.7%	22.8%	4.9%	3.7%	117.0%	113.0%	68.0%	46.0%	489.0%	474.0%	226.0%
State Street Bank	3,388,066	2,248,475	164,677	26,242	.8%	17.0%	7.9%	5.1%	12.6%	18.2%	15.2%	19.7%	NM	NM	NM
Sunwest Bank	131,872	117,548	8,278	768	.6%	9.7%	7.6%	6.7%	15.7%	17.0%	9.7%	(58.0%)	140.0%	130.0%	170.0%
Texas Commerce Bank, NA	7,356,656	5,007,228	325,662	66,193	1%	21.7%	7.0%	4.9%	26.0%	18.5%	13.8%	28.3%	NM	NM	NM
Union Federal S&L	726,731	496,128	26,574	(6,497)	NM	NM	5.5%	3.7%	5.2%	7.0%	(18.9%)	(289.0%)	NM	NM	NM
University S&L ⁹	2,096,467	1,823,399	58,885	(2,985)	NM	NM	3.8%	3.0%	13.6%	(6.7%)	(150.0%)	160.0%	155.0%	211.0%	211.0%
Valley Federal S&L	1,595,378	1,073,682	48,383	(12,203)	NM	NM	4.5%	3.2%	15.0%	3.0%	(20.0%)	(263.0%)	231.0%	197.0%	11.0%
Westlands Bank	239,250	217,904	12,557	1,249	.6%	13.3%	6.2%	5.7%	38.4%	16.1%	104.0%	44.1%	97.0%	89.0%	332.0%
Gill Savings	404,594	344,822	10,685	5,789	2.1%	75.0%	4.6%	3.9%	178.0%	176.5%	125.7%	286.0%	NM	NM	NM

(1) For Fiscal Year ending 9/30/81
 (2) Includes purchase of OceanSide Federal
 (3) Wholly owned subsidiary of Sears Roebuck
 (4) Wholly owned subsidiary of 568 Billion Barclays Bank Ltd.
 (5) Wholly owned subsidiary of Baldwin United
 (6) Wholly owned subsidiary of 570 Billion Sanwa Bank Ltd.
 (7) Wholly owned by Guarantee Financial
 (8) Wholly owned by Financial Corporation of America
 (9) Wholly owned subsidiary of Entex Corporation

Finally, I think it is safe to say that the economic environment is uncertain at best. On one hand there is increasing evidence of a continuing recession and reduced inflation. Conventional wisdom has it that the price of money like the price of most commodities in a recessionary environment will soften. On the other hand we have budget deficits predicted to top \$100 billion for the next three fiscal years, a strong and resolute Federal Reserve Chairman who is committed to keeping a tight reign on the growth of money, and an election year in the face of unemployment likely to top 9.5%. It is no wonder then that a solid consensus for either higher or lower interest rates by year's end has failed to emerge. One thing that is certain is the uncertainty and the continuing volatility of interest rates.

My rather cloudy crystal ball tells me that since markets can accept either good news or bad news but can't stand uncertainty the best posture is one that keeps your portfolio fairly short and liquid.

Once again, my associates and I stand ready to assist you in any way we can. We are gratified by all of you who tell us how much you enjoy our CAPITAL ADEQUACY REPORTS. If you have any suggestions for improvements, don't hesitate to let us know.

Cordially,



Bill Goldsmith
Executive Vice President

The information included in this report is taken from financial statements published by the various institutions included herein. Copies of the actual annual reports are available on request from Professional Asset Management or directly from any of the institutions.

DEPOSITS	Time deposits (including savings accounts) and demand deposits plus deposits in excess of \$100,000 will total 100%.
NET INCOME	Net current operating income after minority interest and taxes but before securities gains and losses (if any) and preferred dividends.
RETURN ON AVERAGE ASSETS	Net operating income available for common (net operating income minus preferred dividends) divided by average assets. For purposes of our illustrations period ending June 30, 1980 and June 30, 1981 assets are averaged.
NET WORTH	Total of paid in capital, surplus and retained earnings.
RETURN ON NET WORTH	Net operating income divided by average net worth. For purposes of our illustration period ending June 30, 1980, and June 30, 1981 net worth figures are averaged.

Professional Asset Management is a licensed investment advisor.

**PROFESSIONAL
ASSET
MANAGEMENT
INC.**

22110 Ventura Boulevard Woodland Hills, California 91364 800/423-5877 Continental U.S.
213/888-2100 California, Alaska, Hawaii

March 25, 1982

IBM Poughkeepsie EFCU
Attn: Mr. Joe Sayres
P. O. Box 1750
Poughkeepsie, New York 12601

Dear Mr. Sayres:

You are cordially invited to attend our second annual Financial Symposium, Wednesday, June 2, 1982, cocktails at 5 p.m. followed by dinner at 6 p.m., to be held at the Marina City Club, 4333 Admiralty Way, Marina Del Rey, California.

Our keynote speaker will be Mr. Michael Flaherty, General Counsel for the House of Representatives Committee on Banking, Finance and Urban Affairs. Mr. Flaherty's keen analysis of financial institutions from his prominent vantage point makes most interesting and informative listening.

In addition, we are privileged to have on the program Mr. Jason Benderly of the Washington Analysis Corporation, a division of Bache Halsey Stuart Shields, Inc. Mr. Benderly is a nationally recognized expert on inflation and its causes and he is widely quoted in the major business journals.

Space is limited and we ask that you make your reservations on or before May 25, 1982. For those of you from out of town, the Marina City Club has rooms available. However, early reservations are recommended. Call J.R. at (800) 423-5877 (in California, Alaska, or Hawaii call collect (213) 888-2100 or drop us a line.

We look forward to seeing you on June 2.

Cordially,



Bill Goldsmith
Executive Vice President

BG/wcn

REGISTERED INVESTMENT ADVISOR



Ted Hruska listens to Judith Williams (which makes sense) as Dick Lindsay listens to Ron James. Who would you listen to?



Wherever there's a pretty face, Millie Bryan, can Steve Roe be far away?



Bill Goldsmith obviously enjoys addressing a captive audience even though he doesn't see too well as old age creeps up on him.



Alan Carlson and Steve Endaya can't seem to get a word in as Dick Haymaker makes a point.



Left to Right: Steve Roe and Ron James, Michael Flaherty and Jason Benderly find something amusing to smile about after a somber forecast by both Michael & Jason.



Bill Goldsmith can usually find something to say - even if his listeners are attractive, like Millie Bryan and Rosalie Feiz.



Larry Heitzman and John Stover from Gill Savings listen with interest to Sonja Chase who can always find something interesting to say.



According to Jason Benderly, Chief Economist for Washington Analysis Corp. President Reagan's economic plan. . . "is widening the gap between income and expenditures. . . the federal deficit could reach \$250 Billion by 1985."



**PROFESSIONAL
ASSET
MANAGEMENT
INC.**

22110 Ventura Boulevard Woodland Hills, California 91364 800-423-5877 Continental U.S.
213/888-2100 California, Alaska, Hawaii

June 10, 1982

Dear Investor,

The more things change, the more they stay the same! It seems as though some people never learn. Back in 1974-75 and again in 1977 credit unions, S&L's, yes, and even some banks started buying a government guaranteed investment called "Ginnie Mae." Many who ventured into this market knew how to spell the name, but little else about Ginnies.

They were bought largely from unlicensed salesmen operating in little more than a "bucket shop" whose only real interest was earning a commission. It mattered little to these salesmen whether the Credit Union, bank or S&L needed or could properly fund the investment. Working from purchased lists primarily of small to medium size S&L's and credit unions who were the most unsophisticated the disembodied voices with a smooth sales pitch sold millions of dollars worth of Ginnies and Freddie's (Freddie Macs). Many who bought are still "paying the piper." Recently an article published in "CUI'S" reported that a West Coast credit union is still involved in a legal battle with a sales firm whose main stock and trade was Ginnie Maes.

Now there was and is nothing wrong with a Ginnie Mae. It does have the full faith and credit of the United States as a guarantee. What was wrong was that too many bought too heavily from people they didn't know (or who didn't know them) knowing little or nothing about what it was that they were buying except perhaps, that it had a government guarantee. As is often the case, history has a way of repeating itself. And those that fail to learn the lessons of history are doomed to err again.

Many of the same people or people like them are back in business, only today they are selling SBA loans (also government guaranteed), Agency for International Development Bonds (AID, also government guaranteed) and certificates of deposit from small, obscure banks and S&L's from all corners of the country.

Now there isn't much wrong with an SBA loan or an AID bond if you understand them and are sure they fit your investment objectives and you obtain competitive bids or offers when selling or buying and you know, really know, the person and firm from whom you are making the purchase. One should ask themselves just why is an SBA loan or an AID bond with the same guarantee as a Treasury note or bond selling to yield, in many cases, 100 basis points or more than the T note or T bond. The plain and simple truth is that they are not worth as much. They aren't as marketable, far less liquid - almost a blind market when buying or selling; therefore, the spread between bid and asked prices is much larger resulting in paying more and receiving less.

Since there is no public market as in Treasury securities, frequently one or two market makers and in tight markets often none, prices are quoted on a "what the market will bear" philosophy. Additionally SBA's and AID's are difficult if not impossible to use for loan collateral.

Now CD's are another matter. A crop of new "money finders" have crawled out from under the woodwork operating from sales rooms, dealing with any obscure bank or S&L who will deal with them "hawking" CD's with the same reckless abandon as their antecedents sold Ginnies and Freddie's.

Credit unions, other small banks and S&L's with plenty of cash and few places to lend it are once again buying the proverbial "pig in a poke", investing without investigating either the "money finder" or institution from whom they are buying a CD. In many cases because the investor is investing "only" \$100 thousand per institution - the insured amount - they feel as safe as they did when they bought the Ginnies many still own at prices at 50% and 60% of cost.

To me there seems to be a frightening similarity in this activity. Two caveats to consider BEFORE making an investment of any sort: Buy from a recognized broker or through a registered investment advisor you know and then know what you are buying. As a registered investment adviser our obligation and commitment at Professional Asset Management runs deep, no different from that of a major brokerage firm.

First, it is incumbent on us to know our clients and their needs and to know well the products we offer and are satisfied that these products fully meet the requirements of our investors. Again, take CD's for example. We only offer in the market place CD's from banks and S&L's that meet rigid standards for performance and capital adequacy determined as a result of extensive analysis of not only the income statements and balance sheets but also of top management as well. This analysis is done on a continuing basis and revealed to you in our CAPITAL ADEQUACY REPORT four times a year. Then when you invest \$100 thousand or \$1 million you do so after reviewing and comparing up to the minute figures. Our commitment to you is to offer CD's only from institutions with a history of solid performance and a current capital adequacy far above regulatory minimums.

While profits and profit ratios are one measure of an acceptable institution, profits or lack of same are sometimes temporary in nature. It is a profitable TREND we measure. If a bank or S&L has a history of profitable operations and one or two quarters of unprofitable performance, this, in and of itself, is not alarming.

On the other hand, CAPITAL ADEQUACY is permanent - or should be. If a short term loss does not severely impact or permanently damage the capital adequacy of a bank or S&L with a history of profitable performance that institution is included in our universe.

**CAPITAL ADEQUACY REPORT
FOR QUARTER ENDING MARCH 31, 1982**

	TOTAL ASSETS	DEPOSITS	NET WORTH	NET INCOME	RETURN ON AVERAGE ASSETS**	RETURN ON AVERAGE NET WORTH**	NET WORTH AVERAGE DEPOSITS	NET WORTH AVERAGE ASSETS	% CHANGE SINCE 3/31/81 - 3/31/82			5 YEAR CHANGE 12/31/77 - 12/31/81				
	(IN THOUSANDS)								ASSETS	DEPOSITS	NET WORTH	NET INCOME	ASSETS	DEPOSITS	NET WORTH	
✓ Abilene Natl. Bank	452,279	404,034	27,984	1,345	1.61%	24.0%	9.4%	8.4%	108.5%	82.4%	(4.1%)	(4.1%)	1,084.0%	1,130.0%	1,160.0%	
Allstate S&L 1	3,254,276	2,275,962	143,860	(6,986)	(.009%)	(17.7%)	6.2%	4.6%	8.6%	(.05%)	(16.5%)	(74.0%)	150.0%	130.0%	85.0%	
American City Bank	389,362	373,222	16,141	(1,293)	(1.3%)	(32.9%)	4.3%	4.1%	.02%	-	5.3%	(408.6%)	175.0%	159.6%	118.5%	
✓ American Natl. Bank	390,484	323,569	27,858	1,047	1.0%	16.2%	9.4%	8.5%	25.6%	20.7%	16.3%	7.9%	14.7%	65.0%	85.0%	
✓ Bank of Newport ST	241,225	205,803	15,032	384	.7%	10.7%	8.3%	7.3%	26.4%	22.0%	10.1%	6.1%	176.5%	105.5%	121.5%	
Barclays Bank 2	832,430	726,827	56,622	(1,288)	(.06%)	(9.1%)	8.0%	7.1%	8.3%	6.5%	(.04%)	(704.0%)	NA	NA	NA	
X California Federal S&L	8,900,000	5,300,000	280,000	(20,000)	(1.0%)	(26.2%)	5.7%	3.6%	37.0%	17.5%	(15.2%)	NM	59.0%	28.8%	37.0%	
California First Bank	3,860,685	3,307,155	186,110	3,612	.04%	8.7%	5.8%	5.0%	9.5%	7.2%	25.9%	(24.8%)	61.2%	59.9%	58.9%	
Capital Bank, NA 3	874,455	670,603	53,833	1,150	.06%	9.6%	8.4%	6.5%	11.2%	11.2%	29.4%	15.9%	NA	NA	NA	
Central Bank	875,725	798,233	50,386	1,421	.7%	12.0%	6.5%	5.9%	6.8%	9.7%	13.0%	(4.0%)	50.0%	49.6%	36.3%	
Community Bank ST	669,059	410,554	166,224	1,830	1.0%	18.2%	9.1%	6.0%	23.0%	6.3%	16.4%	42.9%	147.0%	94.0%	89.0%	
Empire S&L 4	1,387,168	999,816	55,109	(3,900)	(1.0%)	(32.8%)	5.9%	4.4%	22.1%	17.8%	(2.5%)	(862.0%)	155.0%	135.0%	93.0%	
X Far West S&L	1,060,033	721,977	61,908	(3,266)	(1.3%)	(19.7%)	8.6%	6.2%	15.4%	7.9%	(12.1%)	(338.0%)	84.7%	59.6%	35.5%	
Financial Federation 5	2,509,345	2,115,720	145,536	(10,287)	(1.6%)	(25.2%)	7.1%	6.0%	7.5%	5.3%	(20.5%)	(116.3%)	26.5%	16.1%	2.4%	
First Natl. - Amarillo	797,468	604,459	54,302	1,770	.9%	13.9%	9.6%	7.3%	16.3%	15.1%	13.8%	(34.0%)	41.3%	40.3%	75.1%	
First Natl. - Midland	1,710,237	1,389,432	88,390	4,909	1.3%	24.7%	7.4%	6.1%	42.2%	40.5%	25.6%	(9.3%)	218.7%	190.9%	133.6%	
First Natl. - Oklahoma	2,917,811	1,770,090	201,910	10,051	1.0%	21.9%	13.3%	8.1%	41.7%	38.8%	22.0%	108.8%	100.8%	76.6%	44.5%	
First Natl. - Tulsa	1,242,752	878,465	84,765	3,285	1.1%	16.3%	10.2%	7.3%	15.9%	11.7%	11.1%	11.0%	35.3%	34.1%	29.2%	
First Penn Bank, NA	5,036,071	3,168,351	211,098	(5,947)	(.05%)	(10.9%)	6.5%	4.1%	(3.3%)	(4.7%)	(5.3%)	15.1%	(17.7%)	(17.1%)	(26.2%)	
Fuji Bank, N.Y. 6	1,552,000	1,325,000	76,837	1,885	.05%	10.3%	6.5%	5.6%	29.5%	27.5%	9.8%	121.0%	NA	NA	NA	
X Gibraltar S&L - Houston	3,574,549	2,590,512	161,892	(15,169)	(1.8%)	(34.5%)	6.4%	4.8%	12.8%	6.1%	(14.8%)	(280.6%)	81.1%	64.7%	43.4%	
Gill Savings S&L	493,941	416,712	11,470	931	1.1%	48.1%	4.1%	3.4%	180.3%	176.0%	171.2%	109.7%	1,273.0%	1,268.0%	801.0%	
Golden State Bank 7	813,598	663,964	57,372	340	.02%	2.4%	8.6%	7.1%	2.2%	(.01%)	1%	2.4%	344.0%	313.0%	462.0%	
Guarantee S&L	1,806,307	1,213,896	60,167	(2,138)	(.05%)	(13.2%)	5.1%	3.5%	11.3%	5.9%	(13.7%)	(471.2%)	77.7%	47.7%	39.6%	
Heritage Bank	1,281,602	809,364	61,260	247	.05%	40.0%	5.0%	4.6%	47.0%	47.3%	20.1%	(85.4%)	519.0%	567.0%	131.0%	
Hibernia Bank	918,840	798,260	46,245	(850)	(.03%)	(6.9%)	5.9%	5.1%	2.0%	3.6%	(2.4%)	(862.0%)	106.4%	96.6%	22.3%	
Homestead Federal S&L	753,814	433,170	24,008	537	.03%	9.2%	5.9%	3.6%	26.3%	14.9%	5.4%	427.4%	100.9%	99.8%	120.1%	
Honolulu Federal S&L	1,620,607	1,130,358	54,223	(4,531)	(1.2%)	(30.2%)	5.2%	3.6%	20.0%	19.5%	(17.4%)	(333.0%)	124.0%	87.8%	48.9%	
Imperial Bank	1,459,803	1,235,468	69,785	4,150	1.3%	27.4%	6.4%	4.5%	5.5%	33.2%	32.8%	35.6%	(4.0%)	195.0%	185.0%	240.5%
Liberty Natl. Bank	2,073,288	1,527,496	111,278	6,205	1.3%	26.4%	8.1%	5.8%	18.1%	26.4%	44.8%	67.2%	128.0%	125.0%	127.0%	
Midland Natl. Bank 8	424,895	349,109	27,293	1,592	1.6%	25.9%	9.0%	6.8%	13.3%	4.1%	25.0%	(33.5%)	92.6%	74.0%	102.7%	
Pacific Federal S&L	1,219,173	62,249	62,249	(8,235)	(1.0%)	(40.9%)	5.1%	3.6%	5.9%	(.002%)	(11.7%)	NM 9	NM	150.0%	155.0%	44.5%
Penn Square Bank, NA	436,491	403,440	33,051	1,451	1.6%	21.4%	9.5%	8.4%	40.6%	35.4%	21.9%	55.4%	601.0%	595.0%	611.0%	
Southwest S&L	555,092	407,952	28,714	2,623	2.0%	38.0%	7.6%	5.5%	14.2%	16.2%	5.4%	221.0%	152.0%	141.0%	27.0%	
State S&L 10	4,420,779	3,414,278	106,330	8,009	1.0%	38.2%	4.4%	3.3%	126.5%	133.0%	72.8%	156.5%	489.0%	474.0%	326.0%	
Sunwest Bank	136,959	122,266	8,198	(80)	(.02%)	(4.0%)	7.4%	6.6%	21.3%	23.7%	3.0%	(120.6%)	NA	NA	NA	
Texas Commerce Bank, NA	11,161,860	10,554,407	607,453	32,553	1.26%	22.3%	7.7%	5.9%	18.0%	14.0%	18.0%	34.0%	94.3%	72.5%	96.4%	
Union Federal S&L	691,869	496,138	27,238	(1,160)	(.007%)	(15.0%)	5.6%	4.0%	5.0%	3.8%	(21.0%)	(325.0%)	99.4%	76.9%	54.0%	
United Savings - Texas	1,405,784	1,005,784	62,149	(6,527)	(.05%)	(40.9%)	4.3%	3.4%	8.0%	1.5%	(14.8%)	(280.0%)	NA	NA	NA	
Valley Savings 12	2,168,814	1,702,306	61,031	2,746	.04%	13.8%	3.6%	3.1%	12.8%	12.0%	(4.3%)	208.0%	169.0%	155.0%	211.0%	
Valley Federal S&L	1,603,249	1,110,933	44,027	(4,355)	(1.2%)	(33.3%)	4.0%	2.7%	12.7%	2.7%	(27.3%)	(99.0%)	231.0%	197.0%	11.0%	
Westlands Bank	243,620	221,569	12,610	50	.0009%	2.1%	6.2%	5.7%	21.6%	20.3%	93.9%	(85.0%)	97.0%	89.0%	332.0%	
West Coast Bank	130,201	118,786	6,885	255	1.1%	17.8%	7.8%	7.1%	122.2%	127.5%	39.4%	(28.6%)	NM 13	NM	NM	

** Annualized

1. Wholly owned subsidiary of bears.
2. Wholly owned subsidiary of Barclays Bank, Limited.
3. Member Mercantile Texas Corporation.
4. Wholly owned subsidiary of Baldwin Union.
5. A name change to United Savings is planned.
6. Wholly owned by Fuji, Limited.
7. Wholly owned by Sunco, Limited.

8. Member, First City Bancorp.
9. Comparable figures not available due to merger.
10. Wholly owned by PCA.
11. Profit for three months ending 5-31-82 at 250M.
12. Wholly owned subsidiary of Exter Corporation.
13. Comparable operations 3-1/2 years ago.

All institutions insured by FDIC or FSLIC

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Then when we offer you CD's you can be comfortable with an investment of \$100 thousand or up to but not more than a investment of 5% of the net worth in any bank or S&L in our universe. Once again, when loan demand is low and cash is plentiful many unsophisticated investors buy yield with little regard to quality.

Many small banks, S&L's and credit unions in the investing mode are still employing unknowledgeable, unsophisticated and unthinking people to make the investments. I talked to one such person the other day, as an example. She (it could have been a he) asked if the CD she was buying was insured by FSLIC. When I said it was insured by the FDIC she insisted that only FSLIC insured CD's was sufficient. When I questioned her, she frankly didn't know who or what FSLIC was or for that matter FDIC.

I submit that conversations similar to this one occur with all too frightening frequency, daily, in our office. So, when I say that our commitment and obligation to our investors runs deep - it includes informing, teaching and protecting. It's time you, the investor, make the commitment to learn this business of investing. Once again, this process should begin with knowing your product and knowing those you rely on for products and information. If you don't know your broker or investment advisor at least verify the reputation and experience before dealing with a salesperson or firm that person represents. As of this writing the money and bond markets are still confused. After a fairly strong rally the markets in all maturities has backed off sharply.

Inflation is down to an annual rate of 5% to 6% from 12.5% not too long ago but interest rates, although down from peaks in all sectors are still exceedingly high with a record inflation premium built in. Market participants seem to be saying..."we don't believe that this present rate of inflation is sustainable," and with good cause. Record high current budget deficits and estimated future deficits reaching \$250 billion by 1985 may be the fuel to reinflate our economy.


Deflation has its price too in unemployment, lower or nonexistent corporate profits and a soft market for houses and other collectibles. Unemployment widens the Federal deficit causing the government to borrow more and pay more for what they borrow. Falling prices cause corporate bankruptcies and heavy corporate borrowing by firms just to stay afloat pushing up rates and personal bankruptcies near an all-time record help to exacerbate high rates.

The evening of June 2, more than 200 of our clients from across the U.S. gathered at the Marina City Club for our Second Annual Financial Symposium to hear Mike Flaherty and Jason Benderly. There were few dry eyes after both reflected their views that tough times are ahead on both the regulatory and economic fronts as what should be collides with political realities. BE PREPARED are the watch words. We hope you make next year's annual update, but as the accompanying pictures reveal, those at this year's bash enjoyed the evening if not the news.

Finally, our clouded crystal ball tells us that interest rates in all sectors could ease for the next three or four months before heading back up again - possibly to new record highs - by the end of the year or early 1983. Some economists of note, including Henry Kaufman feel new records will be set. So, for the moment, if you can, extend maturities on your CD investments to the 120 to 180 day area to protect today's relatively high rates. Then, if rates do escalate again as anticipated shorten maturity schedules.

Once again, if you have any suggestions on how we can improve our REPORT, write or call in your suggestions.

Cordially,



Bill Goldsmith
Executive Vice President

The information contained in this report is taken from financing statements published by the various institutions included herein. Copies of actual reports are available on request from Professional Asset Management or directly from any of the institutions.

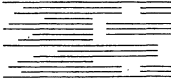
DEPOSITS	Time deposits (including savings accounts) and demand deposits plus deposits in excess of \$100,000 will total 100%.
NET INCOME	Net current operating income after minority interest and taxes but before securities gains and losses (if any) and preferred dividends.
RETURN ON AVERAGE ASSETS	Net operating income available for common (net operating income minus preferred dividends) divided by average assets. For purposes of our illustrations period ending March 31, 1981 and March 31, 1982 assets are averaged.
NET WORTH	Total of paid in capital, surplus and retained earnings.
RETURN ON NET WORTH	Net operating income divided by average net worth. For purposes of our illustration period ending March 31, 1981 and March 31, 1982 net worth figures are averaged.

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Registered Investment Advisor

Addendum No. 4



**PROFESSIONAL
ASSET
MANAGEMENT
INC.**

22110 Ventura Boulevard Woodland Hills, California 91364 800/423-5877 Continental U.S.
213/888-2100 California, Alaska, Hawaii

TO OUR CLIENTS AND FRIENDS:

IMPORTANT MARKET UPDATE. ADD TO YOUR CAPITAL ADEQUACY REPORT.

We have added AllState Savings and Loan and Penn Square Bank, na, to our list of approved institutions since our most recent capital adequacy report was mailed to you. It is our desire to have you update your records as soon as possible with the addition of the enclosed reports.

Our next complete financial adequacy report will be sent to you just as soon as all the data can be collected for the period ending June 30, 1981.

All State is a wholly owned subsidiary of Sears Roebuck.

Penn Square Bank, a national bank, has experienced outstanding growth in the past year with strong indications that this growth will continue.

Located in Oklahoma City Penn Square has become the leading bank in the Southwest servicing the oil and gas industry. Energy related activities such as exploration, production and servicing have been proceeding at record breaking rates. It is anticipated that these activities will continue at high levels for the foreseeable future. Penn Square's growth is closely linked with the growth of the energy industry.

It's total loan portfolio exceeds \$700 million, usually short term and all indexed to prime. It participates on an upstream basis with its larger money center correspondent banks. Penn Square acts as lead bank in joint loan ventures because its prime is normally 50 or more basis points higher than money center rates. As a result banks like Continental Illinois will earn more participating with Penn Square than by going it alone.

We are pleased to add these two fine institutions to our list of well capitalized banks and savings associations.

Cordially,
Bill Goldsmith

PENN SQUARE BANK,na

(000s omitted)

For Period Ending	May 31,1981	May 31, 1980	% Change
TOTAL ASSETS	\$347,108	\$183,470	89% +
EARNING ASSETS	297,000	176,840	68% +
DEPOSITS	300,000	160,000	88% +
PAID IN CAPITAL AND SURPLUS	27,503	11,092	148% +
NET INCOME	2,800	1,700	65% +
RETURN ON AVG. EARNING ASSETS	2.8%*		
RETURN ON AVG. EQUITY	34.8%*		
LEVERAGE	10.6%		
LOAN/DEPOSITS	73.0%		
*Annualized			

ALLSTATE SAVINGS & LOAN*

(000s omitted)

For Period Ending	3-31-81	3-31-80	% Change
TOTAL ASSETS	\$3,100,000	\$2,900,000	7% +
EARNING ASSETS	2,900,000	2,700,000	7.4% +
DEPOSITS	2,300,000	2,100,000	9.5% +
PAID IN CAPITAL AND SURPLUS	170,000	172,000	1% -
NET INCOME	(\$4,000)	2,000	300% -
RETURN ON AVG. EARNING ASSETS	NA		
RETURN ON AVG. EQUITY	NA		
LEVERAGE	18.23		

* Wholly owned by Sears Roebuck

Addendum No. 5

DATE	TOTAL INVESTMENT/ CASH PORTFOLIO	TOTAL \$ AND % IN S & L'S	TOTAL \$ AND % IN COMMERCIAL BKS.*	TOTAL \$ AND % IN E.C.C.	IN PENN SQ.
12/4/81	\$39 mil.	\$14.5 mil. 38%	\$3. mil. 8%	\$9. mil. 23%	\$500,000 1%
1/21/82	\$40 m	\$14.5 m 37%	\$4. m 10%	\$10.5 m 27%	\$1.5 mil 4%
1/29/82	\$41 m	\$16 m 39%	\$5.5 m 13%	\$10.5 m 26%	\$2 m 5%
2/26/82	\$43 m	\$14 m 33%	\$5.5 m 13%	\$14.5 m 34%	\$3 m 7%
3/08/82	\$50 m	\$14.5 m 29%	\$9. m 18%	\$14.5 m 29%	\$3 m 6%
4/27/82	\$51 m	\$16 m 31%	\$10.5 m 21%	\$13.5 26%	\$3 m 6%
5/07/82	\$55 m	\$15.5 m 28%	\$12 m 22%	\$15.5 m 28%	\$3 m 5%
6/18/82	\$57 m	\$16 m 28%	\$12.5 m 22%	\$16.5 m 29%	\$3 m 5%

*excluding Penn Sq. whose figures are shown separately

During this time period our investment policy was to place no more than a maximum of \$3 million in any one institution with the exception of Empire Corp. Central

Name: Penn Square Bank
 Address: Oklahoma City, Okla.

Prepared By	Initials	Date
Approved By		

Certificates of		1	2	3	4
Deposit					
Date		amount	DEBIT	CREDIT	BALANCE
12/4/81	60dys. @ 13% due 2/2/82		500,000.		500,000.
1/21/82	148dys.@14 1/2% due 6/18/82		500,000		1,000,000
1/29/82	28dys. @14 1/2% due 2/26/82		500,000		1,500,000
2/2/82	Matured C/D Prin/Int.	10,833.33		500,000	1,000,000
2/26/82	Renewed + add'l \$1 mil. 60dys. @ 15% due 4/27/82		1,500,000	500,000	2,000,000
3/1/82	ck. matured C/D int. 2/26	5,638.89			2,000,000
3/8/82	60dys. @14% due 5/7/82		1,000,000		3,000,000
4/27/82	Ren. 119dys. @15% due 8/24/82	37,500	1,500,000	1,500,000	3,000,000
5/7/82	Ren. 119dys. @ 15% due 9/03/82	23,333.33	1,000,000	1,000,000	3,000,000
8/18/82	Ren. 180dys. @ 15 1/8% due 12/15/82	29,805.56	500,000.	500,000	3,000,000

#6

Addendum No. 6
INVESTMENT ACTIVITY

DATE: 12-4-81

BID QUOTES OBTAINED BY: D. Dewey

INVESTMENT ACTIVITY APPROVED BY: UNAVAILABLE: STILES, KAINOL : Approved by: Louis C. Bergman

INVESTMENT ON: A MATURITY _____
NEW MONEY 1,000,000 (FROM ECN ON/ON)

BID QUOTES: TERMS:

CONTACTS:

DUTCHESS BK. TR.

EMPIRE CC.

PENN SQUARE

Abilene Nat'l BK

Li BERTY

So. CALIF. SAV'S
1st NAT'L - TULSA

	60	90	120				
DUTCHESS BK. TR.	11	11	11				
EMPIRE CC.	11.85	11.85	11.85				
PENN SQUARE	13.00	-	-	500K			
Abilene Nat'l BK	13.00	13.50	-	500K			
Li BERTY	11.80	11.80	11.80				
So. CALIF. SAV'S 1st NAT'L - TULSA	13.75 10.35	13.75 10.85	13.75 10.35	Insufficient financial data, per Alice Holman with "not good"			

FINAL ACTION: SETTLEMENT DATE: 12-4-81

AMOUNT: \$ 500,000 EACH RATE: 13.00 ON/BOTH

TYPE OF SECURITY: 2 C/D's \$ 500,000 @

TERM: 60 days DUE DATE: 2-2-82 (BOTH)

AMOUNT \$ 500,000 (2⁴³) WIRED TO: 1. ABILENE: FED RES. BK., DALLAS TX. / 2. PENN SQ. BK., OKLAHOMA CITY, OKLA.

For Acct.: Abilene Nat'l BK., ABA # 1030-00732 attn: Dan Thompson

ABA # 111-301818 / fraser credit from Ed STELL

fraser credit: 184 P&FCC

SPECIAL NOTES:

more info. being sent on

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INVESTMENT ACTIVITY

DATE: 1-8-82

BID QUOTES OBTAINED BY: D. Deery

INVESTMENT ACTIVITY APPROVED BY: Sayers (contacted by D. Deery)

INVESTMENT ON: A MATURITY

NEW MONEY \$1,500,000 from ECC Milfed

BID QUOTES: TERMS:	30	60	90	120	150	180	360
CONTACTS:							
<u>Empire C.C.</u>	-	-	13.10	13.45	13.80	13.90	-
<u>Maxine Midland</u>	-	12.35	12.60	12.85	13.25	13.30	13.-
<u>Ecch. Nat. Bk. Chicago</u>	-	-	12.75	13.	13.8	13.50	-
<u>PENN SQUARE</u>	-	13.75	13.75 out to 119 days.				
<u>Guarantee S/L</u>	14.	14.	14. out to 119 days.				
<u>UNION FEDERAL</u>	-	-	-	14.25	14.25	14.25 out to 209 days.	
<u>STATE S/L</u>	14.50	14.50	14.50	14.75	15.25	15.25 out to 270 days.	

FINAL ACTION: SETTLEMENT DATE: 1-8-82

AMOUNT: \$ 1.5 MIL RATE: 15 1/4%

TYPE OF SECURITY: C/D

TERM: 270 dly DUE DATE: Oct. 5, 1982

AMOUNT \$ 1,500,000 WIRED TO: State S/L

Hickton, Calif.

SPECIAL NOTES:

INVESTMENT ACTIVITY

DATE: 1-11-82

BID QUOTES OBTAINED BY: D. Deeryea

INVESTMENT ACTIVITY APPROVED BY: Sayin (contacted by D. Craft)

INVESTMENT ON: A MATURITY ^{*2.5 million due AT STATE S/L + INT. 12/31/81} ^{*260,312.98 to PCC wired}
~~NEW MONEY~~ wired \$1,000,000 out PCC for C/D investment

BID QUOTES: TERMS: 30 / 60 / 90 / 120 / 150 / 180 / 270 / /

CONTACTS:

<u>Empire CC</u>	12.80	12.95	13.10	13.20	13.45	13.90	13.80		
<u>Home Federal S/L</u>	13 7/8	13 7/8	13 7/8	(14)	14	14 1/8	14 1/8		
<u>Dutchess St. L.</u>	12.45	12.25	12.125	12	-	11.75	11.50		
<u>Maine Millland</u>	12.125	12.50	12.75	13.25	13.625	13.625	13.50		
<u>Pen Square</u>	13.50	13.75	13.75	-	-	-	-		

FINAL ACTION: SETTLEMENT DATE: 1-11-82 AMOUNT: \$ 1,000,000 RATE: 14%

TYPE OF SECURITY: C/D TERM: 120 days DUE DATE: 5-11-82

AMOUNT \$ 1,000,000 WIRED TO: Bk of America, San Diego Calif. - main office
615 Broadway San Diego 92101
for credit to: Home Fed Savings & S&W acct # 505-000-56
further credit: JAM P.D. EFCU

SPECIAL NOTES:
Int. at maturity

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INVESTMENT ACTIVITY

DATE: 1-21-82

BID QUOTES OBTAINED BY: D. Dewey

INVESTMENT ACTIVITY APPROVED BY: Sayre

INVESTMENT ON: A MATURITY _____

NEW MONEY *1,500,000 from ECC 2/1/82

BID QUOTES: TERMS:

CONTACTS:

Empire C.C.

Dutchess Bk + Trust

1st Nat'l - Tulsa

Penn Square

Bankers Trust

Home Federal S/L

	30	60	90	120	150	180			
<u>Empire C.C.</u>	13.20	13.30	13.50	13.85	14.10	14.25			
<u>Dutchess Bk + Trust</u>	12.875	12.750	12.625	12.50	12.25	12.			
<u>1st Nat'l - Tulsa</u>	-	-	13.50	13.75	14.15	(14.375)	" per very strong bank"	P.A.M.	
<u>Penn Square</u>	14.	14.	14.50	(14.50)	-	-	" very strong bank"		
<u>Bankers Trust</u>	-	-	-	-	-	13.75			
<u>Home Federal S/L</u>	-	-	-	-	-	14.50			

FINAL ACTION: SETTLEMENT DATE: 1-21-82

TYPE OF SECURITY: 2 C/D'S

1st NAT'L BK OF TULSA:
 (1) AMOUNT: \$ 1,000,000 RATE: 14.375%

TERM: 180 days DUE DATE: 7-20-82

(1) AMOUNT \$ 1,000,000 WIRED TO: Tulsa Bk

(2) 500,000 " " Penn Square

(2) AMT. * 500,000 Penn Sq. at 14 1/2%

148 days due 6-18-82

SPECIAL NOTES: 2 banks rated very strong by P.A.M., more for data coming.

INVESTMENT ACTIVITY

DATE: 1-29-82

BID QUOTES OBTAINED BY: D. Dewey

INVESTMENT ACTIVITY APPROVED BY: Sayus

INVESTMENT ON: A MATURITY _____
 NEW MONEY 2.5 million from ECC ad/dw

BID QUOTES: TERMS:

CONTACTS:

	19 dys.	30	60	90				
<u>E.C.C. ad/dw</u>	(13.50)	-	-	-	\$500,000	19 days	loc.	2-17-82
<u>Dutchess Co.</u>	-	13.50	13.50	13.375				
<u>11 Financial Federation</u>	-	15	15.78	(15.78)	\$1,000,000	89 days	loc.	4-28-82
<u>Abilene</u>	-	13.50	14	(14.75)	\$500,000	90 dys.	loc.	4-29-82
<u>Pan Sa</u>	-	(14.50)	14.75	14.75	\$500,000	28 dys.	loc.	2-26-82

FINAL ACTION: SETTLEMENT DATE: 1-29-82

AMOUNT: \$ as noted above. RATE: _____

TYPE OF SECURITY: 4 C/D's.

TERM: _____ DUE DATE: _____

AMOUNT \$ 1,000,000 WIRED TO: (FOR FIN. FED.) 11 Interstate Bank, 600 South Spring St.

other 3 wired under previous instructions Los Angeles, Calif acct of: 11 Fin. Fed. St's

101-643-241

SPECIAL NOTES:

further credit: SBM P&R FCU.

INVESTMENT ACTIVITY

DATE: 2-2-82

BID QUOTES OBTAINED BY: D. Dewyla

INVESTMENT ACTIVITY APPROVED BY: Sayer

INVESTMENT ON: A MATURITY 2 C/D's MATURING 500,000 TINT 10,833.33 Prns Sp + 500,000 TINT 10,833.33 Abilene
~~NEW MONEY~~ wired to ECC

BID QUOTES: TERMS:

CONTACTS:

	30	60						
<u>STATE S/L</u>	16.20	16.40	*	(NOW AT MAX DEP.)				
<u>Penn Sq.</u>	14.50	14.75						
<u>Abilene</u>	14.75	15.00						
<u>Fuji BK + TRUST.</u>	15.05	15.10	*	(NO INFO. ON FILE)				
<u>E.C.C.</u>	(14.80)	-						

FINAL ACTION: SETTLEMENT DATE: 2-2-82

AMOUNT: \$ 1,000,000 RATE: 14.80

TYPE OF SECURITY: C/D

TERM: 30 days DUE DATE: 3-4-82

AMOUNT \$ _____ WIRED TO: _____

funks out of dd/dw at ECC to C/D at ECC

SPECIAL NOTES: (*) higher rates: reasons given for not purchasing.

INVESTMENT ACTIVITY

DATE: 2-26-82

BID QUOTES OBTAINED BY: D. Deuryan

INVESTMENT ACTIVITY APPROVED BY: Anger (contacted by D. Deuryan)

INVESTMENT ON: A MATURITY 500,000 of Penn Sq. (56.38.84. Amt coming via check)

NEW MONEY 2,000,000 from P.C.C. diff'd

BID QUOTES: TERMS:

	14 days	30	60	90				
CONTACTS:								
<u>Engel CC</u>	13.45	13.85	13.95	14.10				
<u>Penn Square</u>	14.25	14.50	(15)	-	1.5 bid	FOR 60 days	see 4/27/82	
<u>Yasine Mulland</u>	13.-	13.50	13.625	-				
<u>Dutchess Bk</u>	13.-	13.25	13.50	-				
<u>State S/L</u>	-	16.65	16.45	-	to 119 days	(at MAX. 20%)		
<u>Exch Nat'l Chicago</u>	13.375	(13.625)	13.75	-	bid	FOR 31 days	line 3/29/82	

FINAL ACTION: SETTLEMENT DATE: 2-26-82

AMOUNT: \$ as noted above

TYPE OF SECURITY: 2) C/D's.

TERM: _____ DUE DATE: _____

- ① AMOUNT \$ 1,000,000 WIRED TO: Exchange Nat'l Bk of Chicago TRHD. Federal Res. of Chicago
ATTN: W4 Kraus for cred to SAAM A/C OFCU Code 12
- ② 1.5 to Penn Sq. as previous instr.

SPECIAL NOTES:

INVESTMENT ACTIVITY

DATE: 3-8-82

BID QUOTES OBTAINED BY: P Wade / D. Deussen

INVESTMENT ACTIVITY APPROVED BY: Sayer

INVESTMENT ON: A MATURITY 1,000,000 due at ECC. Int = 5,389.02
 NEW MONEY and 1,000,000 from ECC 21/days

BID QUOTES: TERMS:	14 day	30	60	90				
CONTACTS: <u>ECC</u>	13.20	13.30	13.20	13.25				
<u>Exch Nat'l - Chicago</u>	13 7/8	13 5/8	13.50	13.50				
<u>Penn Square</u>	14. =	14.	(14.)	14.	\$1,000,000	60 days	due	5/7/82
<u>Abilene</u>	13.	13.25	13.25	(14.50) <small>(91 days)</small>	\$1,000,000	91 days	"	6/7/82
<u>Marine</u>	12.50	12.85	13.05	13.05				
<u>Central Federal</u>	-	15.25	15.25	15.25				

FINAL ACTION: SETTLEMENT DATE: 3-8-82 AMOUNT: \$ as noted above RATE: _____
 TYPE OF SECURITY: (2) C/D'S TERM: _____ DUE DATE: _____

AMOUNT \$ _____ WIRED TO: as previously instructed

SPECIAL NOTES:

INVESTMENT ACTIVITY

DATE: 3-19-82

BID QUOTES OBTAINED BY: D. Dwyer

INVESTMENT ACTIVITY APPROVED BY: Hayes

INVESTMENT ON: A MATURITY 500,000 w/ Pacific Federal Term 2.2, 105.90 to CCC ad/dep
and NEW MONEY 1.5 new

BID QUOTES: TERMS:	14 days	30	60	90	120			
CONTACTS:								
<u>Pacific Federal</u>	NO RATES OFFERED							
<u>Bonn Square</u> ³	-	14.875	14.75	-		(AT MAX. DEPOSIT)		
<u>Abilene</u>	-	-	-	14.875	14.25			
<u>Exchs Int'l Chicago</u>	14.25	14.25	14.25	14.25	14.25			
<u>Central Federal</u>	-	15.50	15.50	15.75	15.875	\$1,000,000	122 days	7/19/82
<u>Maine Midland</u>	14	14.25	14.35	14.35	14.35	1,000,000	20 days	6/17/82

FINAL ACTION: SETTLEMENT DATE: 3-19-82

AMOUNT: \$ as noted above RATE:

TYPE OF SECURITY: 2 1/2's

TERM: _____ DUE DATE: _____

AMOUNT \$ _____ WIRED TO: as previously instructed
\$1,000,000 EACH

SPECIAL NOTES:

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INVESTMENT ACTIVITY

DATE: 3-29-82

BID QUOTES OBTAINED BY: P. Wink

INVESTMENT ACTIVITY APPROVED BY: Layton

INVESTMENT ON: A MATURITY 1,000,000 w/ Early Dutch Chicago T 11,732.63 Bid. and
~~NEW MONEY~~ 1,000,000 w/ ECC T int 82,355.40 P

BID QUOTES: TERMS: 30 / 60 / 90 / 91 / 120 / 180 /

CONTACTS:	30	60	90	91	120	180			
<u>ECC</u>	14.65	14.70	14.75	<u>14.90</u>	14.75	-	1,000,000	00	82.00
<u>Early Dutch Chicago</u>	14.25	14.25	14.25	14.25	14 1/8				
<u>Dutchess Bk.</u>	13.10	13.10	13.10	13.10	13.10				
<u>P.A.M. { Fuji Bk.</u>	14.60	14.70	14.80	14.80	14.80	14.80			from P.A.M. "Deposit only"
<u>Penn. Sp. ③</u>	15 1/8	15	15	15					(At 100% P.P.)

FINAL ACTION: SETTLEMENT DATE: 3-29-82 AMOUNT: \$ 1,000,000 RATE: 14.90
 TYPE OF SECURITY: [2] C/O'S AT ECC TERM: 91 day DUE DATE: 6-28-82

AMOUNT \$ _____ WIRED TO: _____
1,000,000 @ 14.90% due 6/28/82
91 day

SPECIAL NOTES: funds already at or wired into ECC

INVESTMENT ACTIVITY

DATE: 4-27-82

BID QUOTES OBTAINED BY: D. Deyle

INVESTMENT ACTIVITY APPROVED BY: Sayer

INVESTMENT ON: A MATURITY 4.5% maturing at Penn Sq. \$37,500 Int.
NEW MONEY _____

BID QUOTES: TERMS:

	30	60	90	120	150	180			
CONTACTS:									
<u>ECC</u>	14.30	14.25	14.25	14.15	14.15	14.20			
<u>Penn Sq.</u>	15	15	(15 ^{70/119})	14.75	14.75	14.50			
<u>Fuji.</u>	14.20	14.20	14.20	14.20	14.20	14.20			
<u>American Nat'l.</u>	14.75	14.75	14.75	-	-	-			

FINAL ACTION: SETTLEMENT DATE: 4-27-82 AMOUNT: \$ 1,500,000 RATE: 15%

TYPE OF SECURITY: Billed C/D TERM: 119 days DUE DATE: 8-24-82

AMOUNT \$ _____ WIRED TO: Billed 4.5 at Penn Sq. at maturity
let mail to ECC

SPECIAL NOTES:

INVESTMENT ACTIVITY

DATE: 5-7-82

BID QUOTES OBTAINED BY: A. Deuyca

INVESTMENT ACTIVITY APPROVED BY: Hayes

INVESTMENT ON: A MATURITY 1,000,000 w/ Penn Sq. (T. Bot 23,333.33 to ECC rolldw)
 NEW MONEY 1,000,000 at ECC rolldw

BID QUOTES: TERMS:

CONTACTS:

Penn Sq.

Mainie Natl

1st Nat'l of Mdland

Calif Federal

ECC

	30	60	90	119	120	150	180	
<u>Penn Sq.</u>	15.25	15.25	15	(15)	14.75	14.75	14.75	Roll'd \$1,000,000
<u>Mainie Natl</u>	13.35	14.25	14.25	14.25	14.25	14.25	14.25	
<u>1st Nat'l of Mdland</u>	14.05	13.75	-	-	-	-	-	
<u>Calif Federal</u>	14.50	14.50	14.50	14.50	14.50	14.50	14.50	
<u>ECC</u>	31 days: (14.35)	14.15	14.10	13.70	13.70	13.70	13.70	\$200,000

FINAL ACTION: SETTLEMENT DATE: 5-7-82

TYPE OF SECURITY: 2 C/D's / rollover
1 new

PEN N SQ.
 (1) AMOUNT: \$ 1,000,000 RATE: 15%

TERM: 119 days DUE DATE: 9-03-82

(2) AMOUNT \$ 1,000,000 WIRED TO: 1,000,000 Penn Sq rollover

AT ECC @ 14.35% 1,000,000 ECC new money - funds in ECC rolldw

due 6/07/82

SPECIAL NOTES: for 31 days.

INVESTMENT ACTIVITY

DATE: 3-8-82

BID QUOTES OBTAINED BY: P Wade / D. Deussen

INVESTMENT ACTIVITY APPROVED BY: Sayer

INVESTMENT ON: A MATURITY 1,000,000 due at ECC. Int = 5,389.02
 NEW MONEY and 1,000,000 from ECC 21/days

BID QUOTES: TERMS:

	<u>14 day</u>	<u>30</u>	<u>60</u>	<u>90</u>				
CONTACTS: <u>ECC</u>	13.20	13.30	13.20	13.25				
<u>Exch Nat'l - Chicago</u>	13 7/8	13 5/8	13.50	13.50				
<u>Penn Square</u>	14. =	14.	(14.)	14.	\$1,000,000	60 days	due	5/7/82
<u>Abilene</u>	13.	13.25	13.25	(14.50) <small>(91 days)</small>	\$1,000,000	91 days	"	6/7/82
<u>Marine</u>	12.50	12.85	13.05	13.05				
<u>Central Federal</u>	-	15.25	15.25	15.25				

FINAL ACTION: SETTLEMENT DATE: 3-8-82

AMOUNT: \$ as noted above RATE: _____

TYPE OF SECURITY: (2) C/D'S

TERM: _____ DUE DATE: _____

AMOUNT \$ _____ WIRED TO: as previously instructed

SPECIAL NOTES:

INVESTMENT ACTIVITY

DATE: 3-19-82

BID QUOTES OBTAINED BY: D. Dwyer

INVESTMENT ACTIVITY APPROVED BY: Hayes

INVESTMENT ON: A MATURITY 500,000 w/ Pacific Federal Term 2.2, 105.90 to CCC ad/dep
and NEW MONEY 1.5 new

BID QUOTES: TERMS:

	14 days	30	60	90	120			
CONTACTS:								
<u>Pacific Federal</u>	NO RATES OFFERED							
<u>Bonn Square</u> ³	-	14.875	14.75	-		(AT MAX. DEPOSIT)		
<u>Abilene</u>	-	-	-	14.875	14.25			
<u>Exchs Int'l Chicago</u>	14.25	14.25	14.25	14.25	14.25			
<u>Central Federal</u>	-	15.50	15.50	15.75	15.875	\$1,000,000	122 days	7/19/82
<u>Maine Midland</u>	14	14.25	14.35	14.35	14.35	1,000,000	20 days	6/17/82

FINAL ACTION: SETTLEMENT DATE: 3-19-82

AMOUNT: \$ as noted above

TYPE OF SECURITY: 2 1/8's

TERM: _____ DUE DATE: _____

AMOUNT \$ _____ WIRED TO: as previously instructed
\$1,000,000 EACH

SPECIAL NOTES:

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INVESTMENT ACTIVITY

DATE: 3-29-82

BID QUOTES OBTAINED BY: P. Wink

INVESTMENT ACTIVITY APPROVED BY: Layton

INVESTMENT ON: A MATURITY 1,000,000 w/ Early Dutch Chicago T 11,732.63 Bid. and
~~NEW MONEY~~ 1,000,000 w/ ECC T int 82,355.40 P

BID QUOTES: TERMS: 30 / 60 / 90 / 91 / 120 / 180 / / /

CONTACTS:	30	60	90	91	120	180			
<u>ECC</u>	14.65	14.70	14.75	<u>2</u> <u>(14.90)</u>	14.75	-	1,000,000	00	82.0
<u>Early Dutch Chicago</u>	14.25	14.25	14.25	14.25	14 1/8				
<u>Dutchess Bk.</u>	13.10	13.10	13.10	13.10	13.10				
<u>P.A.M. { Fuji Bk.</u>	14.60	14.70	14.80	14.80	14.80	14.80			from P.A.M. "Investment"
<u>Penn. Sp. ③</u>	15 1/8	15	15	15					(at 100% P.P.)

FINAL ACTION: SETTLEMENT DATE: 3-29-82
 TYPE OF SECURITY: [2] C/O'S AT ECC

AMOUNT: \$ 1,000,000 RATE: 14.90
 TERM: 91 day DUE DATE: 6-28-82

AMOUNT \$ _____ WIRED TO: _____
1,000,000 @ 14.90% due 6/28/82
91 day

SPECIAL NOTES: funds already at or wired into ECC

INVESTMENT ACTIVITY

DATE: 4-27-82

BID QUOTES OBTAINED BY: D. Deyle

INVESTMENT ACTIVITY APPROVED BY: Sayer

INVESTMENT ON: A MATURITY 4.5% maturing at Penn Sq. \$37,500 Int.
NEW MONEY _____

BID QUOTES: TERMS:

	30	60	90	120	150	180			
CONTACTS:									
<u>ECC</u>	14.30	14.25	14.25	14.15	14.15	14.20			
<u>Penn Sq.</u>	15	15	(15 ^{70/119})	14.75	14.75	14.50			
<u>Fuji.</u>	14.20	14.20	14.20	14.20	14.20	14.20			
<u>American Nat'l.</u>	14.75	14.75	14.75	-	-	-			

FINAL ACTION: SETTLEMENT DATE: 4-27-82 AMOUNT: \$ 1,500,000 RATE: 15%

TYPE OF SECURITY: Billed C/D TERM: 119 days DUE DATE: 8-24-82

AMOUNT \$ _____ WIRED TO: Billed 4.5 at Penn Sq. at maturity
let mail to ECC

SPECIAL NOTES:

INVESTMENT ACTIVITY

DATE: 5-7-82

BID QUOTES OBTAINED BY: A. Deuyca

INVESTMENT ACTIVITY APPROVED BY: Hayes

INVESTMENT ON: A MATURITY 1,000,000 w/ Penn Sq. (T. Bot 23,333.33 to ECC rolldw)
 NEW MONEY 1,000,000 at ECC rolldw

BID QUOTES: TERMS:

	30	60	90	119	120	150	180	
CONTACTS:								
<u>Penn Sq.</u>	15.25	15.25	15	(15)	14.75	14.75	14.75	Roll'd \$1,000,000
<u>Mainie Natl</u>	13.35	14.25	14.25	14.25	14.25	14.25	14.25	
<u>1st Nat'l of Mdland</u>	14.05	13.75	-	-	-	-	-	
<u>Calif Federal</u>	14.50	14.50	14.50	14.50	14.50	14.50	14.50	
<u>ECC</u>	31 days: (14.35)	14.15	14.10	13.70	13.70	13.70	13.70	\$200,000

FINAL ACTION: SETTLEMENT DATE: 5-7-82

PEN N SQ.
 (1) AMOUNT: \$ 1,000,000 RATE: 15%

TYPE OF SECURITY: 2 C/D's / rollover
1 new

TERM: 119 days DUE DATE: 9-03-82

(2) AMOUNT \$ 1,000,000 WIRED TO: 1,000,000 Penn Sq rollover

AT ECC @ 14.35% 1,000,000 ECC new money - funds in ECC rolldw

due 6/07/82

SPECIAL NOTES: for 31 days.

INVESTMENT ACTIVITY

DATE: 6-4-82

BID QUOTES OBTAINED BY: D. Sawyer

INVESTMENT ACTIVITY APPROVED BY: Sawyer

INVESTMENT ON: A MATURITY _____

NEW MONEY 1,000,000 at CCC dd/dw.

BID QUOTES: TERMS:

CONTACTS:

ECC

Maine

Ablaine

Calif. Federal

Fuji ⁽²⁾

Conn Sq. ⁽³⁾

	30	60	90	120	150	180	1yr.
ECC	13.70	13.80	13.85	13.85	13.85	13.85	13.35
Maine	13.25	13.50	-	-	-	13.50	12.875
Ablaine	-	-	14.78	-	-	-	-
Calif. Federal	14.25	out to 209 days					
Fuji ⁽²⁾	13.65	13.75	13.90	out to 179 days			
Conn Sq. ⁽³⁾	14.625	-	-	14.35	-	14.50	(AT 11.1.82 Day)

FINAL ACTION: SETTLEMENT DATE: 6-4-82

AMOUNT: \$ 1,000,000 RATE: 13.85

TYPE OF SECURITY: C/D

TERM: 180 days DUE DATE: 12/1/82

AMOUNT \$ _____ WIRED TO: funds already at ECC

SPECIAL NOTES:

INVESTMENT ACTIVITY

DATE: 6-18-82

BID QUOTES OBTAINED BY: D. Deegan

INVESTMENT ACTIVITY APPROVED BY: Deegan

INVESTMENT ON: A MATURITY 500,000 w/ Penn Sq INT OF 27,805.52 to ECC d/d/w
 * NEW MONEY 1,000,000 ~~to~~ ECC d/d/w

BID QUOTES: TERMS:

	30	60	90	119	180	1yr		
CONTACTS:								
<u>Penn Sq.</u>	15 7/8	15 7/8	15	15	<u>15 7/8</u>	15 7/8	\$ 500,000	Pa. Fed over
<u>Amarillo</u>	15	14 5/8						
<u>1st Penn.</u>	14.80	14.80	14.80		15 1/4			
<u>Calif Fed.</u>	15 1/4	15 1/4	15 1/4	15 1/4	15 1/4			
<u>ECC</u>	14.70	14.90	15.35	15.10	15.15			
<u>MANUF. Hanover</u> <small>BILL WATT 212-623-5566</small>	14.50	14.75	14.75	14.75	<u>15.05</u>		\$ 1,000,000	new

FINAL ACTION: SETTLEMENT DATE: 6-18-82
 TYPE OF SECURITY (2) C/D's 1- Roll over
1- new

(1) AMOUNT: \$ 500,000 RATE: 15 7/8 %
 TERM: 180 days DUE DATE: 12/15/82

AMOUNT \$ 1,000,000 WIRED TO: HAN. HAN TRUST (2) 1,000,000 New C/D AT MANUF. HANOVER
NYC, CORP TRUST DEPT. 180 days @ 15.05% due 12/15/82
108 FLOOR 4 NY PLAZA

SPECIAL NOTES: act: Marie Pipitone
021-000306

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INVESTMENT ACTIVITY

DATE: 6-21-82

BID QUOTES OBTAINED BY: D. Reinger

INVESTMENT ACTIVITY APPROVED BY: Sayer (Contacted by D.L. Craft)

INVESTMENT ON: A MATURITY 500,000 w/ Fuji + 18,263.19 INT TO CCC @/New
NEW MONEY

BID QUOTES: TERMS:

CONTACTS:

	30	60	90	120	150	180		
<u>Fuji</u>	14.75	14.95	15.35	15.35	15.35	15.55	Re. P.C.	0.25
<u>Penn Sq.</u>	15.78	15.78	15	15	15	15		
<u>Calif Fed.</u>	15.30	15.78	15.78	15.42	-	-		
<u>Southwest</u>	15.25	15.25	15.25	14.75	14.75	14.75		
<u>ECC</u>	14.65	14.80	15.30	15.30	15.30	15.45		

FINAL ACTION: SETTLEMENT DATE: 6-21-82

AMOUNT: \$ 500,000 RATE: 15.55

TYPE OF SECURITY: C/D

TERM: 182 day DUE DATE: 12/20/82

AMOUNT \$ _____ WIRED TO: Roll over

Int to ECC

SPECIAL NOTES:

INVESTMENT ACTIVITY

DATE: 7-1-82

BID QUOTES OBTAINED BY: D. Deuygen

INVESTMENT ACTIVITY APPROVED BY: Lopez

INVESTMENT ON: A MATURITY 520,000 of Abilene N.B. AT 19,326.39 TO ECC rd/dw
NEW-MONEY

BID QUOTES: TERMS:

P.A.M. CONTACTS:
Abilene
Midland Nat'l
E. C. P.
Mannie
P.A.M. Hill S/C
Southern

	30	60	90	120	150	180			
Abilene	-	14.75	15 5/8	14.50	14.50	14.50			
Midland Nat'l	15	15 1/8	15 3/8	15 3/8	15 3/8	15 3/8			
E. C. P.	14.90	14.95	15.35	15.20	15.30	15.25			
Mannie	14 1/4	14 1/4	14 1/4	14.	14.	14.			
Hill S/C	15 5/8	15 5/8	15 5/8	-	-	-			
Southern	15.75	15.75	15.75						

FINAL ACTION: SETTLEMENT DATE: 7-1-82
TYPE OF SECURITY: C/D

AMOUNT: \$ 520,000 RATE: 15.25%
TERM: 180 day DUE DATE: 12-28-82

AMOUNT \$ _____ WIRED TO: fund wired into ECC rd/dw
then into 500K C/D AT ECC.

SPECIAL NOTES:



Addendum No. 7

AGENDA ITEM

□ IBM POUGHKEEPSIE EMPLOYEES FEDERAL CREDIT UNION SOUTH ROAD / P.O. BOX 1750 / POUGHKEEPSIE / NEW YORK 12601

July 14, 1982

TO: Board of Directors
Supervisory Committee

RE: A 'Reserve for Loss Contingencies' Account

FR: C.M. Casparian, Treasurer

The Investment Committee recommends that the Board of Directors authorize management to set up a new reserve account entitled 'Reserve for Loss Contingencies'.

It is further recommended that 10% of investment earnings be transferred quarterly into this account until such time (and to maintain) the account represents 5% of our total investment portfolio. *

Other Committee actions from the July 12th meeting are indicated on the attached minutes.

*For example, 10% of our current investment earnings, \$600,000, would mean a quarterly transfer of \$180,000. And, with an investment portfolio of \$45 million, 5% would mean a total of \$2,250,000.

attachment

Telephone (Area Code 914) 463-3987 or 463-3992



□ IBM POUGHKEEPSIE EMPLOYEES FEDERAL CREDIT UNION SOUTH ROAD / P.O. BOX 1750 / POUGHKEEPSIE / NEW YORK 12601

July 12, 1982

INVESTMENT COMMITTEE MEETING
Held: July 12, 1982, Monday

Via Phone: Sayres, Casparian, Kaindl

The following recommendations were acted on:

1) Mr. Sayres recommended early redemption of three certificates of deposit with Abilene Bank, Texas due to an unfavorable financial position indicated during the past 90 days. Loss of interest is approximately \$57,000.00.

This recommendation was moved, seconded and Passed Unanimously by the Committee for immediate action.

2) The Committee was in Unanimous Agreement to lower the investment ceiling on new certificates of deposit with other financial institutions from \$3 million to \$1 million, effective immediately. Currently held certificates of deposit will be held to maturity.

3) The Committee recommends that a special reserve account be established for "Reserve for Loss Contingencies". The Committee further recommends that 10% be transferred quarterly from investment earnings into "Reserve for Loss Contingencies", until such time that this account total represents 5% of our total investment portfolio.

The Committee is to recommend this for Board action at the upcoming July 21 Board Meeting.

Finally, the Committee was advised that management is meeting with Merrill Lynch on Wednesday, July 14, to discuss future investment options other than purchases of certificates of deposit.

Notes:

The Investment Committee has reviewed the entire investment portfolio at this time and feels comfortable with the investments now outstanding.

The above actions are excluding Empire Corporate Central.

Telephone (Area Code 914) 463-3987 or 463-3992

The CHAIRMAN. Now we will hear from Mr. Philip Loiacona.

**TESTIMONY OF PHILIP LOIACONA, TREASURER AND MANAGER,
BOLLING AIR FORCE BASE FEDERAL CREDIT UNION, WASH-
INGTON, D.C.**

Mr. LOIACONA. Mr. Chairman, I don't have a prepared statement. I will give a little background. I am treasurer and general manager of the Bolling Federal Credit Union. I have 15 years credit union experience and have been with this credit union for 5 years.

In March, before our venture with Penn Square we had assets of \$8 million. Our loans amounted to \$4 million; we had 250,000 dollars' worth of Treasury bills yielding 9.3 percent. We invested in Federal funds with the National Bank of Washington \$1.5 million yielding an average of 14.3 percent. We had CD's in \$100,000 units in various savings and loans throughout the country amounting to \$2,300,000 yielding 15.6 percent.

We used several brokers—to be exact, approximately eight—all over the country, who made contact with us by phone offering us various insured investments. We deposited \$1 million in Penn Square on April 8 for approximately 30 days, which we renewed twice. Penn Square was subsequently closed on July 5. We now hold \$911,000 in receiver's certificates of which we have written off \$182,000.

The CHAIRMAN. Thank you.
Mr. Arnold?

**TESTIMONY OF JOHN ARNOLD, MANAGER, SOUTHWEST
CORPORATE FEDERAL CREDIT UNION, DALLAS, TEX.**

Mr. ARNOLD. Thank you, Mr. Chairman. My name is John Arnold, manager of Southwest Corporate Federal Credit Union, Dallas, Tex.

Southwest Corporate is a regional corporate Federal credit union. It received its charter from the National Credit Union Administration in 1975 and serves both Federal and State chartered credit unions located in the States of Arkansas, Louisiana, New Mexico, and Texas.

The purpose of Southwest Corporate is to serve the financial needs of its membership. Services to meet those needs are primarily to loan funds when needed, to act as a depository of funds from the membership, and to provide those financial services necessary to assist the credit unions in meeting the needs of their members. Southwest Corporate currently has a membership of 1,575 from the four States.

In November 1980, Southwest Corporate was determined qualified as a "bankers' bank" under regulation D and may act as a passthrough correspondent for other depository institutions required to maintain reserves at the Federal Reserve Bank.

The board of directors of Southwest Corporate is comprised of 11 persons elected by the membership. The responsibility of the board is to set policies under which management functions.

The investment committee is appointed by the board of directors and operates under policies established by the board. The committee submits to the board a detailed list of all investment transac-

tions on a monthly basis. These reports, along with the financial, income and expense statements, are reviewed at the monthly meetings of the board.

The investment committee performs an analysis of each institution it invests in. The audit reports of those financial institutions and the Bankroll¹ of the Chase Manhattan Bank, N.A., are used in making the analyses.

Southwest Corporate receives an annual supervisory examination from the National Credit Union Administration. An annual audit has been performed by Price Waterhouse for the past 4 years, and Southwest Corporate received an unqualified opinion each time.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The following information was received from Mr. Arnold for inclusion in the record:]

Southwest Corporate Federal Credit Union had the following investments in Penn Square Bank:

<u>Purchase Date</u>	<u>Amount</u>	<u>Rate</u>	<u>Maturity Date</u>
4-27-82	1,000,000	15.00%	7-27-82
6-14-82	1,000,000	15.00%	7-22-82
6-28-82	3,000,000	15.50%	7-28-82

Matured certificates:

4-27-82	3,000,000	15.00%	5-26-82
5-27-82	3,000,000	15.00%	6-28-82

The CHAIRMAN. Mr. Mangan?

**TESTIMONY OF JOHN MANGAN, EXECUTIVE VICE PRESIDENT,
KILLEEN SAVINGS & LOAN ASSOCIATION, KILLEEN, TEX.**

Mr. MANGAN. Thank you, Mr. Chairman. I am John Mangan, executive vice president of Killeen Savings & Loan Association in Killeen, Tex.

Killeen Savings & Loan is a State-chartered capital stock association with assets of approximately \$85 million. We had a certificate of deposit with Penn Square Bank, purchased May 6, 1982. It was our first and only transaction with Penn Square Bank. The deposit was placed through a money broker, First United Fund, Ltd., of Garden City, N.Y. We have used and continue to use brokers for the purpose of placing bank CD's for our liquidity portfolio, placing excess funds for short periods of time until the funds are required for loan fundings.

We also on occasion use brokers to raise funds when the amount needed to fund loans has exceeded our expectations.

Thank you.

The CHAIRMAN. Gentlemen, you have all been burned one way or another. Do you feel, whether you have invested through a broker

¹ Trademark.

or directly, that perhaps we should rethink this whole question of secrecy? There are those who contend that a sophisticated investor, as a result of seeing the Peat Marwick audit report on Penn Square with that footnote, should have been brought up short and taken that as a warning there was something wrong. That is again Monday morning quarterbacking. It wasn't that big a red flag, I wouldn't say. But do you feel that in view of the Comptroller's inability to convince management of Penn Square to set their house in order that there should be an obligation on the Comptroller or the appropriate regulator to inform the public, including yourselves, of the conditions that prevail in a financial institution?

Remember, when answering that question, that would mean that if a credit union is encountering difficulties, that credit union also would be required to disclose, or there would be required to be disclosed by the NCUA to the public, the fact that the particular credit union is encountering difficulties.

Mr. Sayres?

Mr. SAYRES. Mr. Chairman, as I stated in my testimony, I firmly believe that the evaluation of an annual report or a financial statement, not only in the case of Penn Square, is not going to give me the information to make an intelligent decision. And that really scares me. I do believe we do need some information coming out of the Comptroller of the Currency in some manner indicating the condition of that bank.

The CHAIRMAN. That would naturally apply to a credit union, would it not?

Mr. SAYRES. It would apply to any financial institution, yes, sir.

The CHAIRMAN. Mr. Loiacona?

Mr. LOIACONA. No, I don't believe that should happen. I feel insured depositors would take their money out and the bank would soon have to close. I feel that the audit report should have been qualified. I feel that in a case like this where there was apparent fraud and many irregularities, that the Comptroller of the Currency or FDIC, whoever has the responsibility, should have prohibited the bank in this situation from taking uninsured deposits.

The CHAIRMAN. If that is the case, that is fine and dandy. But that in essence says to the public at large—

Mr. LOIACONA. Excuse me.

The CHAIRMAN [continuing]. That there is something wrong.

Mr. LOIACONA. Excuse me. I meant to say from soliciting uninsured deposits. No one would know that they couldn't—in other words, allow them to take them but not solicit them.

The CHAIRMAN. Just think that one out, sir. They are soliciting until January 1 through brokers, through various and devious means. You don't think that that news that has been about the marketplace—in other words, if Bayer Aspirin stops advertising today, do you mean to tell me that people aren't going to keep buying Bayer Aspirin for another 2 years? Of course they are.

Mr. LOIACONA. Irregularities occurred over 2 years ago. If they had stopped them from soliciting uninsured funds, no one would be in this position today.

The CHAIRMAN. Mr. Arnold?

Mr. ARNOLD. I was fortunate enough to hear the testimony yesterday, and listened very carefully to what the bankers had to say

regarding this subject. I am not sure that I have come up with a conclusion myself on that. Mr. Chairman, I have thought about it, and there are pros and cons to both sides, the depositor's as well as the lender's side. And I have not made a judgment or come to a conclusion in my own mind about the pluses and minuses of that.

The CHAIRMAN. Mr. Arnold, you are from the great State of Texas.

Mr. ARNOLD. Yes, sir.

The CHAIRMAN. Do you remember the Sharpstown failure?

Mr. ARNOLD. Yes, sir.

The CHAIRMAN. There again, that bank was in difficulty for a long, protracted period of time. A lot of credit unions got burned badly in that one. Do you recall that?

Mr. ARNOLD. Yes, sir.

The CHAIRMAN. Yes, sir. And that was 1973, 1974. At least 8, 9 years ago.

Mr. ARNOLD. Yes, sir.

The CHAIRMAN. And the same situation, with some variations, naturally, but essentially, the pain, the suffering, the hurt, the losses were the same there. People at Sharpstown weren't as slick as the people at Penn Square. But the depositors that got hurt were the same type: credit unions, the small banks, and individuals. Because back then the deposit insurance coverage was not as high as it is today.

Mr. Mangan?

Mr. MANGAN. I believe that there should be some regulatory controls to insure that questionable loans are accurately reflected in the bank's net worth. It is my understanding that many of the loans that had gone bad in the failure could have been charged off as losses quite some time before they finally were. And if they were accurately reflected, either by actual chargeoff to loss or by reserves against losses, then credit unions and savings and loans could have made a more accurate diagnosis of their financial statements.

The CHAIRMAN. You haven't answered the question. The question is, Should there be disclosure when financial institutions are issued a cease-and-desist order or are forced to take certain steps or are told to take certain steps so the public at large is warned that that institution does have difficulty and that unless it complies with the requirements of the regulatory agency, it might well fail or be merged or shut down?

Mr. MANGAN. If that is the case, yes, I think that there should be disclosure. I do believe that in my earlier statement of accurate reflection of possible losses and net worth that would in fact be—

The CHAIRMAN. A type of disclosure. Yes.

Gentlemen, some people have said to me that one of the reasons that a lot of credit unions, as well as S&L's, were hurt so badly by Penn Square is the fact that during the period of time that this occurred you, as managers, had a great deal of money with no place to put it, because your credit union membership was not borrowing, not purchasing cars, not taking out mortgages because of the high rates.

As a result thereof, you had money lying dormant and you had to place it so it would work for you. Was that indeed the case?

Mr. Sayres?

Mr. SAYRES. Absolutely.

The CHAIRMAN. Mr. Loiacona?

Mr. LOIACONA. Yes, sir.

The CHAIRMAN. Mr. Arnold?

Mr. ARNOLD. No, sir. There were places to put it if not out in loans, sir. The loan demand was not sufficient to absorb all the deposits but there were alternative places to place it.

The CHAIRMAN. You had to place it, other than lending it to your membership you had to place it?

Mr. ARNOLD. Yes, sir; that is correct.

The CHAIRMAN. Because your loan demand had gone down very low.

Mr. ARNOLD. Yes.

The CHAIRMAN. Mr. Mangan?

Mr. MANGAN. In our case the reason we placed funds in a bank was that our liquidity requirements state that certain investments qualify for liquidity in maintaining our requirement. Normally if we have excess funds because of higher rates, we will place money in savings and loan associations. In this case, since we needed an investment to qualify for liquidity, it was placed in the bank.

The CHAIRMAN. In the submissions you gave us, Mr. Sayres, there is "Another Caution for Credit Union Investors," reprinted from statement mailing, February 1982. In that one it says:

How do you assure the quality of your investment purchases? By doing your homework. For each institution you entrust with your credit union's funds, you should know (by your own investigation): the institution's present financial condition, recent trends in the institution's condition and performance.

Then "use of assets." Under "use of assets" it says:

The institution's use of assets is extremely important—and typically not to be found on the statements. Is the institution locked into low yielding assets and/or investing in high risk assets with which it has no experience? Find out!

Mr. Sayres, over the years I have always felt, even before I came on this committee, and came to the Congress, that investing in drilling, exploration, in other words, oil and gas ventures, was like going to Las Vegas. That is, people make fortunes but lose fortunes overnight. It is not an exact science. At least I have never found it to be. Perhaps the reason the tax shelters are so generous in this area is because of the potential for loss.

That being the case, were you aware of the high percentage of Penn Square business that was almost entirely energy related?

Mr. SAYRES. No, Mr. Chairman. I now believe 80 percent of their loans was in that area compared to, let's say, the other banks in the community, around 20 percent. So I was not aware of that loan portfolio, the makeup of the portfolio. But I was aware that they were heavily into energy, in oil and gas, yes.

The CHAIRMAN. Mr. Sayres, you yourself just submitted this for us as dated February 1982, right? This caution for credit union investors. That accompanies your statement?

Mr. SAYRES. Yes.

The CHAIRMAN. These cautions, wouldn't they say to you that you should have looked at the composition of Penn Square's invest-

ments prior to purchasing CD's, or investing that much in Penn Square?

Mr. SAYRES. I don't believe it was possible, Mr. Chairman, for me to make that investigation at that time. I don't believe, as I stated in the testimony, that there was sufficient information available to me to evaluate that part of the annual report.

The CHAIRMAN. Well, if you don't know how deep the water is and if you don't know how to swim, should you go into the water and take a chance on drowning just to cool off?

Mr. SAYRES. Mr. Chairman, I would believe, if I was really going to do the investigation that most institutions do today, the relationship to the net worth average assets or the return on the average assets, or the net worth of the banks, I would believe most managers today, whether they work for a credit union or bank, that is the only thing that they can do when they evaluate an annual report or financial statement. To look at a loan portfolio on a financial statement that does not even indicate income, I feel it is impossible to do that at that time.

The CHAIRMAN. Mr. Minish?

Mr. MINISH. Thank you, Mr. Chairman.

Mr. Sayres, on page 3 at the top you say just prior to our involvement with Penn Square Bank the latter part of 1981 we were scaling down our investments in savings and loan associations because of their widely publicized instability and were attempting to diversify our investment portfolio. What was the return to the credit union on your savings and loan deposits?

Mr. SAYRES. Depending on when and where the deposits were made.

Mr. MINISH. Generally.

Mr. SAYRES. Generally I would say 2 percent higher than we were able to receive on the east coast if it was made in California.

Mr. MINISH. Two percent higher than what, 10 percent, 11 percent?

Mr. SAYRES. Again around that time I would say the rate was probably 15, 16 percent.

Mr. MINISH. Fifteen, sixteen percent?

Mr. SAYRES. Yes.

Mr. MINISH. And the total deposits were insured?

Mr. SAYRES. No. Only insured up to \$100,000.

Mr. MINISH. I understand. Then you went from there on the advice of PAM to invest in Penn Square.

And you have here on page 4 one update you received, one of which was Penn Square Bank. That mailing included a report indicating Penn Square had increases from May 31, 1980 to May 31, 1981, of 89 percent in total assets, 68 percent in earnings assets, 88 percent in deposits and 148 percent in capital with a net income increase of 65 percent. And this—and Penn Square became a problem bank almost the beginning of 1980. It was in 1980 that the OCC supervision revealed that there was rapid and uncontrolled growth.

In June 1980 they further identified the major problem, directed the board to, within 5 days, convene a special meeting to review the report and take remedial action. Weren't you aware of that?

Mr. SAYRES. No, sir.

Mr. MINISH. So you relied purely on PAM's mailings?

Mr. SAYRES. And my annual report and financial statements, yes.

Mr. MINISH. Annual report and financial statement of whom?

Mr. SAYRES. The first investment with Penn Square was made December 1981. Information provided by PAM which was much earlier was on a lot of other banks. And we weren't in with Penn Square at that time.

Mr. MINISH. I am aware of that. But at the time PAM was issuing this glowing report about Penn Square, they were already a problem bank.

Mr. SAYRES. I realize that now, sir.

Mr. MINISH. Thank you. That is all.

The CHAIRMAN. Mr. Weber?

Mr. WEBER. Mr. Sayres, at what rate of interest were you investing in Penn Square?

Mr. SAYRES. The first investment made on December the 4th, 1981 was for \$500,000 for 60 days at 13 percent.

Mr. WEBER. What I am interested in is what—that was at 13 percent?

Mr. SAYRES. Yes.

Mr. WEBER. What relationship does that bear to the general market rate of interest?

Mr. SAYRES. At that time I believe that there was a rate higher with a California bank at 13.75 percent. Because we didn't have the information available for us to make the decision or we had not had any report from PAM, we went with the lower rate, 13 percent.

Mr. WEBER. How much above the rate that other banks—do you have figures you can give us on representative interest rates from other banks around the country?

Mr. SAYRES. Yes, I do. I have in the addendum the complete activity of the investments made with Penn Square from the time of the initial deposit through June 1982.

Mr. WEBER. What does that show?

Mr. SAYRES. As an example, January 21, 1982, we deposited \$500,000 with Penn Square for 148 days at a rate of 14.5 percent. Other rates at that time, with the six quotes that were received that day, some with local banks in our area, and some in the State of California, the 14.5 percent received from Penn Square was approximately 1 to 1½ percent higher than could be received anywhere else.

Mr. WEBER. Did that indicate any type of a red flag to you, any type of inquiry, dictate any type of inquiry as to why this bank would be in a position to be paying 1½ percent above what most other banks were paying?

Mr. SAYRES. Not really at that time, because, as an example, the savings and loans in the State of California, of course, are always higher because of their interest rates being higher. I at that time wasn't really aware of what the interest rates were in the State of Oklahoma and I did realize, however, that with their loan volume and assets increasing as they had that they must be putting out everything in loans and that they had that demand for money.

Mr. WEBER. Let me shift the line of questioning a little bit. To what extent did you rely on Professional Asset Management to make up your mind as to this investment?

Mr. SAYRES. Basically the information was handy. The information made my job, let's say, easier in not having to go through the normal calculations, even though we do before a decision is made. PAM is basically an investment adviser and not our broker. Therefore the decision and figures we come up with basically have to be ours.

Mr. WEBER. Your testimony says that there were indications that PAM monitored all the trend areas carefully, 5-year trend analysis on key operating figures and so forth. What indications were there that they were providing those types of investment analyses?

Mr. SAYRES. I was able to, Mr. Congressman, verify from the information on hand with the financial statements received from Penn Square, and the annual report, I was able to determine as an example as of June 30, 1981, that Penn Square's net worth to assets was 9.40, compared to savings and loans in a peer group at that time, which were at 6.6 and Federal Reserve member banks under the same peer group arrangements would probably be 7.04.

Mr. WEBER. I think maybe you are misunderstanding my question. My question was, What indications were there that Professional Asset Management had in fact performed these services? Did they ever—

Mr. SAYRES. They provided a capital adequacy report, as I indicated, probably listing 15 to 20 banks that they had approved as strong banks, good indicators. By indicators I mean good ratios. There was an analysis done because the ratios were there and they were accurate.

Mr. WEBER. I will yield back the balance of my time.

The CHAIRMAN. Mr. Annunzio?

Mr. ANNUNZIO. Thank you, Mr. Chairman. You know, Mr. Chairman, since my first meeting in Oklahoma City at the hearings, I just had a feeling at the hearings that this is probably the biggest snow job ever perpetuated in the country. You know we have had all kinds of swindles, millions and millions of dollars. But here are people responsible for the moneys of other people that put in trust deposits. These people in Oklahoma City, Jennings and the rest of that crowd, they were super con artists. We are not talking hundreds of millions of dollars. We are talking billions of dollars that they were able to con, not only you people representing the credit unions who are not as sophisticated as other bankers with years and years of experience and sophistication. They were also sucked in.

The thing that disturbs me the most is that in 1980 there was an agreement with the Comptroller of the Currency to prevent them from doing certain actions, you know, like a cease-and-desist order, Mr. Chairman. It wasn't exactly a cease-and-desist order, it was an agreement they had with the Comptroller of the Currency, wasn't it?

The CHAIRMAN. That is correct. I would say to the gentleman—

Mr. ANNUNZIO. And here you people in 1982, 2 years later, you represent credit unions—and I have been a long-time supporter of credit unions—2 years later, in one of your statements, Mr. Sayres,

reached a total of \$3 million. I mean you wonder what was going on.

The CHAIRMAN. The thing that disturbs me is that these people don't want to know. They don't want to know in the future about the fact that the Comptroller's letter of agreement was there. They don't want to know. They want to be taken again in the future. They were taken at Sharpstown, they were taken here, they want to be taken again.

Mr. ANNUNZIO. That is what I am getting at. I want to know. Listen, I have been on this committee 18 years. I am one of the original sponsors of truth in lending. I am chairman of the Subcommittee on Consumer Affairs and Coinage. I believe in full disclosures. In the United States of America today, on any loan, any banker that has been here before us will tell you, they have full disclosures on any loan. It is the people's right to know. You know I am getting sick and tired of being a Congressman, and I am the only one that has to undress in public. It is about time that I get some company.

Mr. BARNARD. It is cold outside.

Mr. ANNUNZIO. It's pretty damn cold by yourself, that is right. Especially when you come from the Windy City. I am going on here.

Here is your statement. And I want you to know that this was a snow job and con artists. We are in the year of 1982 and I don't want to go back in history to all the swindles in this country, but they don't teach you anything because of one word: greed. How much more can I make someplace else? That is all it is. The heck it is; nothing else.

Somebody pays me 10 percent, but this guy is going to give me 14 percent for 180 days. Let's grab that 14 percent. But I hope, I don't think we have learned our lesson. I won't be here 10 years from now, but there will be another guy, another genius around that will take in all the others, another con artist. We have had them all throughout the history of the world. You say here, personally I can't help but feel that the Federal agencies were remiss in allowing this bank to perform business as usual when other indicators available to them showed that it was in trouble.

Now understand that the Office of the Comptroller of the Currency warned Penn Square as early as 1980 that the bank lacked sufficient capital and liquidity, had loan problems and had violated banking laws. And in June 1981, the Fed examiners uncovered \$40 to \$50 million in loan losses, enough to wipe out the bank's capital and render it insolvent.

You ask why was Penn Square permitted to continue to perpetuate its problems with funds attracted from institutions like the IBM Poughkeepsie Employees Federal Credit Union. You go on to say I believe the system that allowed this to happen needs some improvement. I could go on and read the rest.

I want to stop with the system, our system needs improvement. Every time a dozen people are killed on the highways, we have to strengthen the drunken driving laws and put everybody in jail. We wait for a disaster to happen before we move, you know. Now we have a disaster here. The Justice Department is looking into all the

aspects of conspiracy and snow jobs and whatever else these people did in violation of banking laws.

That is not the prerogative of this committee. The prerogative of this committee is to get all the facts out on the table so that we can have one more law. One more law. Every time I talk to bankers, I talk to independent bankers, commercial bankers, S&L people, credit union people. Too much regulation. Well God forbid we didn't have all this regulation. And you entrusted with the people's money. What the hell, it would sure be a waste. Got to have regulations.

I ask you, Sayres, Loiacona, Arnold, and Mangan, each one of you has an opportunity to answer this question.

Now you know what happened to you. You know how you got sucked in. You know how you were taken. And you were taken. The responsibility, somebody might not put it on your shoulder, but I am going to put it on your shoulder.

When you tell me you don't want disclosure, well then, if you don't want disclosure and you want to remain a top officer in your credit union and you want that responsibility, you better help find out where you put your money because it is not your money. Now, Sayres, you are in my shoes now. You advise me. I want to correct this thing.

Mr. SAYRES. Mr. Congressman, first I believe maybe there should be some correction to my statement when the question was asked by the chairperson. I do believe we need some disclosures. It indicates that in my testimony. I am certainly not shirking my responsibility to say that I did not make that investment of \$3 million. I made it. I am responsible for it.

And, yes, I was taken by somebody. I really don't know who that somebody is right now. But I do believe that in the future in order to be protected that I don't make the same mistake, what is in my testimony is only my personal opinion as to what I believe should be done. I may not be qualified any further to make any further recommendations.

Mr. ANNUNZIO. Mr. Loiacona.

Mr. LOIACONA. I would like to back up a little bit also. My answer on disclosure, I feel that there should be more disclosure, but through the auditing firm. I think if they are violating rules and regulations from the Comptroller of the Currency, there shouldn't be disclosure. They should be closed. You asked for recommendations? All right. First of all, I think there is a problem with the brokers. With the commission being paid from the other side, from the people receiving the money, I think there is a problem as, you know, who is the broker's client.

Second, when I was dealing with the larger brokerage firms and I assumed they were registered with the SEC.

Mr. ANNUNZIO. What kind of brokers for the record so we spell it out?

Mr. LOIACONA. Well, First United and Professional Asset Management.

Mr. ANNUNZIO. You call them brokers, but I think the record should show you are talking about money brokers.

Mr. LOIACONA. The problem is there is no responsibility without being regulated.

Mr. ANNUNZIO. These are not stock brokers you are talking about, are they?

Mr. LOIACONA. Well, I thought they would probably be registered with the SEC. Now I understand—

Mr. ANNUNZIO. You are talking about the money brokers.

Mr. LOIACONA. Right.

Mr. ANNUNZIO. I want to identify them. There are all kinds of brokers. I want to pinpoint it.

Mr. LOIACONA. Well, the point is that if they were registered with the SEC, there would be a "know your client" rule that they would have to abide by. As far as the insurance, I think that there is a requirement as far as theft and embezzlement insurance for most financial institutions, but little or no requirement for a fidelity bond.

Penn Square in this case I understand had a \$5 million directors and officers and employee bond which is about 1 percent of their assets. I feel that there should be a minimum of 10 percent. In this case, it would be \$45 million.

Accountability, I hope that CPA firms can be held accountable for what they say in their opinion. I feel in this case, there should have been a qualified report. I feel the CPA firms should also be responsible for asking or commenting on the quality of the risk assets, and any excessive concentrations of assets, their source of liabilities, and average maturity of the various liabilities. That way, if they had an awful lot of 30-day CD's that they had to keep rolling over, you would know about it.

As far as the supervising Government agencies, as I said before I feel that if the Government agencies are not going to close the institutions down when there are serious violations or irregularities, they should at least stop them from soliciting uninsured deposits. I think that is obvious. I think the deposit insurance should be increased to a minimum of \$200,000 and probably to \$500,000. And I think that this should be, if it is not feasible to do this across the board, then it should be an optional coverage that the savings and loans or banks can take with the insurance company for an additional premium.

Also I feel that by merging savings and loans and banks that the FDIC and FSLIC are giving an implied guarantee to deposits. I feel that it should be cut and dried. Either you are insured over \$100,000 or you are not. They shouldn't have that discretion to decide we are going to merge this savings and loan, we are not going to merge the others, because they are luring people into large deposits.

There have been a lot of mergers lately with very few losses. I think if they put everybody on notice that whether they merged it or not that they were going to take losses, that we wouldn't have been so gullible to rely on the insurance companies or insurance agencies, and probably the auditing report.

[The following supplemental statement was submitted by Mr. Loiacona for inclusion in the record:]

I am not saying that the FDIC or FSLIC should not merge banks or savings and loans that are in trouble. But that the large depositors should either be insured or not insured. The insurance should not depend on any decision of the insuring agencies. The insuring agencies usually take losses when they merge a financial institu-

tion. If uninsured depositors must share the loss of a closed institution they should have to share the loss of an institution that is merged.

It might be that a better solution would be for the insuring agencies to take half of the loss for uninsured deposits whether it is closed or merged. This would give large depositors some sense of security and reduce the inequity of the current system. I believe it would even save the FDIC and FSLIC money in the long run.

Mr. BARNARD. Would the gentleman yield at that point?

Mr. ANNUNZIO. Oh, yes.

Mr. BARNARD. Mr. Loiacona, are you indicating that you haven't heard about banks failing all over the country and that savings and loans have failed without being merged?

The CHAIRMAN. Did you hear about Economy?

Mr. LOIACONA. I heard about Economy.

Mr. BARNARD. It seems to me that you would be on notice that the FSLIC and FDIC hadn't bailed out every situation that had come about. In fact, we had to pass a bill this year to make it easier for them to merge failing thrifts and failing banks, mainly because of the number of similar problems. I think it would be self-evident that banks are in the area of private enterprise. Just like any other business.

And they are subject to failure as much as anybody else.

The CHAIRMAN. If the gentleman would yield, there is no obligation on the part of the regulatory agencies within the statutes to arrange a merger. You have been on notice from time immemorial, since the FDIC insurance came into being, and FSLIC insurance came into being, that there was a limitation on the amount of insurance.

Did you ever hear of Sharpstown and its failure?

Mr. LOIACONA. No.

The CHAIRMAN. No.

Mr. LOIACONA. Well, what I am saying—

The CHAIRMAN. The point, sir, is to say—

Mr. ANNUNZIO. If the witness would withhold for a minute, you talk about increasing deposit insurance. When I came to Congress it was \$25,000, \$50,000, \$100,000, you are now talking about \$200,000. You were suggested in by a money broker. Somebody must have sold you a bill of goods.

How do you feel about insurance? For instance, after listening to some of these money brokers, any institution that takes a deposit brought in by a money broker is not insured by the Government.

How do you feel about that? No insurance. That will stop the money brokers from selling a con job. How do you feel about that?

Mr. LOIACONA. Well, that is a possible solution.

Mr. ANNUNZIO. It is a possible solution. OK?

Mr. Arnold, will you go ahead and answer the question? I want to give somebody else the time.

How would you go about correcting this situation?

Mr. ARNOLD. Congressman, the question that I am asking myself under these circumstances is the degree of disclosure and specificity of that disclosure. Obviously there currently exist in the law certain disclosure statements now that are made and are available to the public. To go beyond that I do not know to what extent we are speaking of.

And I am sorry. As I indicated earlier, I just have not given it the consideration on the specificity of what type of disclosure—

Mr. ANNUNZIO. Well, you think about it and you write a statement to this committee, and Mr. Chairman, I ask unanimous consent that that statement be put into the record.

Mr. ARNOLD. Yes, sir.

Mr. ANNUNZIO. You can write.

Mr. ARNOLD. Yes, sir.

Mr. ANNUNZIO. We are going to study this part carefully.

Mr. ARNOLD. Yes, sir.

Mr. BARNARD. Would the gentleman yield?

Mr. ANNUNZIO. I have made a unanimous consent request that this statement be put into the record to my answer on disclosure.

The CHAIRMAN. Without objection.

[At the request of Congressman Annunzio, the following additional information was submitted by Mr. Arnold for inclusion in the record:]

RESPONSE RECEIVED FROM MR. ARNOLD

In order for the depositor or investor to more clearly evaluate the strength of a bank with which they may do business, the following additional information would be helpful.

Types of commercial loans by broad categories.

Delinquency schedule of loans.

Number and dollars of non-performing loans, to be charged to reserve.

Institutional deposits over 100,000.00.

Full disclosure of sources of new capital (if outside or internal and whether or not bank financed the capital).

Mr. ANNUNZIO. I will yield to my good, good friend—

The CHAIRMAN. I think the gentleman's time has expired.

Mr. ANNUNZIO. All right then, Mr. Mangan, finish the question.

Mr. MANGAN. I believe that the degree of disclosure of course should be based on the degree of severity of violations that we are talking about. In the case of serious violations, certainly there should be disclosure.

Minor violations that don't affect the financial stability of an institution I think could probably be handled without disclosure with an agreement or a cease-and-desist order, something like that.

Any problem that affects the financial position of the institution should be accurately reflected in a net worth position so that an investor can look at a financial statement and, if he sees what appears to be a strong net worth, then he should be able to conclude that by regulations, by the reporting required by regulations and authorities and by the auditors of the institution, that he is looking at a realistic financial position. Our deposit placed with Penn Square was based on information relayed to us by a money broker, in this case First United Fund, and was not based on any opinion by them but based merely on the numbers on those financial statements.

Mr. MINISH. Mr. Sayres, when Mr. Annunzio asked you if you don't know who to blame, if you don't know I will tell you, in your case it is Professional Asset Management. They are the ones who misled you.

How come you say you don't know?

Mr. SAYRES. Mr. Congressman, I don't believe I said that I didn't know how I got involved.

Mr. MINISH. You said you didn't know who to blame.

Mr. SAYRES. I said at this time.

Mr. MINISH. Don't you know PAM, they are the ones that sold you the bill of goods.

Mr. SAYRES. I am fully aware of that.

Mr. MINISH. Thank you.

The CHAIRMAN. Mr. Vento.

Mr. VENTO. Mr. Chairman, thank you. I will be brief.

I appreciate the fact that—

The CHAIRMAN. Take your time.

Mr. VENTO. That they have been selected for—

The CHAIRMAN. At random.

Mr. VENTO. At random for review here and that probably there are a lot of other companies with regards to the Penn Square problem. We all empathize but we are all concerned about the direction. I think most of us were startled by the fact that so many credit unions specifically had been involved in this investment. I think it points out a real deficiency in terms of your ability to qualitatively look at the types of investments you are making.

I note that for instance the IBM manager here had \$2.9 million uninsured in Penn Square, Bolling Air Force Base, \$900,000. The Southwest Credit Union apparently \$4.9 million. And the other \$400,000 of uninsured assets.

Do you normally have that much invested in uninsured investment, Mr. Arnold?

Mr. ARNOLD. Yes, sir.

Mr. VENTO. What percentage of your portfolio, almost all of it or what?

Mr. ARNOLD. Almost all of it.

Mr. VENTO. Is uninsured?

Mr. ARNOLD. Yes, sir.

Mr. VENTO. You relied on what type evaluation? I know Mr. Sayres gave us the formal statement. Did you all participate in the statement or do you all agree with it?

Mr. ARNOLD. No, sir. You mean Mr. Sayres' statement? I did not participate in Mr. Sayres' statement.

Mr. VENTO. He points out, maybe he would like to answer it, and I would like you to answer it, in evaluating any prospective investment our practice is to request the institution to look at the most recent annual report, financial statement, review various ratios, the increase or decrease in net worth, net income, deposits, assets, reserve position. Those are some specific indices that you look at. Would you have a similar checklist of things that you would look at when you invest in these uninsured types of investments, Mr. Arnold?

Mr. ARNOLD. Yes, sir. In my statement I indicated that there were two basic things that we use. One is the audit report on that financial institution. The second item we use is the Chase Manhattan Bankroll report that does the work we utilize.

Mr. VENTO. What do you pay the Chase Manhattan group for that particular service, Mr. Arnold?

Mr. ARNOLD. This is a data processing report that we pay \$25 per report per institution each time we order it.

Mr. VENTO. Did you have such a report on Penn Square?

Mr. ARNOLD. Yes, sir.

Mr. VENTO. That is principally what you relied on as well as the audit report?

Mr. ARNOLD. Those two specific items, yes, sir.

Mr. VENTO. Do you have any reason to believe today that those reports misrepresented or were fraudulent in terms of the analysis that they presented to you?

Mr. ARNOLD. The——

Mr. VENTO. Your personal opinion.

Mr. ARNOLD. The most recent reports that we had are—available to us was the data as of December 31, 1981. It appears from the report that the trends were sufficiently, I think sufficiently sound as far as the December 31 statements were concerned. When we read the Peat, Marwick, Mitchell & Co. report, the area of the statement regarding the previous qualification of the 1980 statements and said that that had been cleared up now, and that the areas in which the—there was concern had been cleared. And there was no further concern by either the regulatory——

Mr. VENTO. Of course what I asked you is whether or not you had any reason to believe that those reports were false.

Mr. ARNOLD. No, sir, I do not.

Mr. VENTO. Or inaccurate.

Mr. ARNOLD. No, sir.

Mr. VENTO. Today do you? You didn't at the time but do you today?

Mr. ARNOLD. I have no reason to believe they were inaccurate at that time.

Mr. VENTO. In other words, you invested on reports made up in December of 1981. What was the most recent investment made in Penn Square based on those December of 1981 reports?

Mr. ARNOLD. April 27 was our first investment.

Mr. VENTO. That was your first investment, 4 months after the reports?

Mr. ARNOLD. Yes, sir, the reports were—that is correct.

Mr. VENTO. In other words, you made no investment until 4 months after the report. Did you do any further checking at that point along the lines of Mr. Sayres, the financial statement, review of ratios, so forth. What else did you rely upon?

Mr. ARNOLD. Basically just these two reliable sources of information as we——

Mr. VENTO. Well, reliable sources. What liability do they assume in terms of the \$4.9 million uninsured investment that you made? In other words, what cause do you have or what damage do you have against those two reports made in December of 1981?

Mr. ARNOLD. We are looking into that now to see if there are any further actions that can be taken in that regard.

Mr. VENTO. You made no further review to determine anything else? Who was it that sold you on this particular investment? Did you have a sales task force there working on you as well, Mr. Arnold?

Mr. ARNOLD. No, sir.

Mr. VENTO. You had none at all. You did this all on your own? No one recommended that you buy these particular assets or this investment in Penn Square?

Mr. ARNOLD. I do not know of any specific recommendations made by anyone. I have a staff of credit analysts that are on the phone and on a daily basis that are talking to people from throughout the country about investments and investment opportunities. From that standpoint, Penn Square was one of the names that came up in some conversation.

We were in the process of diversifying our portfolio into regional banks at that time. We were heavily concentrated in the money center banks. We were diversifying and in the process of that diversification Penn Square's name came up.

Mr. VENTO. Do you have any assets in financial institutions of similar size as Penn Square as much, say \$4.9 million is what you had, do you have a similar amount of assets in banks? I mean I suppose in Citibank and some of the others, Chemical Bank, you probably have some very large investments on draw.

Mr. ARNOLD. Yes, sir.

Mr. VENTO. But do you have similar types of instruments in other banks like Penn Square? Do you believe you do?

Mr. ARNOLD. At that time, we had some similar type investment in some regional banks that—

Mr. VENTO. Similar instruments?

Mr. ARNOLD. Yes, sir, CD's. Probably about three or four.

Mr. VENTO. And the size?

Mr. ARNOLD. Only one other or two about that size. Approximately two or three others.

Mr. VENTO. I think we would like more specific information, Mr. Arnold.

Mr. ARNOLD. I will be glad to provide it.

[At the request of Congressman Vento, the following additional information was submitted by Mr. Arnold for inclusion in the record:]

RESPONSE RECEIVED FROM MR. ARNOLD

[In millions]

Bank name	Asset size	Amount invested
Fidelity Bank, Oklahoma City	\$679	\$4.5
First City Bank, Dallas	607	2.0
National Bank of Commerce, Fort Worth	523	6.0
Abilene National Bank, Abilene	406	4.0

Mr. VENTO. We appreciate that.

Mr. Sayres, with respect to your evaluation of this prospective investment, did you use the indices you have at the bottom of page 2 and top of page 3?

Mr. SAYRES. Yes, sir.

Mr. VENTO. You utilized those?

Mr. SAYRES. Utilized them ourselves. We were able to compare PAM's indicators, analysis, ratios.

Mr. VENTO. What do you pay for PAM's service, Mr. Sayres?

Mr. SAYRES. We don't pay PAM, sir.

Mr. VENTO. You don't pay them. In other words, they just distributed this free; is that right?

Mr. SAYRES. They are just an investment adviser to us.

Mr. VENTO. That is a fancy name for their being out and selling these particular CD's; is that right?

I mean in other words, they advise you but they really are not representing you. What liability do they have in terms of, or responsibility do they have in this particular case?

Mr. SAYRES. None.

Mr. VENTO. Their advice includes entertainment, speaking engagements, inviting you to various activities, is that right, to try and get across their message, is that an accurate description?

Mr. SAYRES. That is very possible, yes.

Mr. VENTO. Well, I mean you have that attached to your testimony here that they invited you to various luncheons and activities and to hear notable speakers, so forth and so on. I mean is that an assumption, that is part of your testimony?

Mr. SAYRES. That is a fact.

Mr. VENTO. I am not trying to impugn your judgment, just to make sure we understand one another. In other words, you might expect that there could be some credibility if they quote a figure, it might be out of some audit report. But as far as what they are up to, they are trying to sell these CD's for these customers, are they not?

Mr. SAYRES. That is right, they are, yes, sir.

Mr. VENTO. So you know when you are dealing with an institution or money broker like that you have to be careful, don't you?

Mr. SAYRES. Absolutely.

Mr. VENTO. What precautionary steps did you take to protect the considerable purchase of CD's in Penn Square and would you take to protect the considerable investment of CD's in other institutions like this?

Mr. SAYRES. As stated, Mr. Congressman, we did our own evaluation of Penn Square. Evaluated the annual reports and financial statements we had on hand. We did not rely on the information provided by PAM.

Mr. VENTO. Is there anything in writing on that? Do you have a written report, \$2.9 million investment in Penn Square, obviously, you singled this institution out to invest considerable assets in.

Mr. SAYRES. Yes.

Mr. VENTO. In other words, did you have similar investments in other institutions and banks, similar types of instruments, of this size?

Mr. SAYRES. Yes, we did.

Mr. VENTO. And do you have today?

Mr. SAYRES. Yes.

Mr. VENTO. The point is did you formalize this evaluation in any written form?

Mr. SAYRES. We normally go through at least five to six bids any time we have money to invest on any day.

Mr. VENTO. Do you have any reason to believe that the information you received was falsified?

Mr. SAYRES. Not at this time, no, sir.

Mr. VENTO. You do not have reason to believe. Do you suspect it?

Mr. SAYRES. Not at this time, sir, no.

Mr. VENTO. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Gentlemen, how many of you did business with both First United and PAM? Mr. Loiacona, you did both? Mr. Sayres, did you do business, with which one?

Mr. SAYRES. PAM.

Mr. BARNARD. Mr. Arnold?

Mr. ARNOLD. Neither.

Mr. MANGAN. First United.

Mr. BARNARD. I noticed on the letterhead of one of these companies it says "registered investment advisor". What does that mean?

PAM I believe had that. Registered investment advisor.

Mr. SAYRES. Mr. Congressman, I believe it would mean they were registered with the SEC.

Mr. BARNARD. Registered with the SEC?

Mr. SAYRES. Yes.

Mr. BARNARD. What did that really mean to you then?

Mr. SAYRES. Not really that much. The association with the PAM with Mr. Goldsmith, vice president, I had knowledge of Mr. Goldsmith prior to that when he worked for Bache & Co., he had made contacts with the credit union and other IBM credit unions.

Mr. BARNARD. Let me understand how this comes about.

You were on a mailing list, then, from Professional Asset Management, is that it?

Mr. SAYRES. Yes.

Mr. BARNARD. This mailing list included possible investment opportunities?

Mr. SAYRES. Yes, it did.

Mr. BARNARD. Then in making those investments, did you go through PAM or did you go directly to the institution?

Mr. SAYRES. We went directly to the institution.

Mr. BARNARD. And you paid nothing for this service.

Mr. SAYRES. Nothing at all.

Mr. BARNARD. How did the broker, if you want to call him that, how does he get paid for his business?

Mr. SAYRES. I understand he gets paid from the bank.

Mr. BARNARD. From the bank?

Mr. SAYRES. Yes.

Mr. BARNARD. In other words, then, you noticed on his list that this particular bank was paying 2, 3 percentage points more than anybody else. Then on top of that, he was paying a fee.

Mr. SAYRES. Yes, sir.

Mr. BARNARD. That wasn't a red flag to begin with?

Mr. SAYRES. No, sir.

Mr. BARNARD. All right.

Mr. Loiacona, what about you? You don't think that paying above the market price is an indication of how badly a company needs money and so forth?

Mr. LOIACONA. I don't believe we received over the market price.

Mr. BARNARD. In other words, Penn Square was paying about the normal rate?

Mr. LOIACONA. We were receiving 15.6 percent on average for \$100,000 deposits and normally \$1 million would be like a round lot, and the next one would be \$5 million. From \$100,000 to \$1 million is usually half a point higher. We received 16 percent from Penn Square at the time we were receiving 15.6 on \$100,000 investments.

Mr. BARNARD. Mr. Mangan, is First United a registered investment adviser?

Mr. MANGAN. If I recall correctly they have something like that on their letterhead.

Mr. BARNARD. Did that mean anything, that you had more confidence in them than otherwise, or not?

Mr. MANGAN. No, in fact I didn't receive or solicit any actual advice from them other than just naming a bank and a rate and giving me the figures which basically are either mailed to me or read off a financial statement.

Mr. BARNARD. Is not the general practice of credit unions then to ask for statements of condition or financial statements from institutions to which they are loaning money?

Mr. SAYRES. Yes, sir.

Mr. BARNARD. It is?

Mr. SAYRES. Yes.

Mr. BARNARD. What is an illustration, for example, of institutions from which you do ask for a financial statement?

Mr. SAYRES. Any institution we made a deposit with.

Mr. BARNARD. But you didn't ask one of Penn Square.

Mr. SAYRES. Yes, we asked for the financial statement and annual report and received them.

Mr. BARNARD. So what you used then was their audit report?

Mr. SAYRES. Not their audit report, sir. I used their annual report and the financial statements.

Mr. BARNARD. You mean their published annual report?

Mr. SAYRES. The report done by Peat, Marwick, Mitchell & Co. was not received by us at that time.

Mr. BARNARD. There was an auditing firm—Mr. Chairman, do we have copies of the Penn Square published statement?

Mr. HOLLAR. Yes, indeed. We have the—

Mr. BARNARD. No, everybody publishes their statement. They have a publication. This is what you got a copy of.

Mr. SAYRES. Yes.

Mr. BARNARD. What I am trying to determine is if in that published statement there was a letter from the auditor.

Mr. HOLLAR. Yes, I believe there was. We can get a copy for you.

Mr. BARNARD. Therefore, Mr. Sayres, you depended upon that letter in that published financial statement?

Mr. SAYRES. I—

Mr. BARNARD. The public statements banks make are very, very abbreviated. You don't know the quality of the assets. That is not in there. It is strictly just figures, right?

Mr. SAYRES. That is true.

Mr. BARNARD. But do you recall in that public statement there was a letter from an audit?

Mr. SAYRES. There was no statement from the audit firm in the annual report.

Mr. BARNARD. Therefore, you were just using what the bank had sent you?

Mr. SAYRES. That is right.

Mr. BARNARD. No—

Mr. SAYRES. No qualification.

Mr. BARNARD. No qualification or really no indication that it is a true and—

Mr. SAYRES. That is right, yes, sir.

Mr. BARNARD. Mr. Arnold, what about your situation? How far do you go in evaluating institutions?

Mr. ARNOLD. Basically, Congressman, we use the audit report, their last audit report from their auditing firm. And the Chase Bankroll report are two basic elements that we use or, are, if you will, the foundation for our qualitative analysis of those institutions.

Mr. BARNARD. So you actually used the audit report of Penn Square?

Mr. ARNOLD. Yes, sir, that is correct.

Mr. BARNARD. Which one did you use?

Mr. ARNOLD. The one dated December 31, audit as of December 31, 1981, performed by Peat, Marwick, Mitchell & Co.—

Mr. BARNARD. I don't think that is true.

Mr. ARNOLD [continuing]. And dated March 19.

Mr. BARNARD. Peat, Marwick, didn't do one as of 1981. Oh, yes, they did. But you used the Peat, Marwick, Mitchell & Co. audit?

Mr. ARNOLD. Yes, sir, that is correct, and the Bankroll. Those are the two basic analyses we used for—to develop the ratios and—

Mr. BARNARD. You didn't have the previous audit?

Mr. ARNOLD. No, sir, I did not, the 1980 audit.

Mr. BARNARD. Mr. Mangan.

Mr. MANGAN. Yes, sir.

Mr. BARNARD. Did you require any particular financial statements?

Mr. MANGAN. The information given to us was the information from the published financial statements of December 31, 1981, and March 31, 1982.

Mr. BARNARD. Were any of you gentleman at any time contacted by officials of the Penn Square Bank?

Mr. SAYRES. No, sir.

Mr. ARNOLD. Yes, sir.

Mr. BARNARD. Mr. Arnold, you had?

Mr. ARNOLD. Yes, sir, we were.

Mr. BARNARD. How was that relationship developed?

Mr. ARNOLD. As I indicated earlier, as we were diversifying our portfolio into regional banks, smaller, within contiguous States basically, Penn Square's name came up in part of the conversation on data we were collecting and going through.

Contact was made. I am not sure whether they called us or we called them. Contact was made with one of the—a senior vice president of Penn Square requesting their latest audit report. Once that audit report was received, at the same time then, we requested the Bankroll report. And from that point on, following the first investment which we made was April of that year, then the dialog was

between my investment analyst department and the officer of Penn Square Bank.

Mr. BARNARD. Was there any other relationship between your credit union—were any of the officials of Penn Square borrowing money from your credit union?

Mr. ARNOLD. No, sir, never.

Mr. BARNARD. Were any officials of your credit union borrowing any money from them?

Mr. ARNOLD. Not to our knowledge, no, sir.

Mr. BARNARD. What about you other gentlemen, was there any other relationship between your credit unions and—

Mr. LOIACONA. We called at the time the money broker called us with the investment and verified the information. Other than that, I have never talked to them before or since.

Mr. BARNARD. Mr. Mangan.

Mr. MANGAN. No, sir, no other relationship that I know of.

Mr. BARNARD. I would yield to Mr. Hansen.

Mr. HANSEN. Thank you.

I might ask, how are firms such as yours introduced to the institutions into which you arrange investments, gentlemen, whoever?

Mr. SAYRES. I don't understand your question, sir.

Mr. HANSEN. How are firms such as yours introduced to the institutions into which you arrange investments?

Mr. SAYRES. Well, IBM Poughkeepsie, it could be through notification, telephone call from a broker, or it could be the fact that when moneys are on hand to invest, we may call Empire Corporate Central, local banks and any other bank that we have information on that may be interested in receiving the deposits.

Mr. HANSEN. A follow-up to that, and any of you may help shed some light on this. What criteria do you use to determine, then, whether or not an institution is financially safe and sound and what figures do you look at? Do you in addition examine the assets and liability portfolios of these institutions as to safety and soundness?

Mr. SAYRES. Yes, sir, and we also look for the liquidity of the bank and equity of the bank as best as possible with the information on hand.

Mr. HANSEN. How would that have fallen down in this particular instance?

Mr. SAYRES. The ratios were very high in this situation.

Penn Square's indicators indicated that the bank was operating efficiently, growing, and making money.

Mr. HANSEN. I might ask then, when did you first begin looking at the Penn Square Bank and what were the bank's total assets and deposits at this time?

Mr. SAYRES. The first deposit by the IBM Poughkeepsie Employees Federal Credit Union was made December 4, 1981, for \$500,000 at a rate of 13 percent for 60 days. The assets of the Penn Square Bank at that time, according to the annual report, were \$394 million.

Mr. HANSEN. The communication from PAM to you repeatedly was that PAM required rigid criteria from any institution represented to you. Did you find out what those rigid criteria were and did you feel Penn Square met those criteria?

Mr. SAYRES. Yes, especially in the area of reserves, Penn Square appeared extremely high in relation to peer groups and we did check those out.

Mr. HANSEN. You claim now that from the information available to you at the time you were investing in the CD's, you have to conclude there was nothing definitive to point to the coming collapse. The Capital Adequacy Reports you received from PAM showed growth rates from Penn Square Bank, nearly all of which were way above those of its peer group institutions. Didn't this fact perhaps portend coming problems for Penn Square, and would you say now that the data provided you by PAM was insufficient information on which to base an investment decision?

Mr. SAYRES. Did you say, sir, insufficient or sufficient?

Mr. HANSEN. Insufficient information on which to base an investment decision.

Mr. SAYRES. I would have to state today that the information provided by PAM since Penn Square has failed had to be inadequate.

Mr. HANSEN. Where do you see now in hindsight that this may have been corrected?

Mr. SAYRES. I think there was no indicator in regard to the loan portfolio, allowance for loan losses, provisions for loan losses and delinquency.

Mr. HANSEN. Then I might ask when was your last investment of Penn Square? In your statement you state from December 4, 1981, until July 5, 1982, you supplemented with your own information provided you by PAM. What was the nature of this supplemental information?

Mr. SAYRES. It was information gathered from a ratings service with Merrill Lynch and the Empire Corporate Central, which was requesting ratings from U.S. Central. Basically at that time we were not able to get the information from Penn Square Bank.

Mr. HANSEN. On June 18, 1982, when you bought your last CD's from Penn Square, you still didn't have the slightest hint there was something wrong at the bank?

Mr. SAYRES. No, sir. The reserve and equity ratios were still extremely high, much higher than required. As an example of a guideline that I would use there, for a national bank, a commercial bank, the equity would equal at least 5 percent.

In this case it was almost 9 percent.

Mr. HANSEN. I am going to have to go to the vote in a rush, so I am going to ask you gentlemen to stand by for a few moments. I think the Chair will be back shortly. So I appreciate Mr. Sayres' answers to your questions.

Thank you.

[Recess.]

The CHAIRMAN. The meeting will come to order.

Mr. Mangan?

Mr. MANGAN. Yes, sir.

The CHAIRMAN. What was it that encouraged you to invest the amounts of money that you did indeed invest in Penn Square?

Mr. MANGAN. Basically the rate of earnings and the apparent soundness of the bank.

The CHAIRMAN. The rate of earnings. Was the rate of earnings a preferential rate, or a better rate than you saw in other institutions?

Mr. MANGAN. Yes, it was.

The CHAIRMAN. Now, refresh my memory. I am trying to handle a lot of things at the same time here this morning other than what we are doing here. Did you invest independently, or with an adviser?

Mr. MANGAN. We invested the money through First United Fund.

The CHAIRMAN. Now, let me ask you, how does that come about? In other words, are you a regular, would you call yourself a client of First United Fund?

Mr. MANGAN. I suppose so. I don't think we would be classified as a regular client. It is just periodically we do use their services.

The CHAIRMAN. When you have had extra money to invest.

Mr. MANGAN. That is correct. In this case—

The CHAIRMAN. Now did you, or do you invest both with or through First United as well as independently?

Mr. MANGAN. Yes, we do.

The CHAIRMAN. So you go both ways?

Mr. MANGAN. That is correct.

The CHAIRMAN. How did the relationship with First United come about?

Mr. MANGAN. I believe we either received a phone call from them initially or received a package through the mail initially describing their services.

The CHAIRMAN. Had you received similar packages or calls from other brokers?

Mr. MANGAN. Yes, quite a few.

The CHAIRMAN. And what influenced you? I use the word in its true context, nothing derogatory about it, but what influenced you to determine to use First United Fund, or do you use other brokers as well.

Mr. MANGAN. We do use a couple other brokers. First United Fund was one of the first to contact us. I don't recall. It was probably sometime last fall. And we started with them prior to any of the others. So we have been using them since then occasionally.

The CHAIRMAN. OK. Then as to the investment in Penn Square, that was at the recommendation of First United Fund?

Mr. MANGAN. I don't know if I would call it a recommendation. I called them up looking for an investment we could qualify as liquidity, a bank CD. And they quoted me rates at two or three different banks. At that time we decided to place the money with Penn Square because the rate there was higher.

The CHAIRMAN. So it was your choice out of the two or three recommendations. You made the decision and the choice to put the credit union money in Penn Square.

Mr. MANGAN. Savings and loan money, yes.

The CHAIRMAN. OK. When that recommendation was made of two or three institutions, and you made a decision to invest in Penn Square, did First United then send you extensive information about Penn Square, audit reports, annual reports, et cetera?

Mr. MANGAN. They sent us copies of the published financial statements.

The CHAIRMAN. How about the auditor's report?

Mr. MANGAN. No, sir, I did not see an auditor's report.

The CHAIRMAN. Did you ever ask for an auditor's report.

Mr. MANGAN. No, I didn't.

The CHAIRMAN. Do you think you might in the future?

Mr. MANGAN. In the future I don't think we will deposit any more than \$100,000 in any one association.

The CHAIRMAN. That is one way to do it. Once you made that decision to invest in Penn Square, what did First United tell you about the strength of Penn Square? Did they fill you in more thoroughly on Penn Square once you had made that decision, other than send you the published reports?

Mr. MANGAN. No. The decision was based strictly on the numbers on the financial statement. On the apparent strong net worth position of the bank. In our opinion—it was a 90-day deposit, in our opinion the bank with such a strong net worth to asset ratio could not fail in 90 days.

The CHAIRMAN. That plus the rate of interest they were paying?

Mr. MANGAN. That is correct.

The CHAIRMAN. How much higher was it than the rate of other institutions recommended to you by First United?

Mr. MANGAN. The difference was small, I think probably a quarter or a half a percent. In this case they were offering a higher rate for a \$500,000 deposit than the other institutions that were recommended, as I recall, were smaller. We were looking to deposit \$500,000.

The CHAIRMAN. Mr. Arnold?

Mr. ARNOLD. Yes, sir.

The CHAIRMAN. You independently, without, I understand, recommendations from anyone else, you independently made the decision to invest funds of Southwest Corporate in Penn Square?

Mr. ARNOLD. Yes, sir.

The CHAIRMAN. When you make an investment, do you advise the institutions that are part of Southwest Corporate as to where you are investing the funds?

Mr. ARNOLD. Specific financial institutions, no. We do not on a regularly scheduled basis give them copies of our portfolio, if you will.

The CHAIRMAN. So that when you invested in Penn Square you didn't put out a notice that we have invested x number of dollars in Penn Square and that you, as one of the participants in Southwest, should know that part of your funds have been invested in Penn Square?

Mr. ARNOLD. We do not notify the credit unions as to specific investments.

The CHAIRMAN. How long a period of time were you investing in Penn Square?

Mr. ARNOLD. April 27 until its demise.

The CHAIRMAN. April 27, 1982?

Mr. ARNOLD. Yes, sir, 1982.

The CHAIRMAN. So it would not follow, probably, that some of your members might have invested in Penn Square independently as a result of the fact that Southwest had invested?

Mr. ARNOLD. That is correct; they would not because of our——

The CHAIRMAN. I think you realize some of your members did indeed invest——

Mr. ARNOLD. Yes, that is correct.

The CHAIRMAN. We talk about double-dippers here. They were double losers.

Mr. ARNOLD. Yes, sir.

The CHAIRMAN. Do you have a committee, Mr. Arnold, of experts? In view of the fact that yours is probably one of the largest credit unions in the country, could you tell us who makes the decisions as to where the money will be invested on behalf of your clients, so to speak?

Mr. ARNOLD. We have two full-time credit analysts plus a secretary that works in the investment department that does credit analysis on financial institutions. An investment committee that has been appointed by the board of directors, of which one of those that does the financial analysis sits on that investment committee along with myself. A third member of that committee was at the time of this investment, had just left our employment to take employment elsewhere who normally sits on that committee. So we have a three-man committee.

The CHAIRMAN. Tell me, were you aware of or had you seen the audit reports from the independent auditing firms that have been discussed in the hearings in Oklahoma City and again yesterday?

Mr. ARNOLD. We just have a copy of that in our file prior to the time, and have done an analysis on that, as well as the Chase Bankroll which I believe is the call report statistics analyzed and given to us prior to the time of placing any money in any financial institution.

The CHAIRMAN. Did any one of your experts happen to catch the famous footnote?

Mr. ARNOLD. Which one are you speaking of? I am not sure.

The CHAIRMAN. The footnote——

Mr. ARNOLD. Footnote on the financial statement? Footnote No. 4?

The CHAIRMAN. The first audit report was a qualified report. That was by Arthur Young. Subsequently, Peat, Marwick, Mitchell & Co. had a footnote in their report.

Mr. ARNOLD. Yes, sir.

The CHAIRMAN. Did your consultants, economists, whatever you want to call them, bring to your attention the qualifying letter in the Arthur Young report as well as the footnote in the Peat, Marwick, Mitchell & Co. report?

Mr. ARNOLD. We discussed the fact that in the letter of opinion, the opinion letter of Peat, Marwick, Mitchell & Co., there was an indication that the previous audit had been qualified. Based upon the data that we have and that was published in their report along with their footnotes, their cover letter and footnotes, it indicated to us that the problems indicated the previous year that required the qualification of that report had been cleared up as far as all of the parties involved were concerned, the Agency's internal auditors as

well as this, and based upon that we assumed that the error or the cause of the problem had been corrected and that the bank had taken the proper measures to redeem itself or make itself whole in that area.

The CHAIRMAN. Not putting words in your mouth but just listening to that which you have just stated, in essence what you are stating to us is that the Peat, Marwick, Mitchell performance alleviated your apprehensions and satisfied you that things were now going in the right direction at Penn Square.

Mr. ARNOLD. That is correct. Yes, sir.

The CHAIRMAN. So that Peat, Marwick, Mitchell & Co., as far as Southwest is concerned, bears a rather heavy responsibility.

Mr. ARNOLD. Yes, sir.

The CHAIRMAN. Mr. Sayres, did you independently look at these, the Arthur Young and Peat, Marwick, Mitchell & Co., reports?

Mr. SAYRES. I did not look at the Arthur Young report, and the Peat, Marwick, Mitchell & Co., report was not received until March, not issued until March 1982. I believe by that time I had over \$2 million invested in Penn Square already. The note No. 4 in the report which I received after the fact referred to the qualified opinion in regard to allowance for loan losses. It was my understanding that Peat, Marwick, Mitchell & Co., indicated that management of Penn Square had improved on that situation and increased their allowance for loan loss and it was satisfied.

The CHAIRMAN. Therefore did that Peat, Marwick, Mitchell & Co., report serve to placate you, make you feel as though you could sleep better at night?

Mr. SAYRES. Definitely.

The CHAIRMAN. Therefore, would you agree with Mr. Arnold that—

Mr. SAYRES. Yes; I do.

The CHAIRMAN. That they had a responsibility that one might question right now as to how well they had fulfilled that responsibility?

Mr. SAYRES. Yes, sir.

The CHAIRMAN. We are not going to deny you the opportunity to answer the same question, sir.

Mr. LOIACONA?

Mr. LOIACONA. Yes. I believe Peat, Marwick, Mitchell & Co., implied in the sentences after that statement about Arthur Young that the situation had been corrected. Also, in looking at the financial statement, auditors are—one of the things that they are supposed to be doing is to require that there is an adequate allowance for loan losses. And with \$4.7 million in their allowance for loan loss account, I assumed by looking at the statements that this covered all of the possible losses and, you know, bad loans and so forth.

The CHAIRMAN. Did any of you happen to look at the reports that were filed by the First Penn Corp., the parent?

Mr. SAYRES. No, sir.

Mr. LOIACONA. There are some who feel that if the reports filed with the regional Federal Reserve office had been reviewed, that that might have given cause for apprehension.

Mr. MANGAN. No.

The CHAIRMAN. Bill?

Mr. McCOLLUM. I would like to ask one question of these gentlemen. Though I have missed a lot of testimony I have a bottom line type of question I would like each of you to comment on if you could. That is what do you think is the single most important thing that you have learned out of this whole Penn Square incident as far as conducting the affairs that you have in relationship to such institutions as Penn Square in the future? What is the single most important thing you think you have learned out of this?

Mr. Sayres, could you start?

Mr. SAYRES. Congressman, I hesitate on answering that. Basically in my testimony I indicated that I really at this point don't still have the information available to me to make an intelligent decision in regard to Penn Square. Everything I look at today, even with hindsight, I would still have a problem evaluating an annual report or a financial statement of an institution and have confidence that the ratios and figures that I am looking at are going to help me and save me from losing money.

Mr. McCOLLUM. Are you, in essence, saying that this incident makes you more wary, but at the same time you don't feel at this point in time that you have been able to learn something about how to protect yourself better?

Mr. SAYRES. Well, it is definite that I have had to take extra steps as indicated by the D&B report, possibly look into other firms that are offering a rating report to possibly give me more information and make me at least feel that the deposit that I am making is secured.

Mr. McCOLLUM. Mr. Loiacona, what have you learned?

Mr. LOIACONA. Well, I think there are a couple of things here. No. 1, I have always thought that the large bankers knew what they were doing. And it appears that maybe they don't. I am of the opinion now that with the economy in a recession, that a large—any bank could go under just by one of its clients going under. A client goes under, and if it is large enough, and the bank is financing that business, like if a bank is building a large building and they have got all the financing in that, and that building doesn't, or the contractor goes under, it is liable to take the bank with it. With insurance companies, if they are insuring a large amount, they will lay off some of the insurance, split it up between insurance companies.

Second, I have learned that you can't trust the audit reports anymore. We relied on the audit report. We relied on the fact that there is an examination by Federal examiners. I know from our own experience that the NCUA examiners do not let us get away with anything. If they think there is something wrong, they make you correct it. But evidently this is not true with the other financial institutions.

Mr. McCOLLUM. Mr. Arnold, what about yourself?

Mr. ARNOLD. Several things obviously in retrospect, as we look back upon the decision made. I think one thing that it did do was that it validated the policies, however, of our board of directors and the restraints that they have on our investment committee and others. Even though this did occur, I think it could have been a much greater magnitude perhaps had we not had prudent decisions

by our board and constraints upon the investment committee, and therefore, free rein, or whatever. So, I think it did prove and validate that the board has done an excellent job in establishing certain policies and constraints within the investment committee, minimizing potential loss to our members of any single investment or any single loan, if you will, perhaps going under, causing irreparable damage to Southwest Corporate.

Mr. McCOLLUM. So, you have learned your own policies were sound is what you are saying, and that is one?

Mr. ARNOLD. That is one thing. I think it has caused us to change some internal policies insofar as the investment committee is concerned, to go deeper into specifics, not relying on one set of figures or two, but perhaps getting the additional support from another rating agency that is totally independent from anyone else and getting their expertise, advice, on that specific financial institution.

It has caused us to rethink the size of institutions in which we will invest our funds. We have obviously then raised that limit, the deposit size of institutions in which we will place our funds. We probably have moved somewhat away from our regional bank concept back to the major money center banks for primary investments, recognizing that many times the strengths of the national—the large money center banks are great. That if some specific things happen, such as one loan goes bad, there is less possibility of the total bank going under in a large financial institution.

So, those are some of the things basically that we have changed and looked at in retrospect.

Mr. McCOLLUM. Mr. Mangan, what would you say is the single—my time has expired?

The CHAIRMAN. I wonder if the gentleman would be good enough to indulge me.

Mr. McCOLLUM. Certainly.

The CHAIRMAN. I have to go to the Rules Committee.

Mr. McCOLLUM. Absolutely, I yield.

The CHAIRMAN. I would like to ask a few more questions, then Mr. Leach is going to take over and finish the panel.

Mr. McCOLLUM. Thank you. I yield back.

The CHAIRMAN. Thank you kindly.

Mr. Arnold?

Mr. ARNOLD. Yes, sir.

The CHAIRMAN. I just tell you one thing. You say that in rethinking, you are going to larger institutions, concentrating on investing in larger institutions?

Mr. ARNOLD. That is one of the things we looked at and considered.

The CHAIRMAN. Let me give you a little caveat. The fact that they are big doesn't mean that they are all that much better. Did you see the Holt Advisory Service report that came out about 3 weeks ago?

Mr. ARNOLD. No, sir, I did not.

The CHAIRMAN. I commend it to your reading.

Mr. ARNOLD. We shall do so.

The CHAIRMAN. You will find that some of the banks that aren't in such good condition happen to be some of the larger banks in

the Nation, according to their evaluation from the Federal Reserve tapes.

Mr. ARNOLD. The Holder Advisory——

The CHAIRMAN. Holt, H-o-l-t. I am not trying to sell anything, believe me.

Mr. ARNOLD. I understand.

The CHAIRMAN. But you might want to take a look.

Mr. ARNOLD. Yes, sir. Thank you. All the information is appreciated.

The CHAIRMAN. Let's see. Mr. Sayres, just a few questions. Do you use more than one money broker?

Mr. SAYRES. No, sir.

The CHAIRMAN. You use just one?

Mr. SAYRES. Yes, sir.

The CHAIRMAN. How long have you been using PAM?

Mr. SAYRES. Since the early part of 1981.

The CHAIRMAN. How did you happen to come upon them, or how was the relationship established?

Mr. SAYRES. The relationship was established, we knew Mr. Goldsmith before when he worked for another brokerage firm, Bache & Co.

The CHAIRMAN. OK. Did you have a permanent relationship with Mr. Goldsmith, or was it just the fact that he was with Bache & Co.?

Mr. SAYRES. It was a pure business relationship.

The CHAIRMAN. Something just popped in my mind. I go to conventions, on occasion, that have people in the financial community. Every once in a while I would meet people who weren't members of the industry at all. They were always there to buy a drink, provide entertainment, and what have you. I observed this from the sidelines. I later found out they were people from X company handling investments for S&L's and credit unions, et cetera. So, that is a common practice, isn't it?

Mr. SAYRES. That is correct.

The CHAIRMAN. You go to a credit union convention, and if you are a customer of theirs, they have a nice suite, and they say: Come up, bring the wife, have a few drinks and so forth, maybe have a little dinner party for you?

Mr. SAYRES. Yes, sir.

The CHAIRMAN. That relationship, I guess, is a common thing?

Mr. SAYRES. Yes.

The CHAIRMAN. A way of doing business?

Mr. SAYRES. Yes.

The CHAIRMAN. All right. Now, with respect to investing in Penn Square, you heard me discussing with Mr. Mangan, when he said that they were given the names of two or three institutions and they determined they would invest in Penn Square. Could you be a little more specific as to your investment in Penn Square, which was at the recommendation of Professional Asset Management, was it not?

Mr. SAYRES. Yes, sir.

The CHAIRMAN. Did they recommend a number of institutions?

Mr. SAYRES. There were approximately 15 to 20 on the report.

The CHAIRMAN. How many did you invest in?

Mr. SAYRES. It varied, sir. Depending on the amount of money we had to invest it was always our policy that we at least receive five or six bids from other institutions.

The CHAIRMAN. The bids, were they coming from the institutions or through the broker?

Mr. SAYRES. No, this was done by our own office.

The CHAIRMAN. Your own office?

Mr. SAYRES. Yes.

The CHAIRMAN. I thought you invested in Penn Square through the broker.

Mr. SAYRES. The information received was from the broker. Now, we took that information and evaluated it, but also did our own study. Then we went out and called various institutions for other bids. Then we compared those bids to the institutions that were on the PAM report.

The CHAIRMAN. So what service did PAM actually provide to you?

Mr. SAYRES. In my opinion, just as an investment adviser providing the information.

The CHAIRMAN. But you say you go beyond that and make your own independent evaluation?

Mr. SAYRES. Oh, yes, that is required by regulation. Yes, sir.

The CHAIRMAN. Did you invest in Abilene National?

Mr. SAYRES. Certainly did, sir.

The CHAIRMAN. Let me briefly give you a little scenario. There is a bank that shows an annual report for yearend 1981, total loans outstanding of \$286 million, of which \$56,377,000, or almost 20 percent, were loans, commercial letters of credit, and standby letters of credit to directors and shareholders. We on this committee have found that when you see something like that—the insider lending—you should be apprehensive. Under commitments and contingencies in the same annual report the bank stated: “In the normal course of business there are various outstanding commitments to extend credit which are not reflected in the consolidated financial statements.”

Those are forward commitments. The combined standby letters of credit and commercial letters of credit at yearend totaled \$149,372,406; 38 percent of their yearend deposit base. Those are commitments. That is a credit.

In addition, this same annual report stated that during 1981, loans were made to the Abilene Club, a nonprofit restaurant/club operating in the same building as, guess what, Abilene National Bank, at below the normal interest rate charged. Several directors and officers of the bank are directors of the club.

It sounds to me like the club was actually there for the convenience, welfare, and health of the board of directors of the bank.

As of December 31, 1981, loans totaling \$1,450,000 were outstanding to the club at a 10-percent interest rate.

That is a pretty good rate, isn't it?

Mr. SAYRES. Yes, it is.

The CHAIRMAN. Now the prime rate at the time was 15.5 to 15.75 percent. Now in this annual report you have got insider loans, a rather disturbing amount of letters of credit and of all things, a restaurant and club operated by the bank's officers and directors

that are getting a preferential interest rate. Don't you think that those would be some red flags for somebody considering investing in that particular institution?

Mr. SAYRES. I would have to agree with that, Mr. Chairman, yes.

The CHAIRMAN. Thank you. I will ask you to excuse me. I have to go to the Rules Committee on some other legislation that affects credit unions and savings and loans, rather important to you. And I am going to ask Mr. Leach to be gracious enough to take over the chair.

I do want to express my appreciation to you gentlemen for your cooperation with myself, with the staff, with the committee. We realize that it is not easy for you to be here today. By the same token, as I stated in the opening statement, you are just representatives of a group. As I stated in Oklahoma City to the board of directors and to others who got burned, don't feel bad. Patterson and Jennings out-slicked the city slickers. Let's face it. They took Chase, they took Continental, they took Seattle-First. And with all due deference to you gentlemen, those are the experts. They took the Comptroller of the Currency for a sleigh ride. They took the Federal Reserve Board for a sleigh ride. So when you go home to bed tonight you can sleep well.

None of us here are trying to in any way be derogatory. We just wanted to find out for the benefit of the committee and its work of the future how you became involved, because I think you are all typical.

Thank you.

Mr. SAYRES. Thank you.

Mr. LOIACONA. Thank you, Mr. Chairman.

Mr. ARNOLD. Thank you.

Mr. MANGAN. Thank you.

Mr. LEACH. Let me say the minority has a series of bills we were thinking of bringing up at this time but—

[Laughter.]

Mr. LEACH [continuing]. We will defer on that prospect. Let me just make a couple of comments and throw out some questions.

I attended the hearings the chairman held in Oklahoma City and yesterday's session here. In mulling over the whole situation, it strikes me that there is a lot of blame to go around. There are problems involving conflicts of interest, weak internal and external audit controls, less than aggressive regulation. But it is not the small picture that is most important at this time. It is the big picture, the notion of high-priced money seeking higher priced money, the notion of institutions around the country no longer serving the community, but instead putting their investments in larger institutions. Yet these larger institutions have clearly stressed growth over prudence. Also, it would appear that the larger the loan the less the documentation.

A truism regarding banking is that banks and banking systems are only as strong as their customers. When you develop a system of chain investments, however, the customers become less well known, both in terms of their assets as well as their character.

In retrospect, I think all of us have to acknowledge that when we entered into this period of competitively seeking money and competing with everyone to control money, we lost sight of the likeli-

hood that some of those loans being put forth as, say, Penn Square did at 18, 19, 20 percent premium interest, would turn sour since American society simply is not geared to that high a rate of interest.

In addition, in retrospect, what has happened here in partial measure is that financial institutions—whether they were credit unions, Continental Illinois, or Seattle-First—went after oil investments. The wealth of the Midwest and Northeast has largely been transferred to energy-producing States in recent years because of high-priced energy. Now the savings of the Midwest and Northeast have largely been transferred to energy producing States through the escalated transfer of capital from institution to institution.

One of the things that I think we are going to have to be very concerned with is whether this process made a lot of sense and whether there are lessons here for Congress itself. For example, I think we ought to be looking more rather than less skeptically at proposals for interstate banking. I stress this because it is quite clear that the large banks which have argued they are stronger than the small banks due to their greater size and greater diversity of portfolio in essence are not stronger. It is the smaller institutions that have stronger capital bases and that know the character of the people they are dealing with, know their communities far better, and are making wiser loans today.

Do you feel that you have been caught up in a system where you have competed to attract high-priced money and where you have stopped serving, in essence, your own constituents and started serving, in essence, people in more esoteric endeavors in more distant parts of the country?

Mr. SAYRES. I would think, yes, we were caught up in that period of time with the savings instruments that we had to offer to retain our membership, retain our deposits and to retain those deposits at the rates that we had to pay, we were forced into, I believe, investing at least at a 1½, 2 percent higher yield in an instrument such as a certificate. Definitely. If you have approximately \$70 million in money market funds that are only out for 6 months, you definitely can't loan your money out for more than that period of time.

So you are put in the position of investing and trying to find the highest yield.

Mr. LEACH. Do you think in retrospect that if you had simply not sought that money that you would not have been overextended and that interest rates would be lower in this country? It appears that the growth orientation of large institutions which sought out this money overrode prudence. It caused the price of money to go up at a more rapid rate than it otherwise would have in terms of the prime rate. It is also keeping the prime rate higher even as the cost of money comes down because of the need to recapture losses.

I would simply stress that there appears to have been a colossal lack of judgment, starting at the top and seeping down, stemming from the demands of competition. Perhaps if there had been greater emphasis on simply serving a community, some of these problems would not have arisen. Is that reasonable to you?

Mr. SAYRES. Yes, I would agree with you on that.

Mr. LEACH. Would anyone else like to comment on these issues?

Mr. Weber, do you have questions?

Mr. WEBER. No, I have questioned already.

Mr. LEACH. If there are no further questions, we will adjourn at this time and reconvene at 1:30.

[Whereupon, at 11:50 a.m., the committee was recessed, to reconvene at 1:30 p.m., this same day.]

AFTERNOON SESSION

The CHAIRMAN. The committee will come to order.

Will Mr. Renda and Mr. Goldsmith please come forward.

[Witnesses sworn.]

TESTIMONY OF MARIO RENDA, PRESIDENT AND EXECUTIVE DIRECTOR, FIRST UNITED FUND, LIMITED, GARDEN CITY, LONG ISLAND, N.Y., AND WILLIAM GOLDSMITH, EXECUTIVE VICE PRESIDENT, PROFESSIONAL ASSET MANAGEMENT, DEL MAR, CALIF.

The CHAIRMAN. I understand neither of you has a formal opening statement, but Mr. Renda, would you like to say a few introductory words?

If you would bring yourself close to the microphone.

TESTIMONY OF MARIO RENDA

Mr. RENDA. My name is Mario Renda, I am president of First United Fund and First United Fund is a rate-quoting service for CD's, bank CD's. We are registered with the Securities and Exchange Commission as broker-dealers, and we quote rates for banks and savings and loans, thrifts, throughout the country.

The CHAIRMAN. Mr. Goldsmith.

TESTIMONY OF WILLIAM GOLDSMITH

Mr. GOLDSMITH. Mr. Chairman, I am here to answer to the best of my ability any questions that you or your committee may have.

The CHAIRMAN. Well, let me then ask you this question, Mr. Goldsmith.

It seems to me that shortly after the impact of the Penn Square failure, I recall reading some articles in the press wherein you had some thoughts about the lack of information available to people like yourself, and Mr. Renda, as well as the people who have testified this morning for whom I have a great deal of concern.

So why don't you sort of reiterate that to us, for the record, at this point.

Mr. GOLDSMITH. I am not sure——

The CHAIRMAN. I have a pretty good memory. My staff accuses me of that. It seems to me that you expressed dismay with the regulators, am I not correct?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. That is what I mean. If you would just for the record here repeat that, unless you have changed your mind since then.

Mr. GOLDSMITH. No, sir, I haven't changed my mind.

The CHAIRMAN. I mean it seemed to me as though we were on the same wavelength. So regale me with the waves that I like to hear.

Mr. GOLDSMITH. Since July 5 and as a result of two hearings held by your committee and one by Mr. Rosenthal's committee, considerable amounts of information have been made public through the press. From these press releases, there were reports that as early as January or February 1980, and one report that I read either yesterday or the day before, that further, back to 1978, regulators found irregular and unlawful banking procedures at Penn Square.

I have been privileged to hear much of the testimony before your committee yesterday and today. And questions as to whether additional disclosure by Federal agencies should be sought. It is my opinion, based on what I have read in the papers that had—the marketplace is a very wonderful and orderly and very discriminating place.

It seems to me that had information been available in 1978 or 1979 as to the either unlawful or irregular banking practices, that there wouldn't have been a Penn Square in 1982. That a \$50 million shopping center bank would have remained a \$50 million shopping center bank. That no one would have chosen to inflate the assets, or inflate the funding side which enabled them to inflate the assets, in a bank that was irregularly managed.

So yes; I heartily endorse greater accountability on the part of those who are in office, I am wondering who they were placed there to protect. The argument is often made that such revelation would cause a run on a bank. In 1978, it wouldn't have been very important because there are 14,000 other banks around. In addition, when a highly respected and highly regarded, and what I believe to be the largest bank auditing firm in the United States, validated what the public thought was a successfully operated profitable and well-capitalized bank, I further am convinced that, and I am referring to Peat, Marwick, Mitchell & Co.'s certified audit which gave a clear signal that this bank was in excellent financial health.

I am further convinced that auditing firms in some way must be made to tell the truth.

The CHAIRMAN: Could I interrupt you at this point? I would ask both you and Mr. Renda the same question I asked of the panel this morning. That is, did you indeed look at those audit reports, and as a result of examining and analyzing them do you feel at this point in time, knowing what has come to light, do you feel as though those reports were misleading to you in your capacity as advisers, so to speak, or consultants, to the investors who invested money in Penn Square?

Mr. GOLDSMITH. Was your question, sir, do I believe that these audits were—

The CHAIRMAN. That they did not contain enough information or accurate information on the actual status of conditions at the bank, and therefore as a consequence, it was difficult for you to properly advise your clients because you didn't have in hand the information you should have had?

Mr. GOLDSMITH. Yes, sir, that is true.

The CHAIRMAN. Mr. Renda?

Mr. RENDA. Well, Congressman St Germain, first of all First United is not an investment adviser. We are broker-dealers.

The CHAIRMAN. I am sorry I used that terminology. But let's put it this way. It is a question of semantics.

Mr. RENDA. I understand your question.

The CHAIRMAN. I am not trying to give you a new title or anything of the sort, or new duties.

Mr. RENDA. I just would like to say that we don't advise and therefore, a financial statement would be totally unimportant because we are not rendering financial advice.

What we are rendering is a rate quoting service, where we are quoting rates for thrifts and banks throughout the country. We don't know what other brokerage houses are doing, or what other investment advisers or so-called money finders in the industry are doing. Our function in the industry is solely that of a reporting service to let the investors out there know which banks in the 50 States——

The CHAIRMAN. Mr. Renda——

Mr. RENDA. Sure.

The CHAIRMAN. I don't want to be argumentative with you.

Mr. RENDA. No.

The CHAIRMAN. That all sounds fine, but the fact of the matter is do you list any institution in the United States of America?

Mr. RENDA. Do we list any institution?

The CHAIRMAN. That is right.

Mr. RENDA. We don't list any institution.

The CHAIRMAN. You are a rate quoting service.

Mr. RENDA. We quote rates for banks seeking funds.

The CHAIRMAN. Banks seeking funds.

Mr. RENDA. Banks and thrifts.

The CHAIRMAN. OK.

If credit union Y, as a result of a quote from you, invests in bank X, how do you make money?

Mr. RENDA. Well, we get paid from bank X certainly.

The CHAIRMAN. All right, that is my point. You list quotes for financial institutions that are going to pay you a quarter of a point, half a point or what have you.

Mr. RENDA. Yes.

The CHAIRMAN. Not for every bank in the United States of America.

Mr. RENDA. That is correct.

The CHAIRMAN. Therefore, you know, you are a little more than a rate-quoting business. You quote rates. And inform investors where they can invest their funds.

Mr. RENDA. No. We don't.

The CHAIRMAN. No. They have a choice. You give them a list of maybe 15, 20, 40 institutions. You quote rates. Correct?

Mr. RENDA. Yes, we only quote rates.

The CHAIRMAN. In return for quoting those rates, the institution that gets that quote from you invests in an institution that you have quoted, and you are paid a fee.

Mr. RENDA. Earn a fee, that is correct.

The CHAIRMAN. So I get back to semantics. You can call yourself one thing. I can look upon you as another. Someone else might look upon you as another. But the point of the matter is, that as far as

you and Mr. Goldsmith are concerned, you know, the difference isn't all that great.

Mr. RENDA. Oh, but it is, Congressman.

The CHAIRMAN. In your mind. And I don't want to argue with you.

Mr. RENDA. I am not talking semantics as well. I am talking about a different kind of service, a service that we could provide as investment advisers but we don't provide as broker-dealers. We provide very similar service as the Wall Street Journal does. We report a composite. The Wall Street Journal every day publishes what 30-day rates are for CD's, 60-day, 90-day, et cetera. We report every day what some 200 or 300 different banking institutions are quoting for 30, 60, 90 days, the same kind of rates.

The Wall Street Journal never offers advice nor do they review financial statements, issue reports.

The CHAIRMAN. Are you telling me that you would quote rates on an institution even though you knew it was on the problem list and was about to go belly up?

Mr. RENDA. Our only requirement is that the institution be federally insured, FDIC insurance or FSLIC insurance.

The CHAIRMAN. Beyond that you could care less?

Mr. RENDA. Beyond the fact we do check rather thoroughly that the institution is in fact insured and is insured with FDIC or FSLIC.

The CHAIRMAN. That is the extent of it.

Mr. RENDA. We don't review the statement for the purpose of—

The CHAIRMAN. So you don't have clients?

Suppose credit union X were asking you for some quotes.

Mr. RENDA. Yes.

The CHAIRMAN. Who is your client in that instance, or do you have one?

Mr. RENDA. I assume the client or customer in this case would be the bank, because they are paying us the fee.

The CHAIRMAN. The bank in which the funds are going to be deposited.

Mr. RENDA. That is correct.

The CHAIRMAN. So your only obligation is to that institution, not to the credit union looking to make an investment, looking to you for a quote?

Mr. RENDA. Yes, well, our obligation is to offer the investor the highest quote if that is what he is looking for.

The CHAIRMAN. All you do is give him a quote.

Mr. RENDA. That is correct.

The CHAIRMAN. So a credit union that asks you for a quote should know that as far as you are concerned, the only criterion is that that institution you are quoting is federally insured?

Mr. RENDA. That is correct, that they must be federally insured.

The CHAIRMAN. So the credit unions in the future should know that when they go to your firm that is all they are getting and that you are in no way implying quality as far as the institution that you are quoting is concerned?

Mr. RENDA. Well, it is not the only service if we are limiting it to that. I think the fact we are quoting an FDIC or FSLIC insured institution is a service.

The CHAIRMAN. That is all you are doing.

Mr. RENDA. Yes.

The CHAIRMAN. Penn Square was insured.

Mr. RENDA. Yes, it was.

The CHAIRMAN. Sharpstown was insured.

Mr. RENDA. Yes.

The CHAIRMAN. Franklin National, Economy. They were all insured. They went down the tube.

Mr. RENDA. Yes.

The CHAIRMAN. But you don't care about that, as long as they are insured. So the credit union that goes to you looking, as I say, for a quote, all they get is a quote and the assurance that up to \$100,000 in 1982—

Mr. RENDA. We tell them that it is a \$100,000 as well.

The CHAIRMAN. Up to \$100,000 is insured. Beyond that they are on their own.

Mr. RENDA. We also tell them—

The CHAIRMAN. I will have to excuse myself for a vote. I will be back in about 5 minutes.

[Recess.]

The CHAIRMAN. The committee will come to order.

Mr. Goldsmith, tell me how many employees do you have. In other words, do you render a service or give a little more information than does Mr. Renda's firm?

Mr. GOLDSMITH. Well, sir, we have 18 or 19 employees.

The CHAIRMAN. How many employees do you have, Mr. Renda?

Mr. RENDA. We have a total of 40 employees.

The CHAIRMAN. Forty employees?

Mr. RENDA. That is right.

The CHAIRMAN. Do they all check to see if the institution is insured, and quote rates?

Mr. RENDA. They don't. I do myself.

The CHAIRMAN. Then what do the employees do?

Mr. RENDA. They quote rates on the phones during the day and take rate quotes from banks that are calling in throughout the country.

The CHAIRMAN. So you actually have 40 people just on the phones.

Mr. RENDA. No.

The CHAIRMAN. In and out or do you have some on the road.

Mr. RENDA. There are some other roles, and they—

The CHAIRMAN. The road, r-o-a-d.

Mr. RENDA. Other roles, r-o-l-e-s.

The CHAIRMAN. OK. What are their other roles?

Mr. RENDA. We are also government security dealers and we buy and sell government securities.

The CHAIRMAN. Is that under the same title?

Mr. RENDA. Yes, First United Fund.

The CHAIRMAN. First United Fund.

Mr. RENDA. Yes.

The CHAIRMAN. So you quote rates and buy and sell Government securities.

Mr. RENDA. That is correct.

The CHAIRMAN. Local, municipal, Federal Government.

Mr. RENDA. Treasury bills, bonds, notes.

The CHAIRMAN. How many people work in the rate quoting as opposed to the securities section?

Mr. RENDA. There are 15 account execs that quote rates and accept rates during the day.

The CHAIRMAN. The balance of them work in the securities?

Mr. RENDA. Yes, we also run a back-office operation and other related services.

The CHAIRMAN. What do they do in the back office?

Mr. RENDA. Well, they keep track of all the money movement. They also print up confirmations. They keep track of different rates throughout the country. Numerous services.

The CHAIRMAN. Wouldn't that be the same as—

Mr. RENDA. No.

The CHAIRMAN. The people on the phones quoting rates? Oh, they get the rates while the people on the phones in the front office are quoting rates to the investors.

Mr. RENDA. Yes. We have people who are calling the banking institutions and telling them about investors who might need financial statements sent to them or need specific services.

The CHAIRMAN. You mean to tell me that some of the people who want to place funds, like a credit union, do at times ask for a little more information than just rates and whether or not the institution is insured?

Mr. RENDA. They ask for a financial statement to be sent to them 90 percent of the time.

The CHAIRMAN. Right. So you then call the institution on which they ask for the financial statement and ask them to send it to Happy Days Credit Union?

Mr. RENDA. That is right. Most of the time we do keep an ample supply and we may send it directly from our office.

The CHAIRMAN. How do you get your fee? In other words, how do you determine whether you are the individual who is entitled to get the finders fee?

Mr. RENDA. The bank usually determines it. We will say, we will call the bank and say, you know, please expect a call from Happy Days Credit Union, and they are looking to make an investment. And they say fine. Then what rates did you quote them? And we recite the rates we quoted them and the bank pays us a fee.

The CHAIRMAN. But you sort of go on faith and trust because the bank that is looking for invested funds would look at the fact that if they would not pay you then you would not quote them in the future.

Mr. RENDA. That is correct.

The CHAIRMAN. Otherwise, you could end up with a lot of lawsuits, couldn't you?

Mr. RENDA. We haven't had any.

The CHAIRMAN. There is a lot of faith and trust here. Now can you tell me anything else about First United and the services it

renders? I am not interested in your securities business, but rather in what you do for S&L's and credit unions, et cetera.

Mr. RENDA. Services that we provide are we will ask the investor what criteria he may have. So the investor will give us a list of his criteria. The criteria might be we are looking for only national banks. We are looking for thrifts only in our own State. We are looking for institutions with total assets in excess of \$100 million. We are looking for net worth of X.

We enter all of that information into our computer system. So that when that investor calls, the only rates that we will quote him will be rates that fit his criteria.

The CHAIRMAN. But, I just want to make sure one last time: You do not in any way, shape, manner, or fashion recommend an institution, or state: well, there might be a problem with that institution, having reviewed their financial statements?

Mr. RENDA. We do not.

The CHAIRMAN. You don't take that upon yourself.

Mr. RENDA. We do not.

The CHAIRMAN. OK. Mr. Goldsmith.

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. You have how many employees on your staff?

Mr. GOLDSMITH. I think 18 or 19, sir.

The CHAIRMAN. And you have heard me ask Mr. Renda about his operation. Would you be kind enough to explain yourself to me?

Mr. GOLDSMITH. Yes. We primarily specialize in certificates of deposit from what we term the middle market bank or S&L. You see, prior to my founding Professional Asset Management, I spent approximately 7 years with Merrill Lynch and about 4 years with Bache Halsey doing many of the same things.

It was my opinion that the large New York Wall Street firms created a little vacuum in the market in that we were selling CD's for the major banks, Citibank, Chase, Continental, Bank of America. And that the middle market banks which also needed to raise money outside of their traditional market area, needed the same assistance.

And nobody at that time or few at that time were providing it. So when I left Bache the idea was that we would work with what we felt were well capitalized and middle market institutions, by that I mean from roughly \$300 million in size to \$3 billion in size. Those that were largely being ignored by, as I say, the other large brokerage houses.

The CHAIRMAN. I think I better start asking questions to give me what I need and am looking for. When a client calls you that wants to invest funds, say that Happy Days Credit Union calls you, do you quote them rates, as does Mr. Renda?

Mr. GOLDSMITH. Is this a client we have dealt with before, or is it a new client, sir?

The CHAIRMAN. Well, let's take one of each.

Mr. GOLDSMITH. All right.

The CHAIRMAN. Happy Days and Sad Days.

Mr. GOLDSMITH. Well, if it is a client that we have had previous experience with, one of our account executives, there are 10, or 11 who will quote them rates. And since we have worked with ap-

proximately 50 that are on what we call a Capital Adequacy Report—you have a copy of that I, believe.

The CHAIRMAN. Yes.

Mr. GOLDSMITH. This—

The CHAIRMAN. Without objection, we will make a copy of a Capital Adequacy Report a part of the record at this point.

[The copy of the Capital Adequacy Report follows:]



**PROFESSIONAL
ASSET
MANAGEMENT
INC.**

22110 Ventura Boulevard Woodland Hills, California 91364 800/423-5877 Continental U.S.
213/888-2100 California, Alaska, Hawaii

Registered Investment Advisor

March 10, 1982

Dear Investor,

To hear many tell it, the S & L industry is dead. Others are holding the wake BEFORE the funeral. To steal a line from another generation, reports of this demise are greatly exaggerated. However, I think it is safe to say that 1981 was a very difficult year for most S & L's.

You may have noticed that this report includes fewer S & L's and more banks than previous reports. The extent of the industry's difficulties are further underscored by the number of S & L's requiring mouth to mouth resuscitation. Even the best managed institutions sustained substantial losses and the FHLB reduced its minimum reserve requirements from 4% of average assets to 3%.

Hardly a day passes without an article in one or more local or national publications telling of the plight of the S & L industry and the fact that almost daily another institution sinks to zero net worth. What isn't reported is that having a zero net worth is quite different than having no cash flow. Those associations with a steady cash flow from monthly mortgage repayments could ride out a zero net worth or even a negative net worth until interest rates decline and the net worth corrected itself.

We at Professional Asset Management continue to believe in the viability of the S & L industry even though we recognize over the near term additional surveillance and extreme caution are top priorities. Consequently, even though we have reduced the NUMBER of S & L's on our approved list, the QUALITY of the specific institutions we follow remains extremely high. In these difficult times SAFETY and CAPITAL ADEQUACY have no substitutes. Only those banks and S & L's that continue to meet our rigid quality standards are included in this capital adequacy report.

Philosophically it could be argued that since the regulators have relaxed their merger requirements easing the way for interstate mergers and inter-institution mergers, the possibility of failure for all but the smallest S & L has been reduced significantly. It could be argued further that since Congress rescued Lockheed and Chrysler with bailout loans, can it do any less for a large troubled thrift?

Since these are political decisions it is difficult to know with precision what this new political environment or an election year will bring. Therefore we will not speculate in the realm of probability and consider only the land of reality, those factors that reliably measure relative strength and capital adequacy. You will note that the banks and S & L's we have included in this report are very profitable or at the very least possess capital adequacy that is more than adequate in spite of recent losses. The banks continue to reflect both profitability and strong capital adequacy positions.

The continuing relative weakness on the part of even the strongest S & L and the strength of banks in general has created a fairly pronounced two-tier market in the bidding for CD's. Yield differentials favoring S & L's have increased to 75 to 100 basis points in many cases. This differential implies a greater risk plus an element of fear inherent in an S & L investment. Is the additional premium paid by an S & L worth whatever real or imagined risk one perceives in such an investment? This is a decision you will be forced to make with increasing frequency as this year unfolds. That is precisely the reason Professional Asset Management brings you this report. It allows you to study 40 institutions, carefully comparing many of the key elements of safety and capital adequacy before you make an investment.

We will *not* include in this report any bank or S & L whose capital adequacy do not meet rigid minimum standards. We will augment this analysis with personal visits to each institution and personally interview top management as part of our indepth analysis.

Separately much has been said and written of late about expanding investment regulations to permit credit unions to buy bankers acceptances, Euro dollar CD's and commercial paper. Additional avenues for investments are needed, of that there is little doubt. But I was around in the early 70's when many of you reading this entered the world of Ginnie Mae's after learning only to spell the name. But at least Ginnies are guaranteed by the U.S. government. And still because of a gross lack of knowledge and information many lost a bundle of dollars. You're going to have to know much more than how to spell the names to be able to invest intelligently in BA's, Euros or commercial paper. Sadly the loudest spokesmen for increased investment opportunities are many of the same voices who bought heavily into Ginnies and Freddie's a while back. Nothing takes the place of information. Investigate before you invest is an axiom as current today as when it was first uttered years ago. I will discuss BA's, Euros and commercial paper more fully in a subsequent report. However feel free to call on me any time for assistance.

**CAPITAL ADEQUACY REPORT
FOR YEAR ENDING DECEMBER 31, 1981**

	TOTAL ASSETS	DEPOSITS	NET WORTH	NET INCOME	RETURN ON AVERAGE ASSETS	RETURN ON AVERAGE NET WORTH	NET WORTH AVERAGE DEPOSIT
(I N T H O U S A N D S)							
Abilene Natl. Bank	424,377	376,804	27,230	5,477	1.7%	26.7%	9.5
Allstate S&L ³	3,260,475	2,269,918	150,846	(25,299)	NM	NM	6.6
American City Bank	396,444	343,906	17,308	(3,663)	NM	NM	5.2
American Natl. Bank	385,751	336,716	26,748	5,017	1.4%	19.5%	8.4
Bank of Newport	212,824	176,911	14,649	2,014	1.0%	14.4%	8.5
Barclays Bank ⁴	819,326	723,474	56,731	100	NM	1.7%	8.2
California First Bank	4,620,000	3,497,000	184,300	2,680	.07%	1.6%	5.1
Capital Bank, NA	921,550	716,364	53,713	5,228	.6%	11.0%	8.0
Central Bank	916,442	823,963	45,650	7,189	.8%	16.7%	5.5
Community Bank	681,547	445,164	34,694	4,654	.75%	14.4%	7.8
Empire S&L ⁵	1,319,753	959,712	57,549	(5,743)	NM	NM	6.4
Far West S&L	1,038,665	736,300	65,175	(3,890)	NM	NM	9.2
Financial Federation	2,436,805	2,059,344	137,692	(32,024)	NM	NM	6.5
First Natl-Amarillo	797,564	631,085	52,914	8,560	1.2%	17.4%	9.2
First Natl-Midland	1,642,752	1,348,228	84,270	21,543	1.5%	28.7%	6.2
First Natl-of Oklahoma	2,745,700	2,009,306	40,000	19,298	.76%	12.6%	8.7
First Natl-Tulsa	1,294,723	1,014,403	78,641	11,002	.9%	14.7%	8.2
First Penn Bank, NA	5,257,234	3,525,395	216,828	(4,500)	NM	NM	6.2
Fuji Bank, N.Y.	1,800,000	1,380,000	75,000	5,800	.4%	10.17%	6.5
Gibraltar S&L Houston	3,445,086	2,552,124	167,523	(8,928) ¹	NM	NM	6.9
Golden State Sanwa Bk. ⁶	860,000	720,000	60,000	2,100	.26%	4.6%	6.5
Guarantee S&L ⁷	1,693,073	1,164,892	62,283	(6,945)	NM	NM	5.4
Heritage Bank	264,464	242,600	12,381	2,121	.9%	20.2%	5.2
Hibernia Bank	897,339	766,406	47,150	1,089	.14%	2.3%	8.5
Homestead S&L	565,880	323,120	23,471	533	.1%	2.3%	7.2
Honolulu Federal S&L	1,464,748	969,283	56,963	(9,080)	NM	NM	6.2
Imperial Bank	1,397,317	1,172,761	65,717	18,151	1.5%	33.8%	6.2
Liberty Natl. Bank	2,266,840	1,740,164	106,414	14,240	.7%	15.8%	7.2
Pacific Federal S&L	1,717,853	1,249,203	70,382	(24,625)	NM	NM	6.7
Penn Square Bank, NA	394,158	363,754	30,404	4,705	1.4%	18.5%	9.8
Southwest S&L	562,518	377,007	25,227	418	.08%	1.7%	7.2
State S&L ⁸	3,662,590	2,747,716	98,944	18,009	.7%	22.8%	4.5
State Street Bank	3,388,066	2,248,475	164,677	26,242	.8%	17.0%	7.2
Sunwest bank	131,872	117,548	8,278	768	.6%	9.7%	7.6
Texas Commerce Bank, NA	7,356,656	5,007,228	325,662	66,193	1%	21.7%	7.2
Union Federal S&L	726,731	496,128	26,574	(6,497)	NM	NM	5.5
University S&L ⁹	2,096,467	1,823,399	58,885	(2,985)	NM	NM	3.8
Valley Federal S&L	1,595,378	1,073,682	48,383	(12,203)	NM	NM	4.5
Westlands Bank	239,250	217,904	12,557	1,249	.6%	13.3%	6.2
Gill Savings	404,594	344,822	10,685	5,789	2.1%	75.0%	4.6

(1) For Fiscal Year ending 9/30/81

(2) Includes purchase of Oceanside Federal

(3) Wholly owned subsidiary of Sears Roebuck

(4) Wholly owned subsidiary of \$68 Billion Barclays Bank Ltd.

(5) Wholly owned subsidiary of Baldwin United

NET WORTH AVERAGE ASSETS	% CHANGE SINCE 12/31/80 - 12/31/81				5 YEAR GROWTH 12/31/77 - 12/31/81		
	ASSETS	DEPOSITS	NET WORTH	NET INCOME	ASSETS	DEPOSITS	NET WORTH
8.5%	94.0%	90.0%	96.5%	90.0%	764.0%	745.0%	687.0%
4.8%	7.9%	(2.0%)	(14.4%)	(625.0%)	150.0%	130.0%	85.0%
4.5%	5.2%	5.2%	14.5%	(213.0%)	175.0%	159.6%	118.5%
7.3%	12.8%	11.9%	9.0%	51.4%	71.0%	65.0%	108.0%
7.4%	16.3%	15.6%	10.2%	(17.0%)	116.0%	103.0%	178.0%
7.0%	4.9%	5.7%	(2.2%)	(96.0%)	NM	NM	NM
4.5%	27.6%	(1.1%)	27.5%	(15.5%)	63.46%	64.0%	52.0%
6.2%	14.0%	15.5%	30.7%	(14.4%)	NM	NM	NM
5.2%	7.7%	12.9%	13.2%	30.2%	NM	NM	NM
5.3%	25.0%	17.4%	15.5%	11.3%	147.0%	94.0%	89.0%
4.7%	18.7%	15.3%	1.2%	(230.0%)	155.0%	135.0%	93.0%
6.7%	14.3%	13.9%	(5.6%)	(216.7%)	59.3%	48.7%	31.9%
5.6%	4.0%	2.8%	(19.6%)	(119.0%)	NM	NM	NM
7.3%	22.7%	19.4%	16.8%	24.7%	NM	NM	NM
5.9%	35.8%	29.3%	28.3%	49.5%	218.7%	190.9%	133.6%
6.2%	48.5%	50.0%	6.0%	(14.0%)	NM	NM	NM
6.1%	19.0%	12.8%	10.4%	15.5%	NM	NM	NM
4.0%	(.4%)	(.3%)	.05%	97.0%	NM	NM	NM
5.3%	71.0%	47.9%	92.3%	65.7%	NM	NM	NM
4.9%	3.0%	6.5%	(11.8%)	(240.0%)	NM	NM	NM
7.6%	19.3%	11.4%	86.4%	(21.6%)	344.0%	313.0%	462.0%
3.8%	5.0%	1.5%	(10.4%)	(223.2%)	NM	NM	NM
5.5%	41.0%	39.0%	43.0%	39.0%	519.0%	567.0%	151.0%
7.2%	45.0%	39.4%	3.0%	(.75%)	103.0%	95.0%	26.0%
4.4%	10.5%	2.8%	2.3%	(92.3%)	100.0%	43.0%	105.0%
4.1%	10.9%	10.2%	(13.7%)	(60.8%)	124.0%	87.8%	48.9%
5.5%	41.4%	36.4%	57.2%	39.3%	195.0%	185.0%	240.5%
5.3%	30.0%	39.0%	43.0%	35.0%	128.0%	125.0%	127.0%
4.9%	3.0%	0.0%	(26.0%)	(477.0%)	150.0% ²	155.0% ²	44.5% ²
8.9%	36.7%	40.6%	48.9%	9.8%	601.0%	605.0%	611.0%
5.0%	24.0%	19.1%	0.0%	(69.0%)	152.0%	78.0%	37.0%
3.7%	117.0%	113.0%	68.0%	46.0%	489.0%	474.0%	226.0%
5.1%	12.6%	18.2%	15.2%	19.7%	NM	NM	NM
6.7%	15.7%	17.0%	9.7%	(58.0%)	140.0%	130.0%	170.0%
4.9%	26.0%	18.5%	13.8%	28.3%	NM	NM	NM
3.7%	5.2%	7.0%	(18.9%)	(289.0%)	NM	NM	NM
3.0%	15.0%	13.6%	(6.7%)	(150.0%)	160.0%	155.0%	211.0%
3.2%	15.0%	3.0%	(20.0%)	(263.0%)	231.0%	197.0%	11.0%
5.7%	18.4%	16.1%	104.0%	44.1%	97.0%	89.0%	332.0%
3.9%	178.0%	176.5%	125.7%	286.0%	NM	NM	NM

-) Wholly owned subsidiary of \$70 Billion Sanwa Bank Ltd.
-) Wholly owned by Guarantee Financial
-) Wholly owned by Financial Corporation of America
-) Wholly owned subsidiary of Entex Corporation

Finally, I think it is safe to say that the economic environment is uncertain at best. On one hand there is increasing evidence of a continuing recession and reduced inflation. Conventional wisdom has it that the price of money like the price of most commodities in a recessionary environment will soften. On the other hand we have budget deficits predicted to top \$100 billion for the next three fiscal years, a strong and resolute Federal Reserve Chairman who is committed to keeping a tight reign on the growth of money, and an election year in the face of unemployment likely to top 9.5%. It is no wonder then that a solid consensus for either higher or lower interest rates by year's end has failed to emerge. One thing that is certain is the uncertainty and the continuing volatility of interest rates.

My rather cloudy crystal ball tells me that since markets can accept either good news or bad news but can't stand uncertainty the best posture is one that keeps your portfolio fairly short and liquid.

Once again, my associates and I stand ready to assist you in any way we can. We are gratified by all of you who tell us how much you enjoy our CAPITAL ADEQUACY REPORTS. If you have any suggestions for improvements, don't hesitate to let us know.

Cordially,



Bill Goldsmith
Executive Vice President

The information included in this report is taken from financial statements published by the various institutions included herein. Copies of the actual annual reports are available on request from Professional Asset Management or directly from any of the institutions.

DEPOSITS	Time deposits (including savings accounts) and demand deposits plus deposits in excess of \$100,000 will total 100%.
NET INCOME	Net current operating income after minority interest and taxes but before securities gains and losses (if any) and preferred dividends.
RETURN ON AVERAGE ASSETS	Net operating income available for common (net operating income minus preferred dividends) divided by average assets. For purposes of our illustrations period ending June 30, 1980 and June 30, 1981 assets are averaged.
NET WORTH	Total of paid in capital, surplus and retained earnings.
RETURN ON NET WORTH	Net operating income divided by average net worth. For purposes of our illustration period ending June 30, 1980, and June 30, 1981 net worth figures are averaged.

Professional Asset Management is a licensed investment advisor.

Mr. GOLDSMITH. The credit union with whom we have had experience already has a copy of this in front of them and usually, almost 100 percent of the time, financial data from which this was prepared. So then, we quote them rates from, in some cases—seldom all 50 because not all 50 are in the market every day.

The CHAIRMAN. Let me try to compare the two operations. You are not in the securities business.

Mr. GOLDSMITH. No, sir.

The CHAIRMAN. You are merely in the money brokerage business.

Mr. GOLDSMITH. We specialize in certificates of deposits.

The CHAIRMAN. Specializing in CD's. And you go a little beyond what Mr. Renda does. He quotes rates.

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. And says that these are insured institutions. And that they are national banks, State-chartered or what have you.

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. Whereas in your instance you have made a study or done a study on the capital adequacy of the institution?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. So you go a few steps beyond.

Mr. GOLDSMITH. Well, we firmly believe that our client is the investor, not the bank who pays us.

The CHAIRMAN. But you are paid by the bank?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. I take it Mr. Renda is as well, right?

Mr. GOLDSMITH. This is traditional in the brokerage—

The CHAIRMAN. I am not arguing, I just want to make sure we have got the terms straight. All right. So you do go that one further step. Is this because many, or first let me ask are there many of your clients that invest over the \$100,000 insured limit?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. So as a result thereof—

Mr. GOLDSMITH. That is, before Penn Square.

The CHAIRMAN. For that reason you felt and feel that you have to give them a little more than just quote the rate and the fact that it is insured because they are going, many of them, to invest amounts beyond the insured amount.

Mr. GOLDSMITH. That is correct.

The CHAIRMAN. Now you say you have 18 employees?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. How many people are engaged in the studies, and the analysis, as opposed to those who are account executives?

Mr. GOLDSMITH. Two.

The CHAIRMAN. Two in analysis, and the balance are primarily account executives.

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. You have been doing this for how long? I mean when did you start your business?

Mr. GOLDSMITH. Oh, I started our business, we were incorporated in March 1981, and actually opened our doors in April 1981.

The CHAIRMAN. How long have you been in your business, Mr. Renda?

Mr. RENDA. First United is going on its third year.

The CHAIRMAN. Both relatively new kids on the block.

Mr. GOLDSMITH. Well, sir, my experience is almost 12 years doing the same thing.

The CHAIRMAN. Yes, you gave your experience. But as a firm doing this specialized work, looking to serve a market that you felt there was a need to serve.

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. I am just talking about that. I don't know, Mr. Renda, let me see, is a little younger than you but not that much. He has done other things, too.

Mr. RENDA. Thank you, Congressman.

The CHAIRMAN. Mr. Renda, did I read, or am I mistaken, that the fee structure is usually anywhere from one-quarter to one-half of 1 percent?

Mr. RENDA. Well, it would——

The CHAIRMAN. Would you tell us what the typical fee structure is?

Mr. RENDA. Whatever is typical. Different banks, you know, will quote different rates. A larger bank, major national bank will dictate its fee and say this is what the fee is going to be.

The CHAIRMAN. That would be what range?

Mr. RENDA. Well, Penn Square paid us a fee of 50 basis points.

The CHAIRMAN. Some of the larger banks give you 25, 15?

Mr. RENDA. Or less, yes. When you are marketing for a Citibank or a Bank of America or a Chase, they pay a nickel—in the industry what is known as a nickel. I haven't worked for any of the major brokerage houses but, of course, they market \$25 million and \$50 million per hour. At a nickel that is a lot of money. Our general orders are from a bank that may need a total of \$300,000 for the day or \$500,000 for the day. It is a different kind of volume, and therefore the fee structure is a lot different. The amount of work is the same as working for the nickel.

The CHAIRMAN. Right.

Mr. RENDA. Except the number of dollars differs considerably.

The CHAIRMAN. Mr. Goldsmith.

Mr. GOLDSMITH. Gee, I should go to work for Mr. Renda. Penn Square paid us 25 basis points annualized. That is approximately two basis points a month, or if you relate it to dollars, on a \$100,000 investment for 30 days we are talking about \$20.80—some cents in fees.

The CHAIRMAN. What kind of phone lines are you using? Are you getting cut rates on the phones? You would have to.

Mr. GOLDSMITH. No. What we lose on each trade we make it up in the volume, sir.

The CHAIRMAN. All right. That was the Penn Square fee. But would your fees from other institutions run somewhat similar to that which Mr. Renda has quoted?

Mr. GOLDSMITH. Almost universally it is 25 basis points. There is one or two that pay us three-eighths or 37½, and a couple that pay us 5 or 10. Also, all of these figures are annualized, sir. I am not aware, I don't think we have any that pay us 50 basis points.

The CHAIRMAN. Mr. Goldsmith, is there such a document as a PAM Pledge?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. Is this a direct quote? "Before we add any institution to our report," meaning the Capital Adequacy Report, "we send the institution our own carefully designed financial questionnaire, and review the institution's response. * * * We repeat all of this work every quarter." Is that an accurate quote?

Mr. GOLDSMITH. Yes, sir, that is.

The CHAIRMAN. The information that you ask for on these questionnaires, you sent this same questionnaire to Penn Square?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. You received responses from them?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. Would it be possible to provide copies of those responses to the committee?

Mr. GOLDSMITH. If we still have them. Our normal—the purpose of that document internally is to validate the other publicly—the publicly available—the other information that is available to us. And once we compare and it parallels, for example, the bank call reports—

The CHAIRMAN. Well, you see, as you can, I am sure, understand, if you are able to find them, it would be, I think, interesting for us to compare that with what our staff is finding that the actualities are.

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. So it would be, as you can imagine, very helpful to us. So I would ask you if you would give it the old college try, we would be most appreciative.

Mr. GOLDSMITH. Absolutely.

[The following material, described by Mr. Goldsmith's attorney as "the questionnaire form completed by Penn Square Bank and submitted to Professional Asset Management," was submitted for the record subsequent to the hearing:]

(IN THOUSANDS)

	For 12 months ending 12-31-81	For 12 months ending 12-31-80	Rate of Growth for 5 years ending 12-31-81
TOTAL ASSETS	394,158	288,259	600.93%
TOTAL DEPOSITS	363,754	258,723	604.95%
TOTAL LOANS	264,594	197,815	710.57%
PAID IN CAPITAL SURPLUS AND RETAINED EARNINGS	30,404	20,422	611.20%
NET INCOME	4,705	4,285	544.52%
*Figures were based on daily averages.			
**1981 Figure minus 1976 Figure = Difference Difference ÷ 1979 figures = Growth			

PENN SQUARE BANK,na

(000s omitted)

For Period Ending	May 31, 1981	May 31, 1980	% Change
TOTAL ASSETS	\$347,108	\$183,470	89% +
EARNING ASSETS	297,000	176,840	68% +
DEPOSITS	300,000	160,000	88% +
PAID IN CAPITAL AND SURPLUS	27,503	11,092	148% +
NET INCOME	2,800	1,700	65% +
RETURN ON AVG. EARNING ASSETS	.01		
RETURN ON AVG. EQUITY	14.5%		
LEVERAGE	10.6%		
LOAN/DEPOSITS	73.0%		

The CHAIRMAN. Please bear with me. I usually try to be better prepared but there is so much going on.

Mr. GOLDSMITH. Would you prefer that we came back at a later date, sir?

The CHAIRMAN. No, no. No. You know, when you are at the dentist's office, better to have all your teeth drilled and filled at the same time. You know, it is the anticipation that is worse than the realization.

I would ask this of both of you gentlemen. In April, there was an article in the American Banker relating to and describing the situation at Penn Square. And then in June there was a piece in Fortune. Finally, on Friday, Saturday, and Sunday prior to the failure there were numerous reports in newspapers and other publications.

Mr. RENDA, when these came to your attention, did you think that it might be wise to take Penn Square off the list, or determine whether it should be taken off the list, or what action, if any, did you take, or what reaction did you have?

Mr. RENDA. Well, our first response, of course, to rumors in the industry, and there are anywhere between 25 and 100 a month—

The CHAIRMAN. There are?

Mr. RENDA. Yes.

The CHAIRMAN. You are getting my staff in trouble now.

Mr. RENDA. They should call us. We hear them all.

The CHAIRMAN. Because they are supposed to bring them all to my attention, and I haven't been seeing that many. I will be very serious now.

Mr. RENDA. Yes. Well—

The CHAIRMAN. Now rumors, are you talking about those that appear in responsible publications?

Mr. RENDA. No.

The CHAIRMAN. Or just wild rumors; street rumors?

Mr. RENDA. Yes; there are always street rumors.

The CHAIRMAN. Let's differentiate street rumors. I think the American Banker is a rather responsible publication.

Mr. RENDA. Yes, sir. We subscribe to it and get it every day.

The CHAIRMAN. That is why I asked about American Banker in this instance and Penn Square, they wrote about that. Let's forget the street rumors. Let's get the responsible, apprehensive articles, articles that should raise apprehensions.

Mr. RENDA. Let me go on with my trend of thought. As we said, we hear rumors of course. We are not overly concerned about rumors that are heard on the street. When the article appeared in the American Banker, I felt it wise that I might check with Penn Square and also check with some other bankers in Oklahoma. I did call one in particular about Penn Square. We do a lot of business with them. And he has been in the banking business for over 30 years and has a super reputation and a very good ear to the ground.

And he checked, and said he knew those good old boys down in Oklahoma City quite well and knew the bank had problems in the amount of growth and loan demand. He said to me that, certainly, there was no concern from the boys at Continental Illinois, or Chase, or Seattle-First, because they were still buying loans from them and doing participations with them.

The CHAIRMAN. Excuse me. When was this?

Mr. RENDA. This was in April.

The CHAIRMAN. April?

Mr. RENDA. Yes.

The CHAIRMAN. Were you here yesterday?

Mr. RENDA. No, I was not.

The CHAIRMAN. Was anyone representing you here yesterday?

Mr. RENDA. No.

The CHAIRMAN. Seattle-First stopped purchasing in January 1982.

Mr. RENDA. Well, I—

The CHAIRMAN. So your dear friend with his ear to the ground in Oklahoma wasn't all that accurate; was he?

Mr. RENDA. Well, perhaps I wasn't being accurate, because he mentioned major banks. Of course, SeaFirst was a name that has come up an awful lot since the fall of Penn Square. But he mentioned the major banks were still doing business with Penn Square and he felt that probably the major problem was their growth was astronomical, their capital was probably not keeping up with growth. But as far as he knew and as far as contacts, he didn't feel that there was any real trouble with the institutions.

The account exec who got quotes from the institution called Mr. Bert Davis and spoke to him. And—

The CHAIRMAN. Bert Davis?

Mr. RENDA. I believe that is what his name is.

The CHAIRMAN. Was he with Penn Square?

Mr. RENDA. Yes.

The CHAIRMAN. In what capacity?

Mr. RENDA. I really don't know.

The CHAIRMAN. Your account exec contacted Penn Square.

Mr. RENDA. Yes. Anyway, he was reassured that the article was only rumor and that the bank was certainly not having any problems. He said to him that they had some problem loans, but certainly not to any magnitude that would create any kind of a problem. He was concerned that, you know, such articles or such unfounded statements that were made by the American Banker could cause a run on an institution and that it was unfair. Now you have to remember, Congressman, that 95 percent of the investors that call us are \$100,000 investors.

One of the other requirements we have in addition to checking with FDIC and FSLIC if they are insured is that all the institutions we are quoting pay interest monthly. So that if you invest \$100,000 in a banking institution such as Penn Square, you are risking for 30 days, you are risking 30 days interest if the institution should default on the day you are supposed to get an interest payment. So I don't think at that time, I was not overly concerned after the re-assurance I got.

The CHAIRMAN. By the same token, Mr. Renda, I assume you are trying to build up a business that will have a name around the country for efficiency, accuracy, integrity, et cetera, et cetera. So even though the accounts were insured up to \$100,000, isn't it sort of embarrassing to have quoted rates and recommended an investment in an institution about which there had been some question for a period of time?

Mr. RENDA. Well, of course, I don't—

The CHAIRMAN. You would like to be with winners, right?

Mr. RENDA. Of course.

The CHAIRMAN. Even though they don't lose money.

Mr. RENDA. Oh, yes.

The CHAIRMAN. Mr. Goldsmith.

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. With respect to Penn Square, the American Banker's article in April, had that come to your attention?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. What did you do as a result thereof?

Mr. GOLDSMITH. The first thing—excuse me.

The CHAIRMAN. Did you make any inquiries?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. It gave you cause to take a look?

Mr. GOLDSMITH. Absolutely.

The CHAIRMAN. Did you keep—was Penn Square kept on your capital adequacy list subsequent to the April article? I am not saying you should—tell us what you did.

Mr. GOLDSMITH. Capital assets is published quarterly and the bank was closed before we had a chance to remove it.

The CHAIRMAN. How about calls from or to your account executives? Let me ask you this this way. After the April American Banker article, what did you do, or what did someone in your organization—

Mr. GOLDSMITH. No, I did. I called Mr. Bert Davis, who I believe is senior vice president, as senior vice president in charge of the liability management. And I expressed my concern over the article and asked if he could shed any additional light on the article. And I said, since it—the article attacked items that were beyond your responsibility at the bank, I would like you to go to your superiors, or whoever's department that reflected, and get the information and call me. Before he called back I called another bank in town, the largest bank in Oklahoma, and talked to our contact there to see if he was aware of any problems.

The CHAIRMAN. Excuse me. Since you both spoke to Bert Davis, do you think maybe you both spoke to the same good old guy in Oklahoma, without even knowing it?

Mr. GOLDSMITH. I am—

The CHAIRMAN. You called the largest bank in Oklahoma.

Mr. GOLDSMITH. I called the Bank of Oklahoma. First National, excuse me.

The CHAIRMAN. Is that who you called, Mr. Renda?

Mr. RENDA. No.

The CHAIRMAN. I didn't know if you inadvertently were talking to the same people.

Mr. GOLDSMITH. It was a hunch that maybe the biggest bank in town might have some information that they would reveal to us.

The CHAIRMAN. Do you do business with the First National Bank of Oklahoma as well?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. OK.

Mr. GOLDSMITH. And he did not have any information that would either validate or refute that article. Mr. Bert Davis called back, said he had talked to the chairman of the board.

The CHAIRMAN. Who was Mr. Jennings.

Mr. GOLDSMITH. Yes.

The CHAIRMAN. Oh, that is a big help.

Mr. GOLDSMITH. Yes, as I now understand. And that it was their opinion that the article was exaggerated and there were no serious problems at the bank. Of course, it was immediately before that, sir, that sometime in that vicinity that we had received the certified audit from Peat, Marwick, Mitchell & Co. which gave them a complete bill of health. So it was kind of surprising to find on one hand a report from highly regarded auditors, and then a report in a highly regarded newspaper which were highly contradictory.

The CHAIRMAN. Well, you know it is occurring to this Member that a lot of you people might want to hire Phil Zweig, the reporter for the American Banker, rather than Peat, Marwick, Mitchell & Co. He seems to have a much better track record.

Mr. GOLDSMITH. He is batting one for one so far.

The CHAIRMAN. Well, in a few other instances he has been quite accurate.

Mr. RENDA. I might add, Congressman, that I also called the FDIC about that article.

The CHAIRMAN. The FDIC?

Mr. RENDA. Yes. In Washington. And asked them whether they had heard any—had seen the article and had they heard that there were any problems at Penn Square.

The CHAIRMAN. Let me ask you why would you call the FDIC rather than the Comptroller?

Mr. RENDA. Well, because we have a contact we talk to on a regular basis at FDIC to find out if banks are insured and so forth.

The CHAIRMAN. Unfortunately the Comptroller and FDIC don't always talk to each other. Keep that in mind in the future. I wish they did.

Mr. RENDA. Would the Comptroller at that time have said there was a problem?

The CHAIRMAN. I was going to ask you that question; to wit: you called the FDIC. You sort of anticipated my question. Did you by chance call the Comptroller's Office?

Mr. RENDA. No, and they didn't point me in the direction of the Comptroller's Office.

The CHAIRMAN. I think you ought to get to know somebody there.

Mr. RENDA. Perhaps you are right.

The CHAIRMAN. FDIC had no information?

Mr. RENDA. No, they did not.

The CHAIRMAN. You weren't here yesterday, again, when some of the upstream banks were calling the Comptroller's Office, and they said, "Well, don't worry about it; don't call us, we will call you."

Mr. Goldsmith?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. Did you call the FDIC?

Mr. GOLDSMITH. No, sir.

The CHAIRMAN. Did you call the Comptroller's Office?

Mr. GOLDSMITH. No, sir.

The CHAIRMAN. I am wondering, do either of you, I guess you wouldn't have any status or stature or what have you unless you had a friend there, is that correct?

Mr. GOLDSMITH. That is correct. I tried the Comptroller before in another situation, and got nowhere. Their report to me in a former inquiry was that "Our deliberations are secret."

The CHAIRMAN. Let me ask you this, Mr. Goldsmith. After the April article did you have clients who continued to invest funds in Penn Square?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. Up until how late in the day?

Mr. GOLDSMITH. July 2.

The CHAIRMAN. July 2. Let me go over this with you gentlemen together. The Peat, Marwick, Mitchell & Co. audit of the First Penn Corp. and Penn Square Bank. Now did either of you review this carefully, or did you rely upon people in your organization to review it carefully?

Mr. RENDA?

Mr. RENDA. We didn't review it at all. The parent company you are talking about?

The CHAIRMAN. Pardon?

Mr. RENDA. You are saying the parent company?

The CHAIRMAN. This is the audit of both the First Penn Corp. and Penn Square Bank, N.A., for yearend 1981, Peat, Marwick, Mitchell & Co.

Mr. RENDA. We received and reviewed the annual report, and the balance sheet for Penn Square Bank.

The CHAIRMAN. OK. Now, did you, yourself, review it, or somebody in your firm?

Mr. RENDA. Both.

The CHAIRMAN. You reviewed it and someone else did?

Mr. RENDA. Yes.

The CHAIRMAN. Mr. Goldsmith?

Mr. GOLDSMITH. Sir, may I see the document to which you make reference?

[Witness examines document.]

Mr. GOLDSMITH. No, sir. No, sir, this is not the document that we examined. I believe you have a copy of the document we examined.

The CHAIRMAN. Did you give us a copy of the document you examined?

Mr. GOLDSMITH. Yes, sir.

Mr. Chairman?

The CHAIRMAN. Did Mr. Renda see this and say he didn't see it?

Mr. GOLDSMITH. Mr. Chairman, Mr. Hollar and I spoke approximately, it was a week ago. During that conversation he requested some information. And he said he had some information. But it was my understanding at that time that he had the consolidated Penn Square Bank certified audit. And so he did not request it, and I think we did not send it.

The CHAIRMAN. Did you have a copy of the certified—

Mr. GOLDSMITH. Of the Penn Square Bank certified audit.

The CHAIRMAN. Consolidated certified audit. Well, what is that that you have there? Is that the Penn Square Bank consolidated certified audit?

Mr. GOLDSMITH. No, sir. This is the First Penn Corp. This is the holding company. There may be some similarities but there may also be some differences.

This is not the document that we have. There are some similarities. But as I see only one page on the bank and the rest of it was on the parent, or the holding company.

The CHAIRMAN. All right. The page on the bank, had you seen that page?

Mr. GOLDSMITH. It looks similar.

Sir, would you like to request that we send you a copy of what we have? We would be happy to—

The CHAIRMAN. It seems to me we should have a copy of what you have.

Mr. Renda and Mr. Goldsmith, what was it that you saw from Peat, Marwick, Mitchell & Co., please?

Mr. RENDA. We were sent the annual report that is published by the bank. And—

The CHAIRMAN. From Peat, Marwick, Mitchell & Co., did you see anything from them?

Mr. RENDA. No, we did not receive an audited statement.

The CHAIRMAN. Did you seek one out?

Mr. RENDA. No, we did not.

The CHAIRMAN. Mr. Goldsmith?

Mr. GOLDSMITH. Yes, sir?

The CHAIRMAN. Did you have anything from Peat, Marwick, Mitchell & Co.

Mr. GOLDSMITH. Yes, sir, we have a—we have and we had a certified audit for the year ending December 31, 1981, and signed March 19, 1982, on Penn Square Bank.

The CHAIRMAN. Penn Square Bank, not First Penn Corp.?

Mr. GOLDSMITH. That is correct.

The CHAIRMAN. There was a separate audit of Penn Square Bank by Peat, Marwick, Mitchell & Co.?

Mr. GOLDSMITH. There must have been because we have the other.

The CHAIRMAN. Mr. Goldsmith.

Mr. GOLDSMITH. Yes, sir?

The CHAIRMAN. We seem to be having a problem here because my staff tells me that the only audit that Peat, Marwick, Mitchell, & Co. did was done both of First Penn Corp. and within that audit, is a portion that refers to Penn Square Bank, N.A., a wholly owned subsidiary of First Penn Corp.

Now, there is a consolidated balance sheet. Now is this the one you have or not? You have something totally different?

Mr. GOLDSMITH. Not totally different, but different.

The CHAIRMAN. And it is an audit of the bank?

Mr. GOLDSMITH. Yes, sir.

The CHAIRMAN. As opposed to the parent, the holding company?

Mr. GOLDSMITH. Yes, sir.

Mr. RENDA. I might mention, Chairman St Germain, that I believe regulation says that a national bank is not required to provide an audited statement. That might—

The CHAIRMAN. The holding company has on file with the Federal Reserve—

Mr. RENDA. That would explain why the holding company does and the bank does not.

[Pause.]

The CHAIRMAN. We may have further questions for you in writing. If so, I hope you will be cooperative. I want to thank you for your assistance and cooperation.

The committee will be in recess subject to the call of the Chair.

[Whereupon, at 3:25 p.m., the committee was recessed, to reconvene subject to the call of the Chair.]

[Subsequent to the hearing, the committee obtained from Peat, Marwick, Mitchell & Co. a copy of the audited statements of Penn Square Bank, N.A., prepared by Peat, Marwick, Mitchell & Co. That information follows:]

PENN SQUARE BANK, N.A.
(A Wholly-owned Subsidiary of
First Penn Corporation)

Consolidated Financial Statements

December 31, 1981

(With Accountants' Report Thereon)



Peat, Marwick, Mitchell & Co.

Certified Public Accountants

First Oklahoma Tower
Oklahoma City, Oklahoma 73102The Board of Directors and Stockholder
Penn Square Bank, N.A.:

We have examined the consolidated balance sheet of Penn Square Bank, N.A. (a wholly-owned subsidiary of First Penn Corporation) and its subsidiary as of December 31, 1981 and the related consolidated statements of income, changes in stockholder's equity and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The consolidated financial statements for the year ended December 31, 1980, included for comparative purposes, were included in the consolidated financial statements of its parent company, First Penn Corporation, which were examined by other auditors whose report, dated March 13, 1981, was qualified because they were unable to satisfy themselves as to the adequacy of the allowance for possible loan losses due to the lack of supporting documentation of collateral values of certain loans. As described in note 4 to the accompanying financial statements, the Bank, during 1981, formalized its approach to the evaluation of credit risks within the loan portfolio and documentation of the loan files with respect to credit and collateral information. The consolidated financial statements of Penn Square Bank, N.A. were not presented separately and, therefore, not covered by the aforementioned auditors' report dated March 13, 1981.

In our opinion, the aforementioned financial statements present fairly the consolidated financial position of Penn Square Bank, N.A. and its subsidiary at December 31, 1981 and the results of their operations and the changes in their financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Peat, Marwick, Mitchell & Co.

March 19, 1982

PENN SQUARE BANK, N.A.
(A Wholly-owned Subsidiary of First Penn Corporation)

Consolidated Balance Sheet

December 31, 1981
(With comparative figures as of December 31, 1980)

<u>Assets</u>	<u>1981</u>	<u>1980</u>
Cash, time deposits and due from banks	\$ 87,465,338	59,625,519
Investment securities (note 2):		
U.S. Treasury securities	13,123,075	10,992,420
Obligations of state and political subdivisions	<u>34,362,974</u>	<u>31,334,926</u>
Net investment securities	47,486,049	42,327,346
Loans (notes 3 and 4)	277,407,896	203,437,140
Less:		
Unearned discount	2,171,330	1,537,889
Allowance for possible loan losses	<u>4,141,447</u>	<u>2,004,587</u>
Loans, net	271,095,119	199,894,664
Federal funds sold	53,000,000	16,000,000
Bank premises, property and equipment, net (note 5)	3,877,929	2,481,667
Accrued interest receivable	20,495,932	7,372,553
Other assets (note 7)	<u>1,704,004</u>	<u>762,888</u>
	<u>\$ 485,124,371</u>	<u>328,464,637</u>
<u>Liabilities and Stockholder's Equity</u>		
Deposits:		
Demand	232,636,575	142,624,714
Savings and NOW accounts	18,223,800	13,341,126
Time (note 6)	<u>196,817,006</u>	<u>144,822,794</u>
Total deposits	447,677,381	300,788,634
Loans sold under agreements to repurchase	-	2,795,561
Federal funds purchased	900,000	650,000
Accrued interest and other liabilities (note 7)	<u>4,949,589</u>	<u>3,808,039</u>
Total liabilities	453,526,970	308,042,234
Stockholder's equity:		
Common stock, par value \$10 a share. Authorized and issued 100,000 shares	1,000,000	1,000,000
Surplus	18,000,000	10,500,000
Undivided profits	<u>12,597,401</u>	<u>8,922,403</u>
Total stockholder's equity	31,597,401	20,422,403
Commitments and contingent liabilities (note 9)		
	<u>\$ 485,124,371</u>	<u>328,464,637</u>

See accompanying notes to consolidated financial statements.

PENN SQUARE BANK, N.A.
(A Wholly-owned Subsidiary of First Penn Corporation)

Consolidated Statement of Income

Year ended December 31, 1981
(With comparative figures for 1980)

	<u>1981</u>	<u>1980</u>
Interest revenue:		
Interest and fees on loans	\$ 50,947,954	24,665,544
Interest and dividends on investment securities:		
U.S. Treasury securities	1,596,992	299,778
Obligations of state and political subdivisions	2,204,267	1,308,326
Interest on Federal funds sold	678,235	282,715
Other	15,732	-
Total interest revenue	<u>55,443,180</u>	<u>26,556,363</u>
Interest expense:		
Interest on deposits (note 6)	29,843,179	12,820,300
Interest on Federal funds purchased	2,949,376	871,220
Other	95,805	2,745
Total interest expense	<u>32,888,360</u>	<u>13,694,265</u>
Net interest revenue	<u>22,554,820</u>	<u>12,862,098</u>
Provision for possible loan losses (note 4)	<u>6,343,000</u>	<u>1,407,830</u>
Net interest revenue, less provision for possible loan losses	<u>16,211,820</u>	<u>11,454,268</u>
Other revenue:		
Service charges on deposits	785,012	366,920
Other service charges and fee income	553,958	431,738
Other	175,439	89,312
Total other revenue	<u>1,514,409</u>	<u>887,970</u>
Other expenses:		
Salaries	4,521,562	1,997,560
Employee benefits (note 8)	602,703	341,656
Occupancy expense, net	677,197	312,544
Depreciation	698,785	306,284
Other	4,205,984	2,383,203
Total other expenses	<u>10,706,231</u>	<u>5,341,247</u>
Income before income taxes	<u>7,019,998</u>	<u>7,000,991</u>
Income taxes (note 7):		
Current:		
Federal	2,887,000	2,394,000
State	309,000	245,183
Deferred	(901,000)	76,710
	<u>2,295,000</u>	<u>2,715,893</u>
Net income	<u>\$ 4,724,998</u>	<u>4,285,098</u>

See accompanying notes to consolidated financial statements.

PENN SQUARE BANK, N.A.
 (A Wholly-owned Subsidiary of First Penn Corporation)
 Consolidated Statement of Changes in Stockholder's Equity
 Year December 31, 1981
 (With comparative figures for 1980)

	<u>1981</u>	<u>1980</u>
Common stock - balance at beginning and end of year	\$ <u>1,000,000</u>	<u>1,000,000</u>
Surplus:		
Balance at beginning of year	10,500,000	3,000,000
Capital contribution from parent company	<u>7,500,000</u>	<u>7,500,000</u>
Balance at end of year	<u>18,000,000</u>	<u>10,500,000</u>
Undivided profits:		
Balance at beginning of year	8,922,403	4,937,305
Net income	4,724,998	4,285,098
Cash dividends to parent company	<u>(1,050,000)</u>	<u>(300,000)</u>
Balance at end of year	<u>12,597,401</u>	<u>8,922,403</u>
	\$ <u>31,597,401</u>	<u>20,422,403</u>

See accompanying notes to consolidated financial statements.

PENN SQUARE BANK, N.A.
(A Wholly-owned Subsidiary of First Penn Corporation)

Consolidated Statement of Changes in Financial Position

Year ended December 31, 1981
(With comparative figures for 1980)

	<u>1981</u>	<u>1980</u>
Funds provided:		
Net income	\$ 4,724,998	4,285,098
Items which do not use (provide) funds:		
Depreciation	698,785	306,284
Deferred income taxes	(901,000)	76,710
Provision for possible loan losses	<u>6,343,000</u>	<u>1,407,830</u>
Funds provided by operations	10,865,783	6,075,922
Capital contribution by parent company	7,500,000	7,500,000
Increase in:		
Deposits	146,888,747	151,101,364
Loans sold under agreement to repurchase	-	2,795,561
Federal funds purchased	250,000	250,000
Accrued interest and other liabilities	<u>1,318,260</u>	<u>1,837,908</u>
	<u>166,822,790</u>	<u>169,560,755</u>
Funds used:		
Increase in:		
Investment securities	5,158,703	19,344,527
Loans	77,543,455	94,817,612
Federal funds sold	37,000,000	14,900,000
Bank premises, property and equipment, net	2,095,047	851,603
Accrued interest	13,123,379	4,877,277
Other assets	216,826	515,878
Decrease in loans sold under agreements to repurchase	2,795,561	-
Cash dividends to parent company	<u>1,050,000</u>	<u>300,000</u>
	<u>138,982,971</u>	<u>135,606,897</u>
Increase in cash, time deposits and due from banks	\$ <u>27,839,819</u>	<u>33,953,858</u>

See accompanying notes to consolidated financial statements.

PENN SQUARE BANK, N.A.
(A Wholly-owned Subsidiary of First Penn Corporation)

Notes to Consolidated Financial Statements

December 31, 1981
(With comparative information for 1980)

(1) Summary of Significant Accounting Policies

The accounting and reporting policies of Penn Square Bank, N.A., "the Bank", and its wholly-owned subsidiary, the First Penn Leasing Corporation, "the Company", conform to generally accepted accounting principles and general practice within the banking industry. The Bank is a wholly-owned subsidiary of First Penn Corporation (parent company). The following represent the more significant of those policies and practices.

Principles of Consolidation

The consolidated financial statements include the accounts of the Bank and the Company after elimination of all significant intercompany accounts and transactions.

Investment Securities

Investment securities are carried at cost adjusted for amortization of premiums and accretion of discounts. Gains and losses on sales of investment securities are recognized on a completed transaction basis. Such gains and losses for 1981 and 1980 were insignificant and have been included in other revenues in the consolidated statement of income. The basis of the securities sold is determined by specific identification of each security.

Loans

Loans are reported on a gross basis before the reduction of unearned discount and the allowance for possible loan losses. Interest income is recorded on the discounted loans by use of the "rule of 78" method. Interest income is recorded as earned on non-discounted loans. The recognition of interest income is discontinued when, in management's judgment, the interest will not be collectible in the normal course of business.

Allowance for Possible Loan Losses

The Bank maintains its allowance for possible loan losses at levels management considers necessary to reflect the credit risks of the loan portfolio. For financial reporting purposes, the provision to be charged as an operating expense is based on the Bank's past loan loss experience and such other factors which in management's judgment deserve current recognition necessary to maintain the allowance at an adequate level. See note 4.

Bank Premises, Property and Equipment

Bank premises, property and equipment are stated at cost, less accumulated depreciation. Depreciation is charged to operating expense and is computed by the use of the straight-line or declining balance methods over the estimated useful lives of the assets. Leasehold improvements are amortized over the term of the respective leases. Maintenance and repairs are charged to expense as incurred while improvements are capitalized.

(Continued)

PENN SQUARE BANK, N.A.
(A Wholly-owned Subsidiary of First Penn Corporation)

Notes to Consolidated Financial Statements, Continued

Income Taxes

The Bank and the Company are included in the consolidated income tax return filed by the parent company. The Bank and the Company compute their tax provisions for financial reporting purposes as if separate tax returns were to be filed. Deferred income taxes are recorded for timing differences which result from the recognition of certain income and expenses for income tax purposes in periods different from that for financial statement purposes. In computing the provision for Federal income taxes, investment tax credits are used to reduce the provision in the year the assets are placed in service.

Trust Income

Trust income is reported on a cash basis which does not materially differ from the accrual basis.

(2) Investment Securities

A comparison of the recorded value and market value of investment securities at December 31, is as follows:

	<u>1981</u>		<u>1980</u>	
	<u>Recorded value</u>	<u>Market value</u>	<u>Recorded value</u>	<u>Market value</u>
U.S. Treasury securities	\$ 13,123,075	12,490,000	10,992,420	10,643,000
Obligations of state and political subdivisions	<u>34,362,974</u>	<u>29,031,000</u>	<u>31,334,926</u>	<u>26,546,000</u>
	<u>\$ 47,486,049</u>	<u>41,521,000</u>	<u>42,327,346</u>	<u>37,189,000</u>

Management believes there has been no permanent impairment in the value of its investment securities and intends to hold them to maturity.

Investment securities having a recorded value of approximately \$24,031,000 and \$18,549,000 at December 31, 1981 and 1980, respectively, were pledged to secure public and trust deposits and for other purposes required by law.

(3) Loans

A summary of loans at December 31 is as follows:

	<u>1981</u>	<u>1980</u>
Commercial loans	\$ 197,579,003	155,798,134
Real estate loans	43,606,910	26,763,002
Installment loans	23,945,307	17,894,678
Overdrafts	<u>12,276,676</u>	<u>2,981,326</u>
	<u>277,407,896</u>	<u>203,437,140</u>
Less unearned discount	<u>2,171,330</u>	<u>1,537,889</u>
	<u>275,236,566</u>	<u>201,899,251</u>
Less allowance for possible loan losses	<u>4,141,447</u>	<u>2,004,587</u>
Total net loans	<u>\$ 271,095,119</u>	<u>199,894,664</u>

(Continued)

PENN SQUARE BANK, N.A.
(A Wholly-owned Subsidiary of First Penn Corporation)

Notes to Consolidated Financial Statements, Continued

Certain of the Bank's officers and directors had transactions with the Bank in the ordinary course of business. At December 31, 1981 and 1980, loans to them and their affiliated interests approximated \$6,800,000 and \$3,900,000, respectively. In the opinion of management, such transactions were made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons or companies and did not involve more than normal risk. Also, the Bank purchases and sells loans to two banks in which an officer-director of the Bank holds an equity interest. At December 31, 1981 and 1980, outstanding transactions with such banks consisted of:

	<u>1981</u>	<u>1980</u>
Loan participations purchased	\$ 1,490,470	1,737,484
Loan participations sold	<u>5,532,369</u>	<u>6,767,646</u>

The Bank's non-accrual loans at December 31, 1981 approximated \$11,800,000. Such loans are considered in the determination of the adequacy of the allowance for possible loan losses. See note 4. The total amount of interest which would have been recorded under the original terms of the loans, had interest been accruing, was approximately \$2,000,000 in 1981.

(4) Allowance for Possible Loan Losses

A summary of transactions in the allowance for possible loan losses is as follows:

	<u>1981</u>	<u>1980</u>
Balance at beginning of year	\$ 2,004,587	1,002,097
Recoveries credited to the allowance	629,417	212,061
Provision charged to expense	<u>6,343,000</u>	<u>1,407,830</u>
	8,977,004	2,621,988
Less loans charged off	<u>(4,835,557)</u>	<u>(617,401)</u>
Balance at end of year	<u>\$ 4,141,447</u>	<u>2,004,587</u>

Management's judgment as to the level of future losses on existing loans involves the consideration and related effect of current and anticipated economic conditions on specific borrowers, an evaluation of the existing relationship among loans, examinations by regulatory authorities and management's internal review of the loan portfolio. In determining the collectibility of certain loans, management also considers the fair value of the underlying collateral.

During 1981, the Bank formed a loan review function and adopted a formalized approach to the evaluation and documentation of credit risks within the loan portfolio. The conclusions reached from this systematic analysis of the loans are translated on a quarterly basis to adjustments, if any, which are deemed necessary to maintain the allowance for possible loan losses at an adequate level. Also during 1981, the Bank significantly improved its documentation of the loan files with respect to credit and collateral information.

(Continued)

PENN SQUARE BANK, N.A.
(A Wholly-owned Subsidiary of First Penn Corporation)

Notes to Consolidated Financial Statements, Continued

It should be understood that estimates of future loan losses involve an exercise of judgment. It is the judgment of management that the allowance is adequate at both December 31, 1981 and 1980.

(5) Bank Premises, Property and Equipment

Bank premises, property and equipment at December 31 are summarized as follows:

	<u>1981</u>	<u>1980</u>
Land	\$ -	469,426
Buildings and improvements	2,994,203	1,838,075
Furniture, fixtures and equipment	2,740,751	1,268,168
Construction in progress	-	118,682
	<u>5,734,954</u>	<u>3,694,351</u>
Less accumulated depreciation	<u>1,857,025</u>	<u>1,212,684</u>
Total Bank premises, property and equipment	<u>\$ 3,877,929</u>	<u>2,481,667</u>

During 1981, the Bank sold the land used principally for its drive-in facility at its recorded cost of \$469,426 to its parent company.

(6) Deposits

Included in time deposits at December 31, 1981 and 1980 are approximately \$162,400,000 and \$116,473,000, respectively, of certificates of deposit in denominations of \$100,000 or more. Interest expense on such deposits approximated \$20,761,000 and \$8,765,000, for the years ended December 31, 1981 and 1980, respectively.

(7) Income Taxes

The Bank's income tax provisions for 1981 and 1980 differ from the normally expected income tax rate of 46% principally because of income from tax-exempt municipal securities and investment tax credits.

Deferred income taxes result from timing differences in the recognition of income and expense for income tax and financial purposes. The source of these differences in 1981 and 1980 and the consolidated income tax effect of each were as follows:

	<u>1981</u>	<u>1980</u>
Provision for possible loan losses	\$(1,027,500)	72,400
Other, net	<u>126,500</u>	<u>4,310</u>
	<u>\$ (901,000)</u>	<u>76,710</u>

Income tax accounts included in the consolidated balance sheets are summarized as follows:

	<u>1981</u>	<u>1980</u>
Other assets - accumulated deferred income tax benefit	\$ 724,290	-
Accrued interest and other liabilities:		
Federal income taxes payable	1,245,929	822,947
State income taxes payable	154,627	105,460
Accumulated deferred income taxes	-	176,710

(Continued)

PENN SQUARE BANK, N.A.
(A Wholly-owned Subsidiary of First Penn Corporation)

Notes to Consolidated Financial Statements, Continued

(8) Retirement Plan

The Bank has a non-contributory retirement plan covering substantially all of its employees meeting certain age and service requirements. Pension expense was approximately \$58,000 for 1981 and \$74,000 for 1980. The Bank's policy is to fund pension costs accrued with past service costs being amortized over ten years. A comparison of accumulated plan benefits and plan net assets as of January 1, 1981, the date of the most recent actuarial valuation, is presented below:

Actuarial present value of accumulated plan benefits:	
Vested	\$ 232,000
Nonvested	91,000
	\$ 323,000
Net assets available for benefits	\$ 422,000

The assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 7%.

The above data compares the fair value of assets held with the present value of benefits that have been earned based on services rendered and current salary levels. The plan's actuarial liability based on the actuarial cost method used to determine the Bank's retirement expense differs from the actuarial present value of accumulated plan benefits due to the fact that it considers expected future salary increases at a rate of 5% per annum. At January 1, 1981, the actuarial accrued liability under this method was approximately \$516,000.

(9) Commitments and Contingent Liabilities

The Bank has various long-term operating lease agreements under which it makes annual rental payments for the use of certain land and facilities. The lease terms vary but are generally renewable when the respective leases expire. Minimum lease payments for such leases presently approximate \$175,000 annually.

The Bank's intent is to move its principal offices to a new building which is expected to be completed in 1983. Annual rentals for the new space will approximate \$1,500,000 with provision for increases over the lease term.

In the normal course of business, the Bank is involved in various legal actions. In the opinion of management and legal counsel, no material losses from such actions are anticipated.

At December 31, 1981, the Bank had outstanding stand-by letters of credit which approximated \$116,000,000. Should the Bank be required to fund such commitments, approximately \$30,000,000 will be participated to other banks.

The Bank extends lines of credit covering future borrowings of a customer when the customer's financial condition and collateral warrant such extensions of credit. In most instances a maximum amount will be specified and the line may be cancelled at the Bank's option with notice to the customer.

