FAILURE OF PENN SQUARE BANK

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

TO REVIEW THE CAUSES, EFFECTS AND IMPLICATIONS OF THE INSOLVENCY AND LIQUIDATION OF THE PENN SQUARE BANK OF OKLAHOMA CITY

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U.S. SENATE,
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 9:30 a.m., in room 5302, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn and Riegle.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

By coincidence, the Banking Committee is coming in at the same time as the Senate. If you notice the orange light is on and the country is once again in danger. I always thought that orange light should be red.

During the past year, there have been numerous supervisory mergers and some failures of depository institutions, none of which has been quite like the failure of the Penn Square Bank. From its size and the unusual circumstances surrounding its deterioration and failure, Penn Square Bank has been the subject of continuing discussions here in Washington and throughout the country about the condition of our financial system and the supervisory structure designed to insure the system's safety and soundness.

Today's hearing on the failure of the Penn Square Bank provides the members of this committee an opportunity to review for themselves the causes, effects, and implications of the bank's insolvency and liquidation.

After being informed of the Penn Square Bank failure last July, my initial reaction was to ask what the breadth of the problem was and to ask about the ability of the Federal supervisory and insuring agencies to handle it. After being briefed by the regulators, I was confident that the situation would be controlled. Fortunately, that has been the result.

While I believed the Penn Square Bank situation was unique, it certainly had the potential to affect adversely the stability of the financial system.

I decided to conduct committee hearings on the matter but, due to the volatility of the failure and the need to have the regulators devote their initial efforts to contain the problem, I decided to conduct such hearings after the dust had settled and after the agencies had finished establishing their salvage operation and their preliminary investigation. Now that these things have been accomplished, we have an opportunity and a responsibility to examine more closely the demise of the Penn Square Bank.

The general circumstances regarding the failure read like a textbook case of how not to run a bank. The Comptroller's Office became aware of management and loan problems at Penn Square Bank as early as April 1980. In the following months, OCC officials met repeatedly with officers of the bank and the bank's board of directors. Further deterioration of the bank in 1980 resulted in a formal written agreement between the Comptroller's Office and the board of directors dated September 9, 1980, in which the board agreed to make specific changes and improvements in its policies and operations. By the close of 1981, the Comptroller's Office had noted improvements in Penn Square's condition and the establishment of the programs and systems required of it under the 1980 agreement.

But in the first 6 months of 1982, Penn Square went on a lending spree amounting to approximately $1.1 billion in new energy related loans, many of which were apparently of dubious quality. By the time the Comptroller's Office began its April 1982 general examination, Penn Square's fate was already sealed. As the examination proceeded, writeoffs in the loan portfolio grew to the point that Penn Square's capital was wiped out and the bank was declared insolvent.

With the benefit of 20/20 hindsight, it is easy to suggest how things might have been done differently. Penn Square might have been more vigorously supervised, the Comptroller might have required the removal of certain officers, and so forth. The fact remains, however, that bank regulators can do only so much to try and help an institution save itself. If the officers of a particular bank choose to ignore that advice and plunge recklessly ahead, there may be no way that such an institution can be or should be saved.

The strength of the system is that these failures can be effectively administered by the appropriate regulators and that insured accounts are paid off promptly without losses. It bears repeating the well known fact that not a single dollar has ever been lost in a federally insured deposit since the advent of FDIC insurance nearly 50 years ago.

Having said this, we cannot overlook the disruption caused by a bank failure such as Penn Square. Public confidence in the banking system is shaken, institutions with correspondent relationships experience serious losses related to loan participations with the failed bank, and uncertainty is generated in the markets. The seriousness of these effects requires that Federal regulators do all they can to discover banks that are in trouble and to take necessary steps to bring them back to health.

I am hopeful that these hearings will assist us in discovering what lessons have been learned from the Penn Square Bank failure and how those lessons may be applied to improve the health of our Nation's financial system in the future and hopefully prevent repeats of Penn Squares.

Gentlemen, we are happy to have each of you with us today. We have a very distinguished panel of regulators to testify on this particular issue: The Honorable Todd Conover, Comptroller of the Currency; the Honorable William Isaac, Chairman of the FDIC; the Honorable J. Charles Partee, Member, Board of Governors, Federal Reserve System; Mr. Wendell Sebastian, Executive Director, National Credit Union Administration; and Mr. Thomas P. Vartanian, General Counsel, Federal Home Loan Bank Board.

Gentlemen, we are happy to have you with us and we will start with Mr. Conover.

Mr. CONOVER. Thank you, Mr. Chairman. I have a rather lengthy statement that I would like to have entered in the record and I would like to make some brief introductory remarks that summarize and paraphrase that statement.

The CHAIRMAN. We would be happy to include your full statement in the record and I might take advantage at the same time and say that Senator Tower would have liked to have been here but was not able to, but he also has a statement for the record that we would include at this point and he has some questions for you gentlemen that he will submit to you in writing for your response for the record.

[Senator Tower's statement follows as though read:]

STATEMENT OF SENATOR JOHN TOWER

Senator TOWER. Gentlemen, I have reflected on the testimony on Penn Square Bank before the House Banking and Commerce Committees. I have read with interest the proceedings from the questioning on July 16, 1982, when Mr. Conover and Mr. Isaac were before the committees. It is not my intention to ask you gentlemen to be grilled again. Rather, I believe it should be the function of these hearings today to place the Penn Square Bank experience in perspective. That is, how it relates to the future role of our bank regulatory framework, the continuation and size of deposit insurance, and how another Penn Square Bank incident can be prohibited.

In my own State of Texas, exactly 1 month after the Comptroller closed Penn Square Bank on August 6, 1982, the Abilene National Bank was closed. It was foreclosed upon by the holder of the outstanding bank stock loan, Mercantile National Bank of Dallas. Then Abilene National was merged into the Mercantile of Texas holding company. Thus, the depositors were spared the fact of a Federal Deposit Insurance Corporation receivership. I would like to compare and contrast the foreclosure of the Abilene National Bank with the failure of Penn Square Bank in my brief questions today.

These are questions for the Comptroller of the Currency with comments from the FDIC where appropriate at a later date.

One, Penn Square Bank had been rated a 3 at the conclusion of its September 30, 1981, examination with note of improvement having been made. From then until its closing on July 5, 1982, 9 months passed. In fact, on May 11, 1982, the Washington Office of the Comptroller was notified by the Dallas regional administrator that "problems were being uncovered" at Penn Square. Still it was not until June 30, 1982, that a temporary cease-and-desist order was filed.

Sir, in light of this long incubation period for this Oklahoma bank, I am curious how the process went from months of working with the Penn Square Board and careful combing of the loan portfolio to a matter of just a few days in Abilene National's case. I understand about the now infamous article in the Dallas Morning News on July 9, 1982, questioning Abilene National's loan quality which resulted in a liquidity problem. This liquidity problem, I believe is explainable, but I ask why did this bank go from having liquidity problems the week of July 19, 1982, to having the Comptroller declare on July 23, 1982, that Abilene National would have to raise $30 million in new capital by July 30, 1982, due to potential loan losses estimated to between $20 and $30 million? Would you comment please?

Two, then, explain please why Mr. Clifton A. Poole, Jr., the regional administrator in the 11th National Bank Region made the following statement in July 13, 1982, just 10 days before Poole gave his ultimatum to the board: "Abilene National Bank is not receivership and the Office of the Comptroller of the Currency has no plans to place it in receivership."

Gentlemen, as a representative of Texas where 10 percent of the Nation's banks operate and the spirit of community banking is strong, I am interested in being assured that there is consistency in bank regulation. It is incumbent on us as we move toward deregulation that fear and emotions not govern our actions. Observing the chronology and transcripts from both Penn Square and Abilene National, I must ask a final question.

Three, it appears that in our heavily regulated banking environment that our early warning systems have broken down. Tell me what you believe to be bank regulators' role in a deregulated world?

STATEMENT OF C. T. CONOVER, COMPTROLLER OF THE CURRENCY

Mr. CONOVER. Mr. Chairman and members of the committee, I welcome this opportunity to discuss the actions of the Office of the Comptroller concerning Penn Square Bank. Specifically, I want to address two basic questions: First, why did the bank fail despite our supervisory efforts? Second, should our bank supervisory procedures and regulations be changed in light of the failure and, if so, how?

WHY DID PENN SQUARE BANK FAIL?

Penn Square Bank failed because it made an extraordinary number of poorly conceived, poorly administered loans that violated the basic principles of safe and sound banking. The loans were made in total disregard of both the bank's own internal policies and procedures and OCC's supervisory directives. In a flourishing economy, many of those loans would have been marginal at best. But when the downturn in the energy industry began to seriously hurt many of Penn Square's major borrowers, the results were disastrous.

Let me briefly review OCC's supervisory actions concerning Penn Square Bank. Following an examination in early 1980, the bank's board of directors entered into a formal agreement with the OCC that required the bank to take specific remedial actions. The directors individually signed that agreement. We monitored compliance through monthly reports and periodic examinations. In addition, we required the board of directors to travel to Dallas in August 1980 and July 1981 to discuss the bank's problems and necessary remedial actions with our regional office.

When we conducted an examination in September 1981, the bank appeared to have made substantial progress in complying with the agreement. Bank management assured us they would continue their compliance efforts.

When we returned to the bank in April 1982, however, we discovered that the bank had radically altered its course. At a time when the energy industry experienced a sudden and severe decline, Penn Square went on a binge of imprudent lending that virtually assured its own destruction. Some of the bank's actions even warranted referral for possible criminal prosecution.

Between September 1981 and April 1982, Penn Square generated approximately $800 million in new loans—an amount nearly twice the asset size of the bank. Of the $49.1 million in assets eventually classified as loss, approximately $28.5 million had been booked after September 1981. As rumors of the bank's difficulties began to spread, Penn Square experienced a sharp increase in deposit withdrawals in early July. Consequently, on July 5, 1982, before we had even concluded the examination then in progress, I declared Penn Square insolvent when it became clear that loan losses exceeded capital and the bank could no longer meet the demands of its depositors and creditors.

SHOULD BANK SUPERVISION AND REGULATION BE CHANGED?

OCC's supervisory efforts were unsuccessful in Penn Square largely because management chose to ignore them. In the final analysis, we must depend on bank management and directors to carry out our directives. Over the long term, OCC can detect and overcome bank management resistance to supervisory requirements. In the short term, however, our efforts can be frustrated by a bank management that promises one thing and does another. That is what happened at Penn Square.

That raises the question of whether the failure of Penn Square means there should be changes in bank supervision and regulation. We believe that changes are warranted in two areas: Frequency of full-scope bank examinations, and collection and public disclosure of information about banks.

Well before the failure of Penn Square, OCC had planned to change its onsite examination policies to focus more of its resources on problem banks. After reviewing the rapid deterioration of Penn Square, we increased the frequency of our full-scope examinations of troubled banks.

We also believe that the adverse effects of the failure could have been reduced if the public and bank regulators had been provided with better and more timely information on the condition of the bank. Both the market and the regulators can do a better job of disciplining banks if they have more information about bank condition. There are several ways to obtain that information.

First, we are revising the call report. These revisions will, among other things, require banks to report data on past-due loans, maturity structure, interest rate sensitivity, and commitments and contingencies. We are also requiring all banks to file income statements on a quarterly basis.

Second, we intend to make this information available to the public. The OCC is also considering other disclosures, such as publication of income statements and making certain types of enforcement actions public.

Another question is whether we need legislation to address the specific practices that led to the Penn Square failure. I believe the answer is no. That failure was an aberration arising from unique circumstances. Penn Square justifies neither increased regulation nor a reduced pace of bank deregulation.

Bank failures are always regrettable, and we go to great lengths to prevent them. But I do not believe our country needs or can afford a fail-safe banking system. The possibility of failure imposes an important discipline. It acts as an incentive for banks to avoid unnecessary risk. A fail-safe banking system would eliminate this incentive. It would also encourage regulators to reduce risk to the system by limiting bank management's freedom to make business decisions. Without risk, there is no reward, and without reward, it is impossible to attract either capital or good managers. The public interest would not be well served by a regulatory system that is so restrictive or so protective as to eliminate the risk of failure altogether.

[Complete statement of Mr. Conover follows:]

STATEMENT OF
C. T. CONOVER
COMPTROLLER OF THE CURRENCY
BEFORE THE
COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS
U.S. SENATE
DECEMBER 10, 1982

Mr. Chairman and Members of the Committee:

I welcome this opportunity to discuss the actions of the Office of the Comptroller of the Currency concerning the Penn Square Bank of Oklahoma City, which was declared insolvent on July 5, 1982.

While the failure of the Penn Square Bank raises many questions, two are particularly pertinent to the agency:

- Why did the bank fail despite our supervisory efforts?

- Should our bank supervisory procedures and regulations be changed in light of the failure and, if so, how?

I will deal principally with these questions. To aid the Committee in its review of the Penn Square Bank failure, I have also provided, as an appendix to my statement, a summary of OCC policies and procedures affecting problem banks and a more detailed history of OCC's supervision of Penn Square Bank.

OVERVIEW OF THE FAILURE

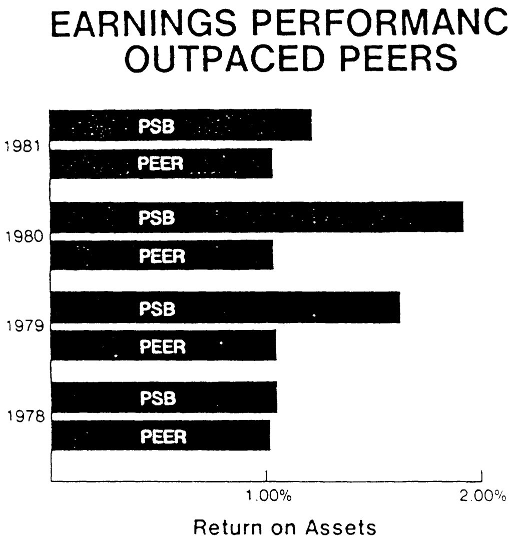
To understand why the Penn Square Bank failed despite our regulatory actions, the direct cause of the failure must be considered: poorly conceived and poorly documented loans that violated prudent banking policies and procedures. The bank had concentrated its loans in the Oklahoma oil and gas production industry. In late 1981 and early 1982, that industry suffered a severe and unexpected decline. Many of Penn Square's major customers began to experience financial difficulties. Rather than reducing its exposure to these firms, Penn Square extended more credit in an effort to "bail out" its customers. In late 1981 and early 1982, the bank originated an extraordinary volume - over $800 million - in new loans. The vast majority of those new loans were to energy-related borrowers.

When the decline in the oil and gas industry continued to deepen, many of the new loans became non-performing. Loan losses greatly exceeded the bank's capital, thus, resulting in a book insolvency. Simultaneously, a severe decline in market confidence in the bank led to a run-off of deposits and other funding sources, thus causing a liquidity insolvency. Accordingly, the combination of a large volume of poor quality credits and a severe downturn in economic conditions directly resulted in the failure of the bank. A primary cause of the insolvency was that the Penn Square management heedlessly disregarded the principles of safe and sound banking and failed to comply with OCC directives.

OCC SUPERVISORY ACTIONS

A Chronology of Events

In 1980 Penn Square Bank was assigned a "3" rating under the Uniform Financial Institutions Rating System despite the absence of many of the usual quantitative indicators for a bank requiring special supervision. OCC was concerned about the bank because of its poor liquidity and funds management, deficient capitalization, and lack of staff expertise. Essentially, we thought the bank's resources were stretched very thin by its extremely rapid growth. In light of the bank's strengths, however, a more severe "4" or "5" rating was not warranted. At that time, the overall quality of the loan portfolio was acceptable and its earnings exceeded those of its peers. See chart below:



Because of its weaknesses, the bank was placed in OCC's Special Projects Program to receive additional supervision. As part of that program, we required, and the bank consented to implement, remedial measures for the identified problems. Through a formal agreement signed by each director under 12 U.S.C. § 1818(b), OCC required the bank, its board, and management to: increase capital; formulate and implement a more stringent loan policy, and establish improved internal review procedures to enforce that policy; develop and implement acceptable policies on liquidity, asset, and liability management; and evaluate and strengthen its staff and management.

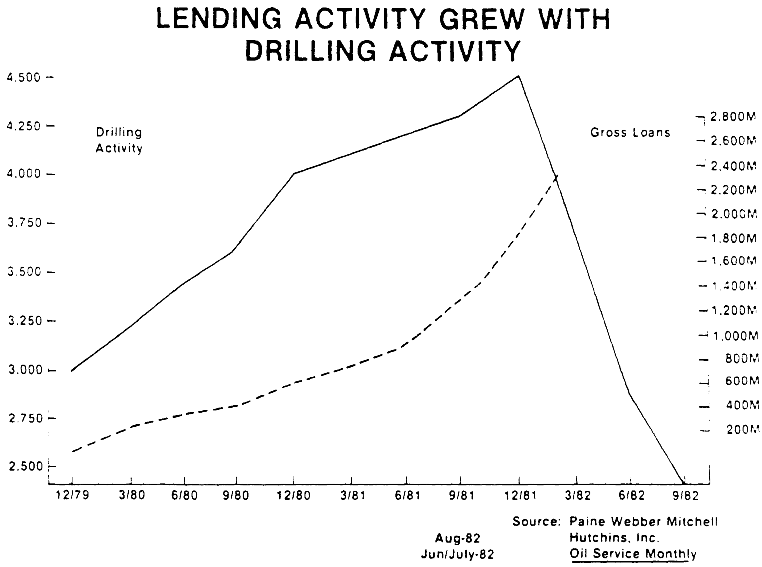
The formal agreement, signed in September 1980, was consistent with our guidelines affecting problem banks. The Office thereafter undertook to monitor implementation and compliance by the bank with that agreement. The bank was examined with the same scope and frequency accorded other "3" rated banks.

We expressed concern over the concentration of credits to oil and gas interests and questioned whether such a concentration was consistent with prudent risk diversification. Nevertheless, we felt that the decision of whether the bank should continue to make loans in the oil and gas industry, provided such loans were of good quality, was within the discretion of management and the board. The bank's strong prior earnings record and the then favorable prospects of 1980 for the energy industry mitigated our concerns regarding those loan concentrations. We did not feel that restrictions on the growth of the bank were necessary or appropriate if such growth conformed to the terms of the agreement, particularly the requirement that capital be maintained at 7.5% of assets.

After initial resistance, the bank's management agreed to implement OCC's proposed remedial measures. By September 1981, the bank appeared to have substantially complied with most of the OCC directives. More particularly, the bank had adopted an adequate capital plan; had increased its capital to an acceptable level; had hired experienced management and lending officers; had adopted an adequate loan policy that required approval by a committee, the Chairman, or the President of all loans over $50,000; had created an internal loan review procedure to assure compliance with the policy; had adopted acceptable policies on liquidity, asset and liability management; and had hired a new chief financial officer to oversee that area. Most significantly, the bank had brought on a new management team which appeared to be competent, in control, and fully committed to improve the bank's condition in a manner consistent with OCC directives.

In normal circumstances, such measures could be expected to improve the bank's condition. Thus, the "3" rating was continued through the September 1981 examination. However, following the September 1981 examination, largely in response to difficulties in the energy industry, the bank engaged in various transactions which were wholly inconsistent with prudent banking practices and in wholesale disregard of agreed upon lending policies and procedures. These actions made the failure of Penn Square Bank inevitable.

As previously noted, between the September 1981 examination and the commencement of our examination in April 1982, the bank originated approximately $800 million in new loans largely to its oil and gas customers who were beginning to experience financial difficulties due to a severe decline in their industry. As indicated in the following chart, domestic drilling activity (as represented by the number of active drilling rigs) was substantial and growing until late 1981, at which time the industry faltered. Penn Square's lending continued to increase beyond that time in disregard of the industry's decline.



Many of those loans were of poor quality and violated the internal lending policies and review procedures mandated by OCC. The extraordinary volume of loans generated was almost twice the size of the bank. It is virtually impossible to prudently manage such explosive growth. By the bank's own count, there were over 3,000 documentation exceptions in the loan portfolio. Many liens were not filed, some had not been taken, and some notes were even unsigned. A large percentage of those loans eventually resulted in loss which caused the bank's failure. Of the $49.1 million in assets eventually classified as loss, approximately $28.5 million (or 58% of losses) had been booked after the September 1981 examination. Had the examination initiated in April 1982 been completed, the bank's rating, would certainly have been increased from a composite "3" to a composite "5". The declaration of insolvency, however, overtook such a redesignation.

Reason for Failure Despite OCC Supervision

The bank failed despite OCC's supervision, in significant part, because bank management acted imprudently and abandoned their compliance with our remedial directives. If the bank had fully implemented the terms of the agreement, its condition would not have deteriorated so rapidly and, very probably, would have improved. Indeed, OCC supervisory procedures and directives, as we followed with respect to Penn Square Bank, have proven to be overwhelmingly effective with "3" rated banks.

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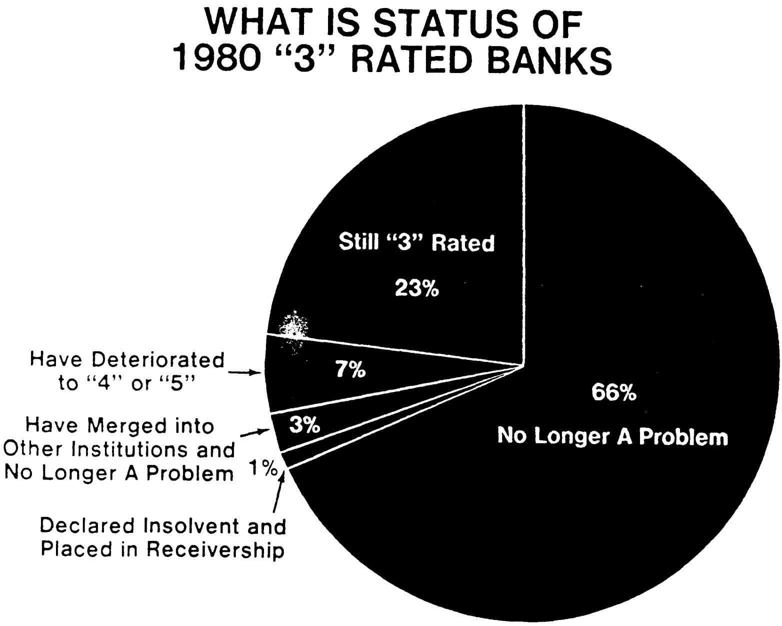
The chart below summarizes the ratings, as of October 31, 1982, of the 215 national banks that were rated "3" in August 1980.



The management of Penn Square failed or refused to adhere fully to the agreement which likely would have prevented the failure. We received repeated assurances from management and the board of directors that the bank would fully comply with the agreement. If Penn Square had ever openly refused to cooperate with our supervisory efforts, OCC would have taken stronger action.

By the time OCC returned to the bank in April 1982, the bank had during the few months between examinations radically altered its course and thereby assured its own failure. The the bank's extraordinary imprudence resulted in:

- o classified assets which were 352% of gross capital funds
- o delinquency in almost 13% of the loan portfolio
- o more than 3,000 credit and collateral documentation exceptions

The conduct of some bank officials was so egregious as to warrant our referral of particular matters to the United States Attorney for possible criminal prosecution.

We followed established and generally successful examination and supervisory procedures in addressing the problems of the bank based upon the facts known to us at the time. However, our experience with Penn Square demonstrates that the agency's supervisory effectiveness is to some extent limited by the responsiveness (or unresponsiveness) of a bank's management and board to our efforts. Over the long term, OCC will usually detect and overcome management resistance. However, in the short term, our supervisory efforts can be defeated by a bank management that promises one thing and does another. Such actions are irresponsible in the best of times. They are disastrous in an economic environment that changes very quickly, as did the oil and gas industry. Essentially, this is what occurred at Penn Square.

LIMITS OF FEDERAL BANK SUPERVISION

The extent to which OCC can or should direct the affairs of national banks is practically limited. Our banking system is a private enterprise system. Consistent with our nation's fundamental economic philosophy, the basic strategy of the federal bank supervisory agencies is to work with bank management to detect and control the risk exposure of their institutions, and to assure a high level of bank compliance with applicable laws and regulations. The role of OCC may be defined as supervisory. We do not take over and manage institutions; we do not substitute for private management. However, if a bank refuses to cooperate, OCC vigorously enforces laws and prudent banking standards within the limits of due process.

In extreme cases, OCC can, consistent with statutory requirements, remove or suspend an officer, or order that bank management carry out or refrain from particular acts.

Generally, however, when a bank is experiencing problems and requires special supervision, OCC will direct the bank management to implement remedial measures and, where appropriate, we will order such changes through formal and informal administrative actions.

In the final analysis, the agency's ability to affect the condition of a bank depends upon the execution of our directives by the officers and directors of the bank. It is not desirable for the regulator to substitute for bank management. A necessary consequence of this properly limited role of bank supervisors is that some banks can and will fail despite our best efforts. In the short term, unless we permanently assign a team of national bank examiners to review all decisions made by a bank, management can deceive us as to whether it is complying with our directives. Despite this risk, the agency must presume the honesty and good faith of management. The bank supervisory system could not operate under a presumption of management dishonesty.

Penn Square's disregard of the agreement was not detectable by OCC's remote monitors because the violations were basically qualitative rather than quantitative in nature. The data in current call reports does not readily reflect changes in the quality of a loan portfolio between examinations. The recently announced changes in call report data should help to alleviate this problem.

More Stringent Action Was Not Warranted

Would the failure have been prevented if OCC had made more extensive use of its formal administrative powers? In my opinion, no.

OCC had considered issuing and, indeed, had threatened to issue a cease and desist order against the bank. However, in practical terms, such an order would have contained essentially the same requirements as the agreement. Moreover, OCC monitors day to day compliance with orders and agreements in essentially the same way. Finally, in light of the apparent cooperation of the bank's management and directors, such an order did not seem warranted.

Neither removal of officers nor civil money penalies were justified in light of the information known to us before the April 1982 examination. While OCC was concerned with the lending activities of Mr. Patterson, Senior Executive Vice President in charge of the energy department, prior to the spring of 1982, we did not believe that his activities or those of anyone else were sufficiently egregious to satisfy the requirements for removal under 12 U.S.C. § 1818(e)(1). By the time we became aware of information that would have justified the removal of any officer or director, the damage to the bank had been incurred and its failure was all but inevitable.

THE LESSONS OF PENN SQUARE

Finally, we come to the other question: Should bank supervision and regulation be changed in light of the failure? As noted before, the primary reason for the bank's failure despite OCC supervisory efforts was that imprudent banking practices resulted in so rapid a deterioration that OCC had insufficient time to implement effective remedial measures. During the period between our examinations, and contrary to its assurances, the bank went on a binge of imprudent lending. Pushed on by unrealistic optimism for a recovery of the energy industry or in an effort to hang on and minimize losses, the bank went too far in extending new credit.

Our experience with Penn Square has confirmed certain conclusions OCC had already reached. Under our recently implemented policies, OCC will provide more frequent examination of all "4" and "5" rated banks and of "3" rated banks with assets of more than $100 million. OCC also will assign more of its examining resources to such banks. The rapid deterioration of Penn Square Bank between exams underscores the need to increase the frequency of examination of banks with composite ratings of "3" or higher.

Among the other specific issues that the OCC is further reviewing in light of the Penn Square Bank experience are:

- o Whether OCC should provide more frequent examinations for banks engaged in large sales of loans and participations
- o Whether OCC can make additional improvements in its remote monitoring system to increase our ability to detect rapid changes in a bank's loan portfolio
- o How OCC might better use information obtained while examining one bank in examining other banks
- o What additional information about banks should be publicly disclosed

These are not easy questions, but they must be answered. Some preliminary conclusions can be drawn from the Penn Square Bank failure.

The adverse effects of the failure could have been reduced if the public and the bank regulators had been provided with better and more timely information on the condition of the bank. This suggests several remedial measures to increase the quality of market discipline and supervisory oversight by improving the amount and quality of information available, particularly from non-registered banks (like Penn Square Bank) that are exempt from many disclosure requirements.

First, the federal bank regulators are changing the Report of Condition and Income, commonly known as the "call report", to provide the regulators with more information about banks. To permit assessment of the quality of loans and leases, banks will be required to report data on past due, non-accrual and renegotiated loans and leases, and the amount of charge-offs and recoveries during the reporting period. Other revisions will require banks to report maturities of assets and liabilities and interest rate repricing opportunities to aid in the analysis of rate sensititivity and rate risk. Finally, to provide improved reporting of income and expenses, all banks will eventually be required to report on a full accrual basis of accounting.

Second, we intend to publicly disclose more information about the condition of banks. Deregulation should result in shifting some of the responsibilities for the discipline of banks from the regulators to the marketplace. If the marketplace is to function efficiently and provide adequate safeguards against excessive risk, market participants must have adequate information. For that reason, information on loans past-due for 90 days will be made public beginning with the June 30, 1983 call report. The Office is also considering other disclosures, such as publication of income statements and making certain types of enforcement actions public.

New Legislation is Not Needed

There is, however, no need for enactment of legislation at this time to address the specific practices that led to the Penn Square Bank failure. That failure was, in large part, an aberration arising from unique circumstances. Penn Square Bank justifies neither increased regulation nor reduction in the pace of deregulation of banking.

The bank's failure raises in stark terms a fundamental regulatory question: Do we want and can we afford a failsafe banking system? The answer must be no.

The possibility of a business failure plays an important role in the free enterprise system. Failures remove inefficient firms so that the resources they consume may be allocated to their more efficient competitors. Most importantly, the threat of failure is essential if the discipline of the marketplace is to function.

The lack of a credible threat of failure can have two adverse effects upon businesses. First, any company may not operate as efficiently if not faced with a risk of collapse. The threat of failure motivates banks to be vibrant and responsive to changing needs for financial services. Second, a business that cannot fail may be inclined to imprudently engage in high risk activities that offer potentially large profits. This second effect has profound implications for banking. Indeed, such thinking may have influenced some of the banks that purchased large quantities of loans and participations from Penn Square Bank. They, and we, have undoubtedly learned a valuable lesson from the failure.

The risk of a failure motivates investors and depositors, not directly involved in managing the bank but who still have a stake in its soundness, to monitor carefully the performance of the bank's management with regard to risk exposure.

A failsafe banking system would forfeit these important benefits. It would also incur unacceptably high social and financial costs. In order to eliminate the risk of serious errors or transgressions that could result in a bank's failure, the freedom of bank management to make business decisions would be curtailed and supplanted by regulatory supervision. The social costs from the resulting loss of individual liberty, entrepreneurial initiative, and industry efficiencies obviously would be unacceptable. Our banking system would become stagnant and unresponsive.

Further, such a system would require almost constant examination of banks because, as we have seen in Penn Square, a bank can change radically in a very short time. The maintenance of such a system would be extremely expensive.

The public interest warrants reasonable supervisory safeguards to assure a safe, sound, and efficient banking system. This requires a high degree of bank monitoring, supervision and, in some cases, even coercion to prevent excessive bank failures. However, the public interest would not be well served by a regulatory system that is so restrictive or so protective as to eliminate the risk of failure altogether.

The failure of the Penn Square Bank if understood in light of its peculiar circumstances--and the conduct of its management and directors--does not demonstrate a need for more federal regulation of banks.

APPENDIX

I. Summary of OCC Supervisory Policies and Procedures

To aid the Committee in understanding OCC's supervisory actions regarding Penn Square, OCC's relevant policies and procedures will be briefly described.

A. Uniform Financial Institutions Rating System

All the federal bank supervisory agencies, including OCC, use the Uniform Financial Institutions Rating System. That system assigns to each bank a numerical rating, from one to five in ascending order of supervisory concern, reflecting the bank's financial condition, compliance with laws and regulations, and overall operating soundness. The system was developed in accordance with suggestions from the General Accounting Office.

Institutions rated composite "1" or "2" pose no serious supervisory concern. Those rated composite "4" or "5" are generally characterized by unsafe, unsound, or other seriously unsatisfactory conditions and carry a relatively high possibility of failure or insolvency. A composite "3" rating indicates an institution with a combination of weaknesses ranging from moderately severe to unsatisfactory. This rating may be assigned to banks exhibiting significant non-compliance with laws or regulations or those whose financial condition is weak and vulnerable to deterioration if business conditions become adverse. Generally, such institutions require more than normal supervision, but their overall financial condition makes failure only a remote possibility.

As of October 31, 1982, the number of national banks in each composite rating were as follows:

- o 2,138 (47.6%) were rated "1"
- o 1,992 (44.3%) were rated "2"
- o 299 (6.7%) were rated "3"
- o 49 (1.1%) were rated "4"
- o 15 (0.3%) were rated "5".

B. <u>OCC On-Site Examinations</u>

The primary supervisory tool used by the OCC to monitor the condition of national banks is the on-site examination process. The three types of commercial on-site examinations are: "general," "specialized" and "special supervisory." A general commercial examination covers all areas of the bank's operations. However, frequent use of the exhaustive general examination procedures is neither necessary nor desirable for most banks. Accordingly, other more targeted examination procedures are also used. A "specialized" examination complements the general examination, but its scope is limited to the areas of significant importance or significant change. Finally, a "special supervisory" examination is usually limited to the review of previously criticized loans, internally identified loan problems, asset-liability management, and compliance with any administrative actions or other enforcement documents between the bank and OCC.

The type and frequency of on-site examinations of a particular bank depend, in part, upon its composite rating. Under the policy in effect between January, 1979 and March, 1982, banks with a composite "3" rating, regardless of size, were examined twice every 12 months with at least one such examination scheduled as a specialized exam. Those rated "4" or "5", regardless of size, were examined twice every twelve months with at least one to be a general examination. Under the current policy, all banks rated "4" or "5" and those rated "3" with over $100 million in assets are examined twice every 8 months with one examination scheduled as a special supervisory. Banks rated "3" with under $100 million in assets are examined twice every 12 months with one examination scheduled as a special supervisory.

C. OCC Remote Monitoring Devices

OCC also supervises the national banking system through the use of remote monitoring techniques. The computerized National Bank Surveillance System ("NBSS") is OCC's key remote monitoring device. The NBSS is primarily designed for the early detection of problem banks and as a supervisory and administrative system for the OCC. As part of the NBSS, Uniform Bank Performance Reports ("UBPR") are produced by the FFIEC from a data base obtained from official Reports of Condition and Income and other reports submitted by banks. The UBPR is designed for use by bank management, bank examiners, and NBSS specialists in the evaluation of banks.

As part of its surveillance program, the NBSS each quarter examines all national banks with a composite rating of "1" or "2" by means of an early warning system called the Anomaly Severity Ranking System ("ASRS") to determine which will receive special review. Banks already receiving special supervisory attention and with a composite rating of "3," "4," or "5" are not subject to ASRS selection and review since these banks are already receiving continuous attention in the special projects program. The ASRS is a computerized scoring system which allocates the highest numerical score to those banks having the most abnormal positions, changes, and trends in performance or composition. Those banks receiving the highest scores under the ASRS are selected for review. Such a review utilizes the skills and special training of designated national bank examiners. It consists of an analysis of the Uniform Bank Performance Report and other available informaton. The NBSS specialist's conclusions and recommendations are presented in writing to each Regional Administrator. Identification of serious conditions of present or potential concern results in an examination, investigation, or discussion with bank management. If no serious conditions are found, the bank may be passed with no further action required.

Finally, the NBSS has an Action Control System. This element is a separate computerized system that records: (a) banks selected for priority review; (b) any conditions of concern observed by the NBSS specialists; (c) the projected date correction is anticipated for each condition; (d) the desired level for each condition; and (e) each condition's current status. Status, progress, and summary reports are rendered at intervals to Regional Administrators and other senior OCC officials. Conditions of concern which have been recorded in this monitoring system cannot be removed until correction has been achieved or until the bank is placed under special supervisory attention with a "3" rating or higher.

D. OCC Administrative Actions

The use of formal and informal administrative actions by OCC to direct banks in improving their regulatory compliance and financial condition depends partially upon the composite rating of the subject institution. This policy was also developed in accordance with suggestions from the General Accounting Office. For banks rated "4" and "5," it is OCC policy to take formal administrative action. Typically, such action will involve Agreements or Cease and Desist Orders executed pursuant to our enforcement authority (12 U.S.C. 1818). For banks rated "3," it is OCC policy to consider similar formal administrative action. However, if formal action is determined to be inappropriate, then informal remedial action is taken through the use of a Memorandum of Understanding between the Regional Administrator and the bank. Of course, formal administrative actions, if appropriate, may be taken with respect to "1" and "2" rated banks.

OCC has found these policies generally successful in supervising banks requiring special attention, particularly 3-rated banks. Sixty-six percent of banks assigned a composite rating of "3" in August, 1980 were rated "1" or "2," as of October 31, 1982, 23% were stabilized at "3," and 7% were rated "4" or "5,". An additional 3% had been acquired in non-supervisory mergers, and 1% had failed.

II. History of OCC Supervision of Penn Square

The investigation and review of this matter by OCC is still continuing. Nevertheless, based upon what we presently know, it is clear that the OCC supervisory personnel followed OCC policies and procedures in their supervision of Penn Square. A chronology of events affecting Penn Square follows.

A. 1960 - 1979

Penn Square received a national bank charter in 1960. In 1976, it became 100% owned (less directors' qualifying shares) by the First Penn Corporation. From the time it was chartered until 1977, the bank experienced strong but manageable growth and was not subject to any unusual supervisory action. However, from May of 1977 until its closing, the bank experienced a period of extraordinary growth.

B. The Events of 1980

February 1980 Examination

The bank first became a matter of supervisory concern following an examination dated February 29, 1980, which concluded on April 14, 1980. This examination revealed a bank which was basically sound and had shown exceptional growth in the area of oil and gas lending. Those loans resulted in a concentration of credit and the sale of participations to other banks. The loan loss reserve was adequate. The internal controls were acceptable. The overall quality of the loan portfolio had deteriorated, but not to an unacceptable degree, and the bank's earnings exceeded those of its peers. Nevertheless, Penn Square had some problems, including insufficient liquidity, inadequate capital, an increase in classified assets, and violation of banking laws. Accordingly, out of an abundance of caution, the bank was designated to receive special supervisory attention and was rated a composite "3" pursuant to the Uniform Financial Institutions Rating System.

OCC Begins Special Supervision and Enters into Formal Agreement

On June 9, 1980, the Deputy Regional Administrator forwarded the report of examination to the board of directors with a transmittal letter detailing many of his concerns. The letter directed the board of directors to convene a special meeting within five days to review the report and take remedial action. The letter also indicated that a full board meeting would be held in the Dallas Regional Office of the OCC to discuss administrative action. On the same date, the Deputy Regional Administrator also recommended to Washington that the OCC take enforcement action.

On June 19, 1980, the Regional Administrator and his staff advised the bank's chairman and the executive vice president of the examination findings. He also told them that the bank would be subject to formal administrative action by this Office pursuant to the cease and desist process. By letter dated July 15, 1980, the Chairman of Penn Square's board of directors informed OCC that a special meeting of the board of directors had been held to review the most recent report of examination and to formulate a capital plan. The bank's president, in a separate letter, described specific actions the bank would take to correct some of the problems OCC had noted in its report.

On August 27, 1980, the Regional Administrator convened a meeting with the bank's full board of directors at its Dallas Regional Office. During that meeting the board was clearly informed of the problems in the bank and of the need for corrective action. They were also presented with a formal agreement. On September 9, 1980, all the members of the bank's board of directors individually signed the formal agreement pursuant to the cease and

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desist statute. Among other things, the agreement required Penn Square to correct all violations of law, achieve and maintain an adequate level of capital, establish and implement a program to reduce the level of criticized loans which included the development of internal procedures and guidelines, conduct a management study, take steps to improve its liquidity, and report monthly to the OCC.

The agreement did not expressly restrict the growth of the bank because growth that would have occurred in compliance with the agreement would not have substantially increased the risk to the bank. In other words, through the capital maintenance requirements and new operating procedures mandated by the agreement, OCC believed that it had largely controlled and prevented any future imprudent growth.

Notification of Other Regulators

A copy of the February 29, 1980 examination report of Penn Square was furnished to the Federal Reserve District Bank, which had supervisory responsibility for Penn Square's holding company, and to the FDIC Regional Office. Additionally, when Penn Square was placed under special surveillance in July of 1980, the Special Projects Division, in accordance with OCC policy, provided to the Washington offices of the Federal Reserve Board and the FDIC copies of an OCC memorandum outlining the bank's problems and the remedial measures to be taken. Both the FRB and the FDIC were also notified in July, 1980 of the prospective formal action against Penn Square by OCC.

September 1980 Examination

From September 9 through September 11, 1980, OCC conducted a special supervisory examination of the bank to review previously critized loans, past-due loans, new loans, the bank's capital plans, and its liquidity. The examination disclosed rapid growth with funding heavily dependent upon rate-sensitive deposit sources. Liquidity was strained, and the existing staff was overtaxed by business volume. However, a significant improvement in the quality of the loan portfolio was found. Additionally, the bank was soon to receive an injection of $3.3 MM in equity capital from its holding company.

OCC Special Supervision Continues

On October 8, 1980, the Regional Administrator sent a letter to the bank's board of directors which transmitted the examination report and which analyzed existing problems and the level of compliance with the agreement. This letter also directed further action. Specifically, it required the board to implement procedures within the next quarter which would improve the level of capital and to provide additional monthly reports so OCC could better monitor the bank's liquidity.

C. The Events of 1981

December 1980 Examination

Because of the findings of the September 1980 special examination, a general examination, utilizing financial data as of December 31, 1980, was conducted by a select team of examiners from January 5, 1981 through February 27, 1981. It disclosed deterioration in the bank's overall condition. The major concerns continued to be inadequate capital, poor asset quality, ineffective loan administration, inadequate staffing and policy development, weak internal controls, deficient liquidity, and imprudent asset and liability management practices. During 1980, the bank had more than doubled in size. Most of this growth continued to be concentrated in energy-related loans. Additionally, violations of banking laws and the formal agreement were cited in the report.

The bank, however, continued to show some strengths and positive development. The management expressed a willingness to comply with the agreement and to correct the deficiencies noted in the examination report; to that end, the bank established a management task force. Some violations of law had been corrected and more were corrected during the examination. The bank had partially satisfied the requirement in the agreement by adopting policies and procedures in several areas of its operations. Earnings continued to be high when compared to those of similar banks. A plan to increase the bank's capital had been adopted.

July 1981 Meeting

Nevertheless, OCC remained concerned with the continued problems at the bank and its non-compliance with the agreement. A lengthy discussion ensued in the Washington and Regional Offices of the OCC on whether a cease and desist order should be imposed on the bank. Ultimately, it was determined that OCC would inform the board of directors that, unless the bank provided convincing assurances that it was going to correct the deficiencies, OCC would impose a cease and desist order.

Accordingly, on June 2, 1981, the examination report was sent to the board of directors and in a comprehensive letter dated July 1, 1981, the Regional Administrator informed the board that management had failed to supervise prudently the bank's activities. The letter pointed out, among other things, that this lack of supervision had manifested itself in the following:

- Numerous violations of banking laws;
- Inordinate asset/liability management risk;
- Uncontrolled growth of bank resources; and
- Noncompliance with the formal agreement with OCC.

The letter requested that the board of directors arrange a meeting in our Dallas Regional Office to discuss the report and to determine further action to be taken by the board and management.

On July 29, 1981, a meeting was held in the OCC Dallas Regional Office between representatives of OCC from the Regional and Washington Offices and the full board of directors of Penn Square and several newly hired bank officers. Most of these new officers, including the new President, Mr. Beller, had impressive prior experience in banking and were known by OCC officials in the Regional Office. At this meeting, OCC discussed the report and detailed its supervisory concerns. During the meeting and afterwards, Mr. Beller, Mr. Jennings (the Chairman of the Board) and most of the other directors indicated their agreement with OCC's concerns and their resolve to improve the condition and compliance of the bank. During this meeting, Mr. Beller told OCC's Regional Director for Special Surviellance that he would not have accepted a position with the bank unless he was to have full control and that he did, in fact, have full control. His role as spokesman for the bank during the meeting tended to verify this statement.

September 1981 Examination

In accordance with the OCC procedures requiring the examination of "3"-rated banks, a special supervisory examination utilizing data as of September 30, 1981, was conducted during the period October 8 through October 30, 1981. The OCC Regional Director for Special Surveillance was the examiner in charge. He was familiar with Penn Square as a problem bank from his position in the Regional Office and was an able and experienced examiner. Although the bank's overall condition remained of concern, this examination revealed improvements. The report noted that the bank had significantly improved its lending staff, its loan policy and its internal controls.

Of particular significance to OCC was the creation of a satisfactory internal loan approval policy, loan processing department, and an internal loan review procedure. The examiner-in-charge ("EIC") received express assurances from President Beller and other officers that under the new approval policy no new loans in excess of $50,000 were to be made without the review and approval of the president or a loan approval committee. Further, all loans were to be scrutinized by a loan review committee.

The EIC specifically expressed concern to Mr. Beller about the bank's ability to control the lending activities of Mr. Patterson, the Senior Executive Vice President in charge of the energy department. However, Mr. Beller assured the EIC that he had initiated efforts to bring Mr. Patterson under control and that he would succeed. On several occasions during the examination, Mr. Beller told the EIC that he had total control over the bank and that Mr. Jennings never disputed anything that Beller wanted to do. Accordingly, the EIC left the bank assured that there were adequate controls over Mr. Patterson. OCC had no reason to believe that Mr. Beller's assurances of control over Mr. Patterson were untrue. In a letter to OCC dated December 9, 1981, the bank detailed its new management structure and therein showed Mr. Patterson reporting directly to Mr. Beller.

Improvements were also observed during the September, 1981 examination in asset-liability management and control. The violations of law noted in the December 1980 report had been corrected and the bank appeared to have made considerable progress toward full compliance with the agreement. The periodic reports submitted by Penn Square pursuant to the agreement similarly reflected progress and a desire by the new management to improve the condition of the bank and to comply with the terms of the agreement.

The implementation of satisfactory internal loan review procedures, the quality and commitment of new management and the now adequate capitalization tended to mitigate our concern for the energy-related loan concentration. Given the importance of energy to the local economy, it was neither surprising nor improper that a bank in that area should have a large number of loans to energy-related concerns. Moreover, at that time, the future for the energy industry in Oklahoma appeared quite favorable. Spot prices on crude oil had reached a high of $42/bbl. in late 1980 after increasing tenfold in less than a decade. Drilling companies achieved record returns in 1981. Most analysts failed to predict the sharp decline in the oil and gas industry which was to occur within a very short time.

D. The Events of 1982

In light of the problems still remaining in the bank, representatives of the OCC attended the board of directors' meeting of the bank of January 12, 1982 to discuss the results of the examination. The bank's board was informed that a more detailed examination would be conducted near the end of the first quarter of 1982. As late as January 1982, OCC believed, on the basis of the information available, that the outlook for Penn Square was favorable and that all substantial areas for concern were being addressed and corrected.

April 1982 Examination

On April 19, 1982, OCC began the general examination that ultimately led to the closing of the bank. OCC entered the bank expecting to find its condition substantially improved. However, by the second or third week of the examination, there were indications that the bank's condition had declined and that it had significant problems. Among the problems discovered was that the bank's loan files were in disarray and lacked essential documentation. This tended to slow considerably the review of the bank's loan portfolio. It should be noted, however, that at this time there were no indications that the bank faced a serious risk of imminent failure.

Much of the change in the bank's condition was directly and indirectly due to the severe, rapid and unforeseen decline in the oil and gas industry during the fourth quarter of 1981 and the first quarter of 1982, i.e., after the September, 1981 examination. By March, 1982, the price of crude oil had dropped to below $30/bbl. By July, 1982, the number of active drilling rigs in the United States had decreased by 40% from December, 1981. The major oil companies experienced a record decline in earnings; the first quarter 1982 earnings of 72 U.S. oil companies had fallen 35% from the same period in 1981. Losses and severe cash strain were also experienced by the smaller and more highly leveraged oil and gas production companies.

The impact of this decline upon many of Penn Square's most important borrowers was devastating. The bank had concentrated in loans to firms in the oil and gas industry. As those firms began to experience financial difficulties the bank, instead of prudently reducing its exposure, made large additional loans in an effort to assist those customers. Many of those loans were made in violation of the lending policies and procedures OCC had insisted be installed. More importantly, many violated the essential tenets of prudent banking and - if viewed realistically - had little likelihood of being repaid.

The examination disclosed that between September 30, 1981 and March 30, 1982 the bank had originated an astonishing $800 million in new loans. A large portion of those loans were to energy firms. Of the $49.1 in assets eventually classified as loss, almost $28.5 million were booked after September 30, 1981. The bank's imprudent lending eventually produced total classified assets equal to 352% of gross capital funds and delinquency in almost 13% of the loan portfolio.

A properly managed institution with a similar concentration in well structured energy credits could have survived the decline in the oil and gas industry. However, the combination of poor credits, poor management, and an adverse economy proved fatal to Penn Square. The problem assets led to deficient capitalization and, due to an excessive dependence upon purchased funds, severely strained liquidity.

The Insolvency

In May and early June, the news media began to give increasing attention to the bank and there were indications that the bank might lose some of its major sources of funding. On June 25, media attention and rumors in the industry had reached a point to cause OCC to be concerned about the possibility of a liquidity emergency. OCC knew that if such an emergency occurred, it would effectively deny the OCC an opportunity to complete its examination in an orderly manner and deny the board any opportunity to save the institution by recapitalizing it or arranging a sale or merger.

Throughout the examination, OCC kept the bank's management fully informed of the facts as they were discovered. Based on the preliminary findings of the examination, the OCC issued a Notice of Charges and a Temporary Order to Cease and Desist on June 30, 1982, to require immediate action by the directors to rehabilitate the bank, including: the injection of $30 million in additional capital by July, 9, 1982, correction of collateral and documentation deficiencies, curtailment of new lending activities, and the engagement of independent auditors to reconcile the asset accounts of the bank. On July 1, 1982, OCC attended a special meeting of the Board of Directors to advise the directors of the preliminary examination findings and the administrative action taken by OCC.

Subsequently, when the OCC determined that the additional capital was needed immediately to restore confidence in the bank and slow a deposit runoff, the Temporary Order to Cease and Desist was amended to require the bank to obtain $30 million in new equity capital by the close of business on July 2, 1982. No additional capital was injected. Subsequently, the OCC further amended the Temporary Order to limit transactions with affiliates to prevent the bank from repurchasing participations from its holding company.

In late June 1982, OCC contacted several of the banks holding large amounts of participations in Penn Square loans. These contacts had two objectives: first, to seek assistance of the banks in averting the possible failure of Penn Square through creation of a consortium to purchase the bank or through some other means; and second, to ascertain the effects of the possible failure of Penn Square on the soundness of those institutions.

OCC informed the other federal financial regulators of the new developments at Penn Square as they were discovered. On May 21, 1982, while the examination was still in progress, the Regional Administrator notified the Regional Director of the FDIC that the examination was uncovering significant problems. On June 23, 1982, the Regional Administrator further informed the FDIC's Regional Director of the conditions disclosed by the ongoing examination. Subsequently, on June 30, 1982, the OCC met with the Chairman of the FDIC in Washington and informed him that the problems had grown significantly worse. Responding to the growing public and industry concern over the bank's condition and mindful that the concern could create a severe liquidity strain on the bank, the OCC invited the FDIC to join its ongoing examination for contingency purposes. The FDIC did join the examination on July 1, 1982. The OCC, in a letter dated July 2, 1982, formally requested that the FDIC begin preparations for a potential purchase and assumption transaction or payout of insured deposits.

As of Friday, July 2, the loan losses were not sufficient to render the bank insolvent on a book basis. However, the bank had lost sufficient support from the marketplace to render it dependent upon the Federal Reserve Bank for funding. The borrowings from the Fed allowed it to operate on a solvent basis for July 2 and the next half day (July 3).

Due to concerns about the depth of the bank's loan problems and the possible impact upon other institutions, OCC's examiners worked through the weekend to try to determine the true condition of the bank's loan portfolio. Based upon the review done by the examiners, we determined, as of July 5, 1982, that the losses then identified exceeded the capital funds of the bank. Also, by the end of the weekend, the regulators and bank management had concluded that withdrawals on the next day of business (Tuesday, July 6) were likely to be enormous. On July 5, 1982, the Federal Reserve Bank of Kansas City, in response to a question from this Office, indicated that it was no longer willing to fund the bank's operations at the discount window. The bank, already dependent upon the Fed for its funding survival, would therefore not be able to meet the demands already placed upon it in the ordinary course of business. Because no other source of funding was available, it was insolvent on a liquidity basis. We became satisfied on July 5, 1982, of the insolvency of the bank. Accordingly, on that date, acting pursuant to our statutory duties, at 7:05 p.m. (CDST) we declared the bank insolvent and appointed the FDIC as receiver.

The CHAIRMAN. Thank you very much.
Mr. Isaac.

STATEMENT OF WILLIAM M. ISAAC, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. ISAAC. Thank you, Mr. Chairman.

The events surrounding the Penn Square failure have been widely publicized and are well known to the committee; I will not dwell on them in my prepared remarks. I would like to focus on the lessons to be learned from Penn Square and update the committee on FDIC's post-closing activities.

FAILURE CONFIRMS LESSONS OF THE PAST

Our feeling is that the failure does not teach us much new. Rather, it confirms a lesson of the past, namely that laws, regulations, and supervision are not always effective in preventing or curing problems where a bank—and its board of directors—are dominated by a strong personality who is set on a course of mismanagement. We feel strongly that uninsured depositors and other investors need to pay more attention to how their banks are run and must be provided better information upon which to base their judgments. To the extent that Penn Square has heightened awareness of this, it has been beneficial.

Well before Penn Square, we were in the process of revising and expanding the call reports we obtain from banks. We believe Penn Square underscores the desirability of collecting more and better information and of making more information available to the public. Quarterly reports on nonperforming loans, for example, will be required commencing January 1, and this information will be made public commencing with the reports of June 30, 1983. While some bankers have expressed concern about making this information public, I should point out that similar information has been reported for years to the SEC by publicly held institutions without resulting in any undue harm. If institutions with higher than normal ratios of nonperforming loans have more difficultly attracting funds, we believe that is a healthy and appropriate result of disclosure. Given timely and factual information about banks, we hope and believe the investing public will reward the better-managed institutions with lower-cost funds.

In addition to seeking additional information about banks and requiring its public disclosure, we are proceeding with the deposit insurance study mandated by title VII of the Garn-St Germain Act. In an environment where funds may be transferred almost instantaneously by electronic transmissions anywhere in the world, where money managers must operate profitably on narrowing spreads, and where deposits are more likely to be viewed as investments than ever before, it is appropriate to reexamine the basic tenets of our insurance programs and regulatory structure. We are particularly concerned that as federally mandated restrictions on competition are diminished there be some effective substitution of market discipline. Our study is directed toward finding answers about how to maintain the integrity of our financial system in this challenging new competitive environment. We look forward to appearing before you next year to discuss these matters.

When the FDIC was appointed receiver for the Penn Square Bank on July 5, we found ourselves faced with one of the most difficult situations we have ever encountered. I cannot speak too highly of the performance of the scores of FDIC employees who have been working 16- and 17-hour days, 7 days a week since that holiday weekend. The early days were chaotic, and some of the banks participating in the Penn Square loans were understandably concerned about their inability to get all of the information they wanted. Our first priority had to be to make funds available to insured depositors and issue receiver's certificates to the uninsured general creditors. During August and September, we detailed 41 extra people to the receivership to expedite the handling of loans, and we now believe we are on top of these administrative problems.

The creation of the Deposit Insurance National Bank proved to be an effective way of avoiding panic, minimizing inconvenience to depositors, and limiting disruption in the community. Last week we obtained court approval to sell the former banking house and remaining deposits to an investor group that is seeking a national bank charter. We expect the charter to be granted soon, and when that is done we will transfer the remaining insured deposits to the new bank and terminate this aspect of our operations.

Attached to my statement is a report on the status of the Deposit Insurance National Bank and the receivership. As noted there, we acquired assets of Penn Square Bank amounting to $511.3 million. As of October 31, 1982, we had collected $221.4 million in principal and interest on loans—including $101.6 million on loans sold by Penn Square to the other banks. Expenses charged to the receivership as of October 31 totaled approximately $3 million, or 1.36 percent of collections. As we work off the better assets and concentrate on the tougher problems, this ratio of expenses to collections can be expected to rise significantly. As noted in the attachment, interest income of the receivership through October 31, 1982, totaled $12.8 million.

Excess funds collected are invested in Treasury obligations and earn market rates of interest pending distribution to holders of receiver's certificates. It is our hope an initial distribution can be made to holders of the receiver's certificates in an amount of 10 to 15 percent of their face value during the first quarter of 1983.

POSSIBLE CRIMINAL VIOLATIONS

An important part of our work in the receivership is the ongoing investigation of possible criminal violations which may have contributed to the bank's failure. Since our last report to the committee detailing activities through September 30, 1982, we have referred 13 additional cases to the Attorney General, for a total of 43 referrals of possible criminal activity. Active and successful prosecution of these cases by the Attorney General would do more to deter future bank problems than anything I can think of.

I would be pleased to answer any questions. Thank you.

[Attachments follow:]

December 3, 1982

FDIC REPORT ON RECEIVERSHIP OF PENN SQUARE BANK, N. A., AND OPERATIONS OF THE DEPOSIT INSURANCE NATIONAL BANK OF OKLAHOMA CITY

Penn Square was closed July 5, 1982, by the Comptroller of the Currency, who named the FDIC receiver.

Status of the Penn Square Receivership

Upon appointment as receiver, the FDIC acquired for liquidation all the assets of Penn Square totaling $511.3 million. In addition, the FDIC acquired $8.2 million in assets which had been charged off by the bank prior to its closing. The liquidation portfolio included the following categories of assets at book value:

Cash and Due From Banks	$ 27,695,235
Securities	48,424,725
Installment Loans	22,382,169
Commercial Loans	334,030,402
Mortgage Loans	48,885,019
Owned Real Estate	5,818,718
Other Assets	8,446,206
Overdrafts	15,617,418

In addition, Penn Square had outstanding loan participations sold to other banks equal to $2.1 billion as of the date of the closing.

As of October 31, 1982, the FDIC had collected $221.4 million in principal and interest on loans, securities, and other assets. Out of the total collected, $101.6 million was paid to the holders of loan participations sold by Penn Square, $7.5 million was used to repay secured advances from the Federal Reserve to Penn Square, and $13.5 million was paid to owners of pledged deposits.

Receivership Income and Expenses

Expenses of the liquidation from inception of the receivership to October 31, 1982, totalled approximately $3.0 million, or 1.36 percent of collections. The ratio of expenses to collections is expected to increase significantly as the liquidation progresses and the quality of the remaining assets declines. Expenses of the receivership were as follows:

Salaries	$1,987,692	Equipment	$ 93,990
Employee Benefits	114,956	Supplies, Computer & Court Costs	104,570
Outside Services	186,357	Interest Expense	301,679
Travel	13,858	Owned Asset Operating Expense	10,286
Building and Lease Costs	221,839		

Interest income of the liquidation from inception of the receivership to October 31, 1982, totalled approximately $12.8 million, as follows:

Loans	$8.8 million
Securities	1.6 million
Mortgages	2.4 million

Collected receivership funds are invested in U.S. Treasury securities and earn market rates of interest.

The FDIC operates in two separate capacities in the liquidation of Penn Square: in its corporate capacity, as insurer of deposits, and in its capacity as receiver. Payments to all insured depositors, as well as all costs incurred in connection with the payment of insured deposits, are borne by the FDIC's insurance fund. In its capacity as receiver of Penn Square, the FDIC operates as a fiduciary on behalf of all creditors of the bank, which includes the FDIC to the extent of the insured deposits paid. The FDIC's claim against the receivership excludes its administrative expenses incurred in paying deposit claims. The FDIC does not have a preference for its claim but shares *pro rata* with all other creditors with proved claims in the distribution of the failed bank's assets.

The FDIC bears a substantial part of the costs incurred in the liquidation of assets. For example, lodging, meal, and travel costs (except those travel costs incurred in connection with specific receivership functions) for FDIC liquidators and examiners assigned to the closed bank are paid as an insurance expense and are not recovered from the receivership estate of the bank. The same is true for the salaries of Washington Office supervisory and support personnel who work on Penn Square matters. However, all other FDIC expenses incurred in the liquidation of assets are charged to the receivership estate of Penn Square and are recovered first as administrative expenses from the receiver's collections.

The receivership staff includes liquidators, in-house attorneys, loan work-out specialists, and bookkeeping and clerical employees. In addition, oil and gas experts have been retained. The receivership staff totals 283, including 77 permanent FDIC employees and 206 former Penn Square and other locally-hired employees. An additional 2 FDIC employees and 14 former Penn Square and other locally-hired employees are employed by the DINB. Prior to the closing, Penn Square had 383 employees.

Litigation By and Against the Receivership Estate

The FDIC, in its capacity as receiver of Penn Square, is involved in extensive litigation, a significant amount of which had been filed prior to the bank's closing. At the present time there are pending approximately 250 different legal actions in which the FDIC is a party. Roughly 20 percent of these actions are bankruptcy proceedings in which FDIC is involved as a creditor. Many of the actions are suits to collect on loans and other assets of Penn Square.

Several major claims have been made in actions brought against the FDIC as receiver of Penn Square and other parties arising out of the bank's energy-related lending activities. These suits raise legal issues regarding letters of credit, the rights of loan participants, and general bank receivership principles. Some litigants have raised allegations of fraud on the part of certain oil drilling companies and Penn Square officers.

Bond Claims and Directors Liability Matters

FDIC personnel have been conducting a thorough examination of Penn Square's records since July 5, 1982, with a view toward developing and presenting substantial claims under Penn Square's bankers blanket bond. The FDIC is also investigating potential claims against former officers and directors of the bank and the bank's accounting firm.

Criminal Irregularity

The FDIC is conducting, in conjunction with the FBI, a thorough investigation of the events and activities which led to Penn Square's failure. At the present time, the FDIC has discovered 43 matters which may constitute criminal offenses under federal law. Evidence in these matters has been referred to the Justice Department for further investigation and possible prosecution.

Receiver's Certificates

Depositors with amounts on deposit in Penn Square in excess of the insurance limit of $100,000 had their deposits up to the insurance limit transferred to the DINB, while the excess became a claim against the Penn Square receivership. Each such depositor is being issued a "Receiver's Certificate" in an amount equal to the uninsured portion of the deposit. The excess depositors' claims have general creditor status, which means they will share in liquidating dividends with the FDIC and other general creditors from the recoveries realized from the receiver's liquidation of the bank's assets. The FDIC is hopeful that a first dividend can be paid to creditors with proved claims during the first quarter of 1983.

The receivership has issued 1,792 receiver's certificates in the total amount of $157.8 million as of November 30, 1982.

It is too early to make any reliable estimate of the total recoveries likely on Penn Square's assets. First estimates of possible recoveries will probably be completed in early 1983 and, once made, will undoubtedly be subject to significant change as the liquidation progresses.

Status of the DINB's Operations

The DINB was established by the FDIC in order to make the insured deposits immediately available.

On July 5, 1982, the DINB assumed 24,538 insured deposit accounts totaling $207.5 million. As of November 30, 1982, the DINB had 1,525 insured deposit accounts totaling $4.9 million which consisted of $4.4 million in demand deposits and $500,000 in time deposits. The FDI Act authorizes the operation of a DINB for up to two years. Before the end of that period, the FDIC may transfer the bank's business to another insured bank in the same community or it may conclude the bank's business and cease its operations.

13-540 O - 83 - 4

The CHAIRMAN. Thank you very much, Mr. Isaac.
Mr. Partee.

STATEMENT OF J. CHARLES PARTEE, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. PARTEE. Thank you, Mr. Chairman.

I am happy to appear before this committee today to discuss the Federal Reserve's involvement with the Penn Square Bank. Let me state at the outset that the Federal Reserve's involvement was limited to its role as a lender of last resort, regulator of Penn Square Bank's parent bank holding company and to a general concern over the impact of bank failures on the orderly operation of the Nation's financial system.

FEDERAL RESERVE'S INVOLVEMENT WITH PENN SQUARE BANK

As a lender of last resort, the Federal Reserve provides essential credit to depository institutions for the purpose of providing temporary liquidity in times of need. The lending function of the Federal Reserve is conducted through the District Federal Reserve Banks, which operate under broad guidelines established by the Board in Washington. In the case of Penn Square Bank, the Federal Reserve Bank of Kansas City was the lending bank. The president of the Kansas City Reserve Bank has appeared before a congressional committee to explain the Reserve Bank's loans to Penn Square Bank in detail, and his testimony is a matter of public record. Briefly, the relevant facts are as follows.

On June 30, Penn Square Bank requested, and was granted, a $20 million loan from the Federal Reserve Bank of Kansas City. This loan was supported by a pledge of $26.3 million of Penn Square Bank's customer notes. The loan was repaid the next day. Friday, July 2, the bank again borrowed, this time in the amount of $5.7 million, which was collateralized by $39.4 million of Penn Square Bank's customer notes.

Over the July 4 weekend, the Federal Reserve Bank was notified by the Comptroller of the Currency that the Penn Square Bank's current loan losses and potential loan losses arising from irregularities in loan documentation and other business practices would extinguish the bank's capital funds. The Comptroller also informed the Federal Reserve that the Penn Square Bank would be unable to meet the demands of its depositors and creditors from private funding sources. In response to the Comptroller's evaluation of the bank's asset portfolio, its capital position, and the dissipation of its private funding sources, the Federal Reserve Bank notified the Comptroller of the Currency of its intention not to extend credit to the bank under these circumstances. Subsequently, the Comptroller declared the bank insolvent, and it was closed on July 6. The Federal Deposit Insurance Corporation, as receiver, paid the $5.7 million loans owing to the Federal Reserve Bank of Kansas City, which released the collateral to the receiver.

The Federal Reserve also functioned as the regulator of the bank's parent company, First Penn Corp. The condition of First Penn Corp. was essentially reflective of the condition of the bank, since the parent company was a "shell" principally serving as a vehicle to hold the stock of the bank. As is the case when the holding company owns a national bank, the Reserve Bank relied on the findings of the Comptroller with respect to the bank's condition. The Federal Reserve Bank of Kansas City inspected the First Penn Corp. on two occasions between the beginning of 1981 and the time the bank failed in July 1982. There was no evidence that any of the activities of the holding company contributed to or were in any way responsible for the Penn Square Bank's difficulties. Indeed, virtually all of the parent company's assets were represented by deposits with, investments in, or loans purchased from the Penn Square Bank.

In the context of the Board's concern over the effect of the failure of Penn Square Bank in the markets generally, the Federal Reserve explored possible alternatives to liquidation of the bank. Given the circumstance and the short period of time available to arrange an alternative solution, however, it became clear on Monday, July 5, that the bank was destined for liquidation.

SOLUTION FOR UNINSURED DEPOSITORS

Prior to the closing, the Federal Reserve was notified that the Penn Square Bank had a substantial amount of uninsured deposits from financial institutions. Under the receivership, the uninsured depositors were to be given "receiver's certificates" amounts equal to the uninsured portion of their respective deposits. In response to the potential liquidity needs of these financial institutions, the Federal Reserve announced that the "receiver's certificates" would be acceptable as collateral for advances at the Federal Reserve discount window. Since the failure of the Penn Square Bank, the Federal Reserve has received only a limited number of discount window borrowing requests from these institutions. As of today, there are no loans outstanding secured by "receiver's certificates."

The Federal Reserve has also reviewed the Penn Square episode to determine the capacity of existing bank laws and regulations to handle a similar situation should it occur in the future. It is our judgment that current banking statutes and regulations, and the supervisory tools available to Federal bank regulators are adequate at present to oversee the safety and soundness of our Nation's banking system. We would point out, once again, that the failure of Penn Square resulted from an extreme emphasis on growth at the expense of sound lending and funding practices, and in the absence of proper management oversight and controls. The extremely unsound banking practices that caused the failure of the Penn Square Bank represent an isolated instance, not characteristic or typical of commercial banks or depository institutions generally. Indeed, the evidence we have continues strongly to indicate the overwhelming majority of banks being operated in a sound and prudent manner.

The CHAIRMAN. Thank you, Governor Partee.

STATEMENT OF WENDELL SEBASTIAN, EXECUTIVE DIRECTOR, NATIONAL CREDIT UNION ADMINISTRATION

Mr. SEBASTIAN. Thank you, Mr. Chairman. As you know, Chairman Callahan's brother was taken very seriously ill yesterday and he left to be with his family. I appreciate your indulgence in allowing me to testify in his behalf. We have submitted a rather lengthy formal document for the record and I'd like to simply make a few remarks to summarize the Penn Square failure and its effect on credit unions.

[Complete statement follows:]

TESTIMONY OF

EDGAR F. CALLAHAN

CHAIRMAN

NATIONAL CREDIT UNION ADMINISTRATION BOARD

Mr. Chairman, members of the Committee, I am pleased to be here today to give you an updated report on the impact of the Penn Square Bank failure on credit unions. It is my sincere hope that this report will fully address any concerns which this Committee or others might have regarding current credit union operations. I certainly welcome this opportunity as I believe we might now have a better perspective on this matter looking at it 5 months later.

The closure of the Penn Square Bank resulted in certain operating losses for 139 federally insured credit unions whose uninsured deposits totalled $111.5 million. All of these insured credit unions continue to operate and serve their members. In the vast majority of cases, the credit unions were able to absorb these operating losses through their operating income and, of course, no credit union member has lost any money. In those requiring assistance, traditional methods such as waiver of reserve transfers or charges to reserves have been adequate in most cases. In a few instances, however, a very limited amount of temporary direct assistance has been given in the form of guarantees or deposits.

As for the amount of loans against the Receiver Certificates, $35 million has been requested and granted thus far by the Central Liquidity Facility. For your further information, we anticipate $10 million of this to be paid back within the next week.

At this point in time, I am quite hopeful that no credit union will have to be closed as a result of Penn Square. I believe that valuable lessons have been learned not only by this agency, but more importantly by credit union decision-makers. Although, in all fairness, I must say that hindsight is certainly an advantage. At the time, a decision-maker had to weigh two factors as I see it. One, the available information on the financial condition of the bank which, as I understand it, included a satisfactory 1981 year-end audit from Peat, Marwick, Mitchell & Co. as well as other traditional financial information. Against this would have to be weighed a concern for concentrating funds in order to receive a relatively high yield. Any such concern would, of course, be somewhat ameliorated by the fact that, prior to Penn Square, the last significant credit union losses in a failed bank were in the Sharpstown Bank in 1971.

Nevertheless, credit union managers are re-thinking their investment strategies. In our examinations we will be looking more closely at credit union investment policies to make sure that they have been developed as carefully as possible. Of course, Mr. Chairman, credit union investments are fixed by statute and in general are limited to government guaranteed obligations or to deposits in insured institutions. Further, NCUA regulations require that if money brokers are doing business with a credit union, the credit union itself must transfer directly any funds involved. As far as the money brokers are concerned, there is little doubt as to their contribution to the concentration of credit unions in Penn Square. However, I am not aware of any impropriety or illegality on their part. We have sought comments on our investment regulations and we will continue to study this area before we adopt any changes. Copies of the investments authorized by statute, the investment regulations, and the request for comments are attached as Enclosures (1)-(3).

I realize that when something like this occurs, there is a very legitimate question that should be asked of a regulator - what are you going to do to help prevent this or similar situations from occuring in the future? Well there is no perfect answer, but we have been taking steps. The most important is our examination. We are in the midst of reviewing the role of the examiner towards giving him or her greater flexibility and the opportunity to exercise judgment in the actual conduct of the exam. We want them to not just follow the form, but to take some further initiative and ask questions and hopefully find the early signs of the next "Penn Square" type situation.

Next, we are increasing the frequency of our exams with an eventual goal of reaching each and every credit union yearly. Further, we are reviewing the make-up of the exam itself in an effort to identify ways to make it more effective.

Also, I have tried to vastly increase the lines of communication between the agency and the credit unions. Our regional offices are much more autonomous and decisions can be made much more rapidly. If we can alert credit union managers and boards of directors to potentially adverse situations at the earliest possible time, we can try to minimize future problems in these areas. As a matter of fact, a letter to all credit unions cautioning against concentration of deposits in a single institution due to yield was sent by this Agency in June of 1981 (Encl. (4)).

Before I proceed Mr. Chairman, I do want to try and set this particular credit union loss in perspective.

Losses are a normal part of doing business and they are planned for. In the credit union business, the vast majority of these losses occur as a result of loans and a much smaller percentage results from investment losses. This is due to two factors: (1) credit unions do much more lending than investing as their primary function is to make loans to their members; and (2) the Federal Credit Union Act limits credit union investments primarily to those issued, insured, or guaranteed by the government.

But investment losses can occur in the safest of investments as credit unions found out in 1979 in their experience with Ginnie Maes. Substantial credit union investment losses occurred as the result of Ginnie Mae investments made that year and these losses continue to be realized. But they were small compared to loan losses and they were absorbed.

For example, in 1981, Federal credit unions experienced loan losses of approximately $183 million. This was 25 times greater than their losses due to investments of $7.3 million. Loan losses were slightly less than 1% of total loans made while investment losses were only 1/10th of 1% of all investments. Even if the Penn Square losses had occurred last year, the percentage of investment losses would still have been only about 4/10 of 1%. My point is that loans will continue to be the main risk area for credit unions.

As you know, Mr. Chairman, the present financial atmosphere has raised the question of further disclosure by financial institutions and your bill (P.L. 97-320) has mandated a study which includes disclosure. I agree that this could be a productive area, but I want the Committee to see first-hand the current credit union disclosure requirements. I have inserted at this point a sample disclosure form that is updated monthly and posted in the lobby of all Federal credit unions.

Figure 3-1: Statement of Financial Condition (FCU 109A)

Internal Use Only Report Type __ | Acct. Code No. 100 | 70165 A — Charter # or Ins. Cert. #

STATEMENT OF FINANCIAL CONDITION AS OF December 31, 19X1

Our Federal CREDIT UNION

ASSETS:

Ref.*	Item — LOANS & CASH	$ Amount	¢	Acct. code no.
	1. a. Outstanding balances of lines of credit loans to members	1,500,000	00	702
	b. Real estate loans to members (first lien) (Orig maturity over 12 years)	400,000	00	703
	c. Loan balances fully secured by shares	96,611	00	706
	d. All other loans to members (excluding a,b,c, above)	2,900,000	00	001
	e. Total loans to members (include items a,b,c, and d)	4,896,611	00	700
	2. All other loan accounts (excluding amts. in 1,a,b,c,&d)			710
	3. (Less) Allowance for loan losses	40,120	00	719
	4. Net Loans Outstanding (Sum of 1e plus 2 less 3)	4,856,491	00	002
	5. Cash (cash on hand, petty cash, checking accts., etc.)	85,389	00	730

Ref.*	INVESTMENTS (A + B = C)	Remaining Maturities A. 1 Yr. or less $	¢	Remaining Maturities B. More than 1 Yr. $	¢	C. Total $	¢	Acct. code no.
	6. U.S. Govt. Obligations							741
	7. Federal agency securities							742
	8. Common trust investments							743
	9. Shares, deposits, & certif. in corp. centrals							744
	10. Shares, deposits, & certif. in other CUs							745
	11. Shares, deposits, & certif. in banks S&L's & MSB's							746
	12. Loans to other credit unions	180,000	00			180,000	00	747
	13. All other investments							003
	14. Shares in Central Liquidity Facility (Direct or Indirect)							751
	15. (Less) Allowance for investment losses							759
	16. Net Investments (Sum of 6 through 14 Less 15)					180,000	00	004

Ref.*	OTHER ASSETS	$	¢	Acct. code no.
	17. Land and building (net of depreciation)			007
	18. Other fixed assets (net of depreciation)	95,440	00	008
	19. Monetary control reserve deposits			793
A	20. All other assets	7,345	00	009
	21. TOTAL ASSETS (Sum of 4,5,16 & 17 through 20)	5,224,665	00	010

FCU 109A

LIABILITIES SAVINGS EQUITY

Ref.*	Item (A+B=C)	Remaining Maturities A. 1 yr. or less $	¢	Remaining Maturities B. More than 1 yr. $	¢	C. Total $	¢	Acct. code no.
	22. Promissory notes							812
	23. Reverse Repurchase Transac.							813
	24. Other notes Payable							814
	25. Interest payable							818
B	26. Accounts payable					8,973	00	800
	27. Dividends/Interest on shares/deposit payable					97,845	00	820
	28. All other liabilities					1,504	00	012
	29. Total Liabilities (Sum of 22 through 28)					108,322	00	011
	30. a. Share certificates	1,000,000	00	500,000	00	1,500,000	00	908
	b. Share draft accounts					200,000	00	902
	c. Member Deposits (SCU's Only)							005
	d. Other member savings					2,796,873	00	006
	e. Non-member Savings							920
	f. Total savings/shares/deposits (Sum of 30a through 30e)					4,496,873	00	013
	31. Regular/statutory reserve					526,361	00	931
	32. Investment Valuation reserve (SCU's only)							015
	33. Special Reserves							016
	34. Other reserves							017
	35. Undivided Earnings					93,109	00	940
	36. Net Income (Loss)							960
	37. TOTAL LIABILITIES SAVINGS & EQUITY (Sum of 29, 30f and 31 through 36)					5,224,665	00	014

Ref.*	MARKET VALUES OF INVESTMENTS	Remaining Maturities A. 1 Yr. or less $	¢	Remaining Maturities B. More than 1 Yr. $	¢	C. Total $	¢	Acct. code no.
	38. U.S. Governmnt Obligations							018
	39. Federal agency securities							019
	40. a. All other Investments	180,000	00			180,000	00	020
	b. ____							021

*Numbers in this column refer to notes to financial statements, letters refer to supplementary schedules which are attached.

Figure 3-2: Statement of Income (FCU 109B)

Internal Use Only* Report Type __ | Acct. Code No. 100 | 70165 A — Charter # or Ins. Cert. #

STATEMENT OF INCOME
FOR PERIOD ENDED 12/31/X1

Ref*	Item	OPERATING INCOME:	Month Dec. 19X1	¢	Period from 10/01/X1 To Date	¢	Year-to-date	¢	Acct. code no.
	41	Interest on loans (gross)	49,787	00	131,345	00	525,383	00	110
	42	(Less) Interest refunded							119
	43	Income from investments	937	00	3,206	00	12,825	00	120
	44	Other operating income							050
	45	Total Gross Income (Items 41-44)	50,724	00	134,551	00	538,208	00	100
		OPERATING EXPENSES:							
	46	Employee compensation	7,964	00	23,052	00	92,908	00	210
	47	Employee benefits							220
	48	Travel & conference expense	480	00	4,731	00	5,211	00	230
	49	Association dues							240
	50	Office occupancy expense	557	00	1,988	00	7,951	00	250
	51	Office operations expense	1,416	00	8,916	00	35,664	00	260
	52	Education & promotional expense	7,197	00	3,294	00	13,174	00	270
	53	Loan servicing expense	836	00	1,278	00	5,110	00	280
	54	Professional & outside services	1,000	00	2,092	00	8,366	00	290
	55	Provision for loan losses	2,713	00	7,592	00	30,371	00	300
	56	Member Insurance	2,665	00	8,547	00	34,189	00	310
	57	Operating fees (exam., & super)	815	00	2,437	00	9,749	00	320
	58	Interest on borrowed money							340
	59	Annual meeting expense					5,817	00	350
	60	Misc. operating expense	23	00	26	00	103	00	075
	61	Total Oper. Exp. Before Div. & Int. on Dep. (Total of items 46 to 60)	25,666	00	63,953	00	248,613	00	061
	62	Net Operating Inc. (Loss) Before Div. & Int. on Dep. (Item 45 less 61)	25,058	00	70,598	00	289,595	00	052
		NON-OPERATING GAINS OR LOSSES							
	63	Gain (loss) on investments							420
	64	Gain (loss) on disposition of assets							430
	65	Other non-operating income (expense)							440
	66	Total Non-Operating Gains and Losses							063
		ALLOCATION OF INCOME							
	67	Total Net Income (Loss) Before Div & Int/Dep	25,058	00	70,598	00	289,595	00	054
	68	Interest on deposits (SCU's only)							055
	69	Dividends	15,654	67	46,964	00	187,857	00	380
	70	Net Income (Loss) After Div & Int/Dep	9,403	33	23,634	00	101,738	00	056
	71	(Less) Req. trans to reg. or stat. reserve	5,072	40	13,455	00	53,820	00	057
	72	Provision for loan losses adjustment	2,713	00	7,592	00	30,371	00	058
	73	Change to Undivided Earnings as a Result of Operations	7,043	93	17,771	00	78,289	00	059

FCU 109B

Our Federal CREDIT UNION

Ref*	Item	CLASSIFICATION OF LOANS OUTSTANDING	A. Number	B. $ Amount	¢	Acct. code no.
	74.	Degree of delinquency:				
		a. current and less than 2 months	2,714	4,894,602	00	060
		b. 2 to less than 6 months	4	387	50	061
		c. 6 to less than 12 months	1	563	30	062
		d. 12 months and over	1	1,058	20	063
		e. Total loans (sum of 74a thru 74d.) (must equal 1e. + 2)	2,720	4,896,611	00	064
		OTHER LOAN INFORMATION	**A. Number**	**B. $ Amount**	**¢**	**Acct. code no.**
	75.	Loans sold and being serviced by the credit union				065
	76.	Real estate loans made during current year	14	400,000	00	066
	77.	Total loans made during current year (include real estate loans)	637	2,370,490	00	067
	78.	Total loans made since organization	6,700	48,564,910	00	068
	79.	Total loans charged off since organization		58,503	00	069
	80.	Recovery of loans charged off since organization		46,500	00	070
	81.	Net loans charged off since organization		12,003	00	071
		MISCELLANEOUS INFORMATION				
	82.	Dollar amount of forward commitments to purchase (securities, etc.)				072
	83.	Number of members at end of month		2,044		073
	84.	Number of potential members		8,176		074

We certify, to the best of our knowledge and belief, this statement and the related statements are true and correct and present fairly the financial position and the results of operations for the periods covered.

G. L. White — Certified correct by: (Please Print)
202 - 357-1460 — Telephone No.

G.L. White — Treasurer-Manager (Signature)
1/1/X2 — Date

Geofrey Learner — President/Authorized Officer
1/1/X2 — Date

* Numbers in this column refer to notes to financial statements, letters refer to supplementary schedules which are attached.

As you can see it is very detailed and thorough. It includes such items as allowance for loan losses, total loans, investment losses, and detailed information on delinquent loans. Many people were not aware that credit unions have been making this type of disclosure for a number of years. I would also like to point out that many of the credit unions involved in Penn Square provided to their members a full explanation of the situation in their newsletters.

A final point, Mr. Chairman, and I will be glad to answer any of your questions. This concerns the matter of cooperation among the regulators. I was personally informed of the pending action on Penn Square before it was taken and our staffs have exchanged information on a routine basis as we went along. Even if one regulator had more advanced information about the other's problem institutions there is only so much you can do with this information. For example, one of the credit unions experiencing a difficult recovery from Penn Square is having this trouble not only from the Penn Square losses but from rumors about another bank in which it had deposits. Because of the atmosphere set by the Penn Square fallout and newspaper stories of possible problems in the other bank, this credit union went ahead and took its deposits out of the other bank. The early withdrawal penalties were almost as damaging as the uninsured deposit losses and the combination made it much more severe.

Again, I want to thank you for the opportunity to present this report, Mr. Chairman. I hope that it has helped to place the credit union involvement in Penn Square in perspective. In my opinion, while Penn Square was certainly a serious problem, the credit union system seems to be handling it.

This concludes my statement.

Sec. 107 - FEDERAL CREDIT UNION ACT

(7) To invest its funds (A) in loans exclusively to members; (B) in obligations of the United States of America, or securities fully guaranteed as to principal and interest thereby; (C) in accordance with rules and regulations prescribed by the Board, in loans to other credit unions in the total amount not exceeding 25 per centum of its paid-in and unimpaired capital and surplus; (D) in shares or accounts of savings and loan associations or mutual savings banks, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation or the Federal Deposit Insurance Corporation; (E) in obligations issued by banks for cooperatives, Federal land banks, Federal intermediate credit banks, Federal home loan banks, the Federal Home Loan Bank Board, or any corporation designated in section 846 of Title 31 as a wholly owned Government corporation; or in obligations, participations, or other instruments of or issued by, or fully guaranteed as to principal and interest by, the Federal National Mortgage Association or the Government National Mortgage Association; or in mortgages, obligations, or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation pursuant to Section 305 or Section 306 of the Federal Home Loan Mortgage Corporation Act; or in obligations or other instruments or securities of the Student Loan Marketing Association; or in obligations, participations, securities, or other instruments of, or issued by, or fully guaranteed as to principal and interest by any other agency of the United States and a Federal credit union may issue and sell securities which are guaranteed pursuant to section 306 (g) of the National Housing Act;* (F) in participation certificates evidencing beneficial interests in obligations, or in the right to

receive interest and principal collections therefrom, which obligations have been subjected by one or more Government agencies to a trust or trusts for which any executive department, agency, or instrumentality of the United States (or the head thereof) has been named to act as trustee; (G) in shares or deposits of any central credit union in which such investments are specifically authorized by the board of directors of the Federal credit union making the investment; (H) in shares, share certificates, or share deposits of federally insured credit unions; (I) in the shares, stocks, or obligations of any other organization, providing services which are associated with the routine operations of credit unions, up to 1 per centum of the total paid in and unimpaired capital and surplus of the credit union with the approval of the Board: Provided, however, That such authority does not include the power to acquire control directly or indirectly, of another financial institution, nor invest in shares, stocks or obligations of an insurance company, trade association, liquidity facility or any other similar organization, corporation, or association, except as otherwise expressly provided by this Act; and (J) in the capital stock of the National Credit Union Central Liquidity Facility; <u>(L) investments in obligations of, or issued by, any State or political subdivision thereof (including any agency, corporation, or instrumentality of a State or political subdivision), except that no credit union may invest more than 10 per centum of its unimpaired capital and surplus in the obligations of any one issuer (exclusive of general obligations of the issuer); and</u>*

(8) to make deposits in national banks and in State banks, trust companies, and mutual savings banks operating in accordance with the laws of the State in which the Federal credit union does business, or in banks or institutions the accounts of which are insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation,* and for Federal credit unions or credit unions authorized by the Department of Defense operating suboffices on American military installations in foreign countries or trust territories of the United States to maintain demand deposit accounts in banks located in those countries or trust territories, subject to such regulations as may be issued by the Board and provided such banks are correspondents of banks described in this paragraph;

* Changes made by the Garn-St Germain Act (P.L. 97-320)

Part 703

Investments and Deposits

§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;

(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.

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NATIONAL CREDIT UNION ADMINISTRATION

ADVANCE COPY

PROPOSED RULES & REGULATIONS

THIS ADVANCED COPY CONTAINS A PROPOSED NCUA REGULATION WHICH IS SCHEDULED TO APPEAR IN THE FEDERAL REGISTER WITHIN A FEW DAYS. COMMENTS SHOULD BE DIRECTED TO THE NATIONAL CREDIT UNION ADMINISTRATION, WASHINGTON, D.C. 20456.

July 16, 1982

NATIONAL CREDIT UNION ADMINISTRATION

12 C.F.R. Part 703

INVESTMENTS AND DEPOSITS

ADVANCE NOTICE OF PROPOSED RULEMAKING

AGENCY: National Credit Union Administration

ACTION: Advance Notice of Proposed Rulemaking

SUMMARY: During the summer of 1981, the National Credit Union Administration reviewed and substantially eliminated mandatory regulatory provisions governing the granting of loans by Federal credit unions. In late 1981, the National Credit Union Administration began a review of its regulations that govern the liability side of the Federal credit union balance sheet. Now, the National Credit Union Administration is soliciting comments on whether, and to what extent, it should modify its rules governing investments and deposits by Federal credit unions.

DATES: Comments must be received on or before August 20, 1982.

ADDRESS: Send comments to Robert Monheit, Regulatory Development Coordinator, National Credit Union Administration, 1776 G Street, N.W., Washington, D.C. 20456.

FOR FURTHER INFORMATION CONTACT: Robert M. Fenner, Deputy General Counsel, Telephone: (202) 357-1030.

ENCLOSURE 3

SUPPLEMENTARY INFORMATION:

A comment that surfaced quite frequently during this Agency's recently culminated proposal to deregulate Federal credit union share accounts was that NCUA should give serious consideration to relieving regulatory restrictions on the asset side of the Federal credit union balance sheet as well. At the outset, it should be specifically noted that Part 703 of NCUA's regulations governs only the manner in which a Federal credit union may invest and deposit its funds. The Federal Credit Union Act itself sets out in detail the types of investments that Federal credit unions may make and the places in which they may maintain deposit accounts.

The Current Regulation

In its present format, Part 703 is subdivided into three essentially separate sections. The first, Part 703.1, implements the statutory authority provided in sections 107(7)(D) and 107(8) of the Federal Credit Union Act (12 U.S.C. §§1757(7)(D) and 1757(8)). These sections provide, respectively, the authority to invest in shares or accounts of federally insured mutual savings banks and savings and loan associations and the authority to make deposits in national banks, wherever located, and in state banks, trust companies and mutual savings banks that operate in accordance with the laws of the state in which the Federal credit union does business. Part 703.1 adds some restrictions to the breadth of these statutory authorizations and refines the geographic limitations that the statute contains.

The second of the regulation's three parts, 703.2, implements the authority presently codified at §107(7)(C) of the Federal Credit Union Act (12 U.S.C. §1757(7)(C)) which authorizes Federal credit unions to invest their funds in loans to other credit unions. It has been the NCUA's position that this statutory provision allows Federal credit unions to make advances to other, nonmember credit unions, and thus that it is not a reference to their authority to make loans or to extend lines of credit to member credit unions. Accordingly, Part 703.2 first recites the statutorily imposed limitation that the aggregate of all loans and lines of credit extended to other (nonmember) credit unions may not exceed 25% of the lending credit union's paid-in and unimpaired capital and surplus. It imposes a one year maximum maturity limit for all loans and credit lines. Several other procedural requirements, all designed to reflect sound business policy, also are imposed.

The third subdivision of the rule, Part 703.3, was added in mid-1979. It restricts or prohibits Federal credit unions from engaging in certain investment activities. The rule reflects NCUA's determination that the specified activities are either beyond the authority of credit unions or represent unsafe or unsound practices. The rule prohibits the use of standby commitments, adjusted trading and short sales, and sets forth limitations regarding cash forward agreements, repurchase and reverse repurchase transactions, and futures contracts. Specific limitations on the purchase and sale of securities are also set forth. The rule was prepared by NCUA in reaction to very specific, concrete examples of losses that credit unions were sustaining as a result of certain speculative activities in the government securities market. The authority for the promulgation of this rule is NCUA's general statutory rulemaking authority.

Request for Comments

The NCUA Board requests public comment concerning the course it should follow with respect to Part 703. That is, public comment is specifically requested on whether the Board should remove or modify any or all of the procedural restrictions presently in place governing the manner in which a Federal credit union may deposit or invest its funds. The Board requests that commenters identify specific provisions of Part 703 that either are unduly burdensome or otherwise unwarranted, or that continue to be justified, and the reasons therefore in either case. Again, it should be noted that provisions that govern exactly what types of investments and what types of deposits may be made, both of which are imposed by statute, will necessarily remain unchanged.

In an effort to provide some initial guidance to this process, staff at NCUA have identified several key issues concerning the regulation. The first subdivision of the regulation contains restrictions on the use of third party brokerage services in connection with the making of deposits. The restriction reflects NCUA's past experience with losses sustained by credit unions in dealing with institutions that utilize a broker to attract deposit money. Comment is sought on whether conditions still warrant this type of restriction and on what voluntary alternatives to the regulation should be employed by credit unions to prevent investment in weak financial institutions through third parties.

This same broad question is raised by the second subdivision of the regulation. In view of the NCUA Board's action in 1981 substantially deregulating the area of lending in general, the question presented is whether the area of loans to other credit unions represents a risk that warrants a detailed and restrictive regulation. An additional question concerns the interplay of the aggregate 25% of paid in and unimpaired capital and surplus lending limitations contained in the present regulation and based on §107(7)(C) of the Federal Credit Union Act with the 10% of unimpaired capital and surplus limitation on loans to members, based on §105 of the Act. Presently, this interplay is dealt with by Part 703.2's specific application to loans to nonmember credit unions only.

Quite clearly, the chief substance of Part 703 is contained in its third subdivision, which addresses investment activities. It has been the experience of the NCUA that problems involving investments have arisen not out of a particular type or class of investment, but rather with respect to the method or technique by which the investment is made. Moreover, it has been our experience that some credit union management personnel have been overwhelmed in dealing with sophisticated brokers and complex investment schemes. The third subdivision of the regulation reflects this experience. The existence of the regulation also provides a basis upon which administrative action against dishonest or unscrupulous brokers may be brought. Each of the substantive prohibitions and restrictions set forth in Part 703.3 except (b)(5), which is permissive in nature, represents the Agency's view that the various specified transactions are either unsafe or unsound or should be otherwise prohibited. The activities which have been prohibited are standby commitments, loan-type repurchase transactions to parties not authorized by Section 107(5) of the Act and futures contracts except as may be incidental to a credit union's operations. All other transactions are considered to be unsafe and unsound beyond the limits imposed in the regulation. Standby commitments fall into this category also. The Board specifically solicits views and comments on whether any of these restrictions should be modified, strengthened, or eliminated and on what voluntary alternatives credit unions should employ to prevent unsafe and unsound investment activities. Whether additional practices should be addressed is also a concern to the Board. Commentors are advised to support their views with specific documentation and reasoning. Inasmuch as the regulation itself addresses specified, concrete examples of abuses and losses that were in fact occurring, unfocused, generalized comments will be accorded relatively less weight.

The NCUA prepared an Interpretive Ruling, IRPS No. 79-4, to accompany Part 703. Deregulation of Part 703 may result in a corresponding repeal of the Interpretive Ruling. It should be noted, however, that the substance of the Ruling will remain available, in the form of guidances set forth in NCUA's Accounting Manual for Federal Credit Unions.

By the National Credit Union Administration Board, July 7, 1982

Rosemary Brady
ROSEMARY BRADY
Secretary of the Board

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

LETTER TO CREDIT UNIONS

NCUA LETTER NO. 57 DATE: June 24,1981

TO: THE BOARD OF DIRECTORS OF THE FEDERALLY INSURED CREDIT UNION ADDRESSED:

The current interest rate environment places a great deal of pressure on the management of credit unions to seek the highest possible yield on investment portfolios to accommodate the dividend rates necessary to remain competitive in the marketplace for members' funds. The National Credit Union Administration urges that credit unions fully evaluate the risk factors associated with the higher yields.

The dangers of failing to do so are underlined by the recent failure of a large thrift institution. Investors, including a number of credit unions, that had funds invested or deposited in excess of the insured limit ($100,000) stand to lose substantial amounts. A financial analysis of that institution, coupled with diversification of the investor's portfolio, could have resulted in limiting the potential loss as well as reducing the overall risk exposure inherent in the investment portfolio.

A credit union should have written investment policies; a "management plan" to effectively meet its responsibility in managing the investment portfolios of the credit union. There are certain key factors which must be considered when integrating investment policy into overall goals and objectives. These factors are safety, liquidity, and yield. As a result of the liquidity pressures placed on financial institutions in recent years, credit unions should move to more efficient funds management techniques to match asset and liability maturities to effectively manage their liquidity position. Safety and yield, the other two key elements that must be addressed in the written investment policies, should be evaluated jointly. Very often investments with higher risk factors and greater price volatility command the greater yields.

One important method utilized to lower the investment risk factor is diversification in the investment portfolio. This practice effectively reduces the credit risk (the risk one takes in recovering the principal at maturity plus a reliable income stream over the life of the investment) by reducing the possibility of incurring a catastrophic loss from the failure of a single or a few institutions or the default of a single or a few obligations.

ENCLOSURE 4

The National Credit Union Administration realizes that it is customary in the credit union industry to maintain a significant portion of the investment portfolio in one or a small number of financial institutions. If the officials of a credit union choose to concentrate investments in one institution, this should be addressed in the written investment policies under the diversification issue. Procedures should be established to review at least on a quarterly basis, the financial condition of the institution in which the credit union concentrates its investments. In fact, where large concentrations of investments are concerned, monthly evaluations are encouraged. The credit union should also inquire about the investment policies of such a financial institution to satisfy itself that the institution has appropriately diversified its portfolio.

The issue of investment risk is being raised because the National Credit Union Administration wishes to make credit unions aware of potential problem areas arising from the increasingly competitive nature in the financial marketplace resulting from recent legislation as well as the current economic condition.

LAWRENCE CONNELL
Chairman

The CHAIRMAN. Thank you, sir.
Mr. Vartanian.

STATEMENT OF THOMAS P. VARTANIAN, GENERAL COUNSEL, FEDERAL HOME LOAN BANK BOARD

Mr. VARTANIAN. Mr. Chairman, members of the committee, I appreciate the opportunity to provide the views of the Federal Home Loan Bank Board concerning the Board's involvement in the Penn Square matter. Unfortunately, Chairman Pratt and Board Member Jackson were unable to be here today, but I greatly appreciate the committee's willingness, and the other witnesses, to allow me to appear here this morning.

I have submitted a lengthy statement for the record and just prefer to make a brief statement at this point.

The CHAIRMAN. Your statement and all of your statements will be included in the record in full.

Mr. VARTANIAN. Thank you, Mr. Chairman.

The interdependence of financial institutions and the relatively large size of Penn Square indicate that there are systemic implications and valuable lessons to be learned from the Penn Square matter. As a supervisor of FSLIC-insured institutions, having dealt with numerous failures and near failures over the last 20 months, we share the concern of the Federal regulators to minimize the effects of failures.

Between January 1, 1981, and October 1982, we have approved 673 mergers involving roughly $94 billion of assets in the savings and loan industry. That has involved the disappearance of 759 institutions. Of those mergers, 256 were supervisory mergers sometimes under very difficult circumstances, and 62 of those mergers have been assisted by the FSLIC. There have been two liquidations, numerous receiverships, and conservatorships.

REGULATORY STRUCTURE REMAINS SAFE AND SOUND

In a deregulated environment such as we are experiencing and in a volatile interest rate environment, failures have and will continue to occur, but the critical and fundamental point it seems to us as regulators is that the regulatory system has acted effectively and swiftly and the structure remains safe and sound. Perhaps it is similar looking at a glass that is only half empty or half full. We can focus on the failure and try to devise a system that will prevent all failures, something that probably cannot be done; or we can focus on Federal regulatory structure and a Federal insurance safety net that will insure effectiveness of the system and will assure that the problems will be handled without disruption in the marketplace when failures do occur.

Based upon our experience in this matter and in other problems over the last 20 months, we believe no remedial legislation or regulations are needed directly in response to the Penn Square matter and we would advise against over reaction in terms of promulgating laws or rules that might handcuff the productive and creative abilities of the fine managers who exercise their discretion throughout the industry.

All indications are to us that deregulation is working and that the safety and soundness features built into the system are also working. Indeed, there are positive signs in the marketplace that notwithstanding the severe economic strains the thrift industry has been under over the last 20 months, that things are changing. For instance, since the signing of the Garn-St Germain bill on October 15, 1982, and since the moderation of rates, the Federal Home Loan Bank Board has closed seven conversions from mutual form to stock form, bringing $75 million of new capital into this industry. Over the past 7 years, that represents 5 percent of all the conversions and 11 percent of all the new capital brought into the industry.

EFFECTS OF PENN SQUARE BANK PROBLEM

The immediate effects of the Penn Square problem on the Federal Home Loan Bank Board were as follows: 14 institutions had uninsured deposits in Penn Square with a maximum potential loss of $15.6 million; 7 of those, totaling $13.2 million in potential maximum loss, had uninsured deposits that exceeded 10 percent of their net worth. Of those 14, we have classified them as follows: 7 have a minimal potential loss; 5 have a moderate potential loss with some substantial reduction of net worth; and 2 have severe potential losses in that the total loss could have wiped out their entire net worth. One of those institutions is already a candidate for supervisory merger in the immediate future.

However, from our perspective, we strongly believe all problems were resolvable and are resolvable either with assistance or supervisory mergers. Even if in all 14 cases those institutions were severely impaired, we believe we could have handled them under our normal procedures and in fact they would have been a very small part of our current workload.

Relatively speaking then, the effects of the Penn Square matter on the thrift industry were fairly minimal. However, we have used this occasion to reassess our practices and the practices and potential exposure of savings and loan associations throughout the country.

The conclusion of the Board is as follows: the Board's and the FSLIC's procedures and policies are adequate to prevent widespread problems in the industry. Those procedures and policies center upon regulations that limit interdepository deposits, an exam process that checks for violations of those regulations, and the intention to issue a supervisory bulletin and to begin a task force to determine what information ought to be provided the Federal regulators regarding such problems.

What lessons has Penn Square taught the Federal Home Loan Bank Board? Well, from Penn Square and the other problems we have handled over the last 20 months, we believe that the current safeguards, regulations, and enforcement authorities of the banking agencies are adequate to insure safety and soundness throughout the system. However, no matter how stringent a regulatory process is devised, ultimately, it depends upon the abilities, the good faith, and the cooperation of executives and managers throughout the industry, and absent evidence of widespread abuse, we think it would be an error to artificially restrict the abilities of all managers to prevent the abuses by a few.

Therefore, it is our conclusion that it would be a mistake because of Penn Square to halt or slow deregulation and that the negatives of one bank failure are far outweighed by the positive effects and the public benefits of deregulation. We think it would be far better for the regulatory agencies to spend their resources in four areas in the future.

First, the agencies should improve the supervisory and exam procedures and data collection to obtain better information and more timely information.

Second, the agencies should insure better general disclosure in the industry over time.

Third, the agencies should completely reevaluate the accounting system for financial institutions as the Federal Home Loan Bank Board is currently doing.

Fourth, the agencies should study ways to reform deposit insurance systems so that they are focused on risk sensitivity and the cost of that risk is internalized so as to encourage therefore marketplace discipline.

I appreciate the opportunity to present this testimony on behalf of the Board and will be glad to answer any questions the committee may have.

[Complete statement of Mr. Vartanian follows:]

Statement of Thomas P. Vartanian, General Counsel, Federal Home Loan Bank Board

Mr. Chairman, Members of the Committee, I appreciate the opportunity to provide my views on behalf of the Federal Home Loan Bank Board concerning the circumstances surrounding the failure of the Penn Square Bank on July 5, 1982. Unfortunately, Chairman Pratt and Board Member Jackson were unable to appear today, but I appreciate the Committee's willingness to let me appear on their behalves.

Because of the increasing interdependence of financial intermediaries and the relatively large size of the bank, the Penn Square failure had significant systemic implications for the whole federally insured financial structure. As supervisor for depositories insured by the Federal Savings and Loan Insurance Corporation, which has handled a large number of failing institutions in the last 20 months, the Bank Board shares the concern of the banking regulatory agencies that all possible steps be taken to minimize the likelihood of financial failures. However, the Board believes it is also important to recognize that in this deregulated and volatile economic environment where failures have and will continue to occur, the federal insurance regulators have responded swiftly and efficiently and the structure remains in a stable and sound condition today. The lending practices which contributed to the Penn Square failure provide an important lesson to financial institutions and reinforce the need for prudent operating practices. The Board does not believe any further federal regulation is necessary or appropriate to safeguard against future similar occurrences.

IMPACT OF PENN SQUARE FAILURE ON SAVINGS AND LOANS

At the time of its failure in July, 1982, Penn Square had total deposits of approximately $465 million, and it was the fourth largest commercial bank failure in the history of the United States. As a direct result of their dealings with Penn Square, a large number of commercial banks are expected to post substantial losses resulting from uninsured deposits. Additionally, a large number of credit unions and savings and loans had uninsured deposits in the bank. The full extent of these losses will not be known for some time, until the Federal Deposit Insurance Corporation, as receiver, completes its task of collecting and liquidating the assets of the bank.

As a result of the Penn Square failure, fourteen FSLIC-insured institutions have potential losses in uninsured deposits totalling roughly $15.6 million at a maximum. Seven of these 14 institutions, with uninsured deposits totalling approximately $13.2 million, have uninsured deposit balances exceeding 10 percent of net worth. Of the fourteen institutions affected, seven have potential maximum losses which would be classified as minimal, five have potential maximum losses which could be classified as moderately severe or moderate, and two have potential maximum losses which could be severe.

At the time the bank failed, in two cases, the potential total loss of the uninsured deposits of the associations affected could have resulted in a loss of their net worth. In four other cases a potential total loss of the uninsured deposits could have resulted in a substantial reduction of net worth. These potential immediate problems were, however, significantly ameliorated by the FDIC's issuance to uninsured depositors of "receivers certificates" in the amount of their uninsured deposits, as evidence of their claims as "general creditors" in the distribution of the bank's assets by the receiver. The certificates issued are eligible collateral for borrowing from the Federal Reserve Bank, but do not qualify as liquidity under the Bank Board's regulations, since they do not represent an obligation of an insured commercial bank.

While it is not possible at this time to estimate the ultimate value of the receivers' certificates, the Bank Board has instructed each institution with uninsured losses to establish an allowance for loss equal to a minimum of 20 percent of the uninsured portion of its deposit. This loss reserve is based on the FDIC's historical experience with the average rate of recovery on uninsured deposits in past bank liquidations. Additional losses or recoveries of this amount will be recorded as soon as they are identifiable.

It is extremely important to note that, even though the maximum potential losses of two associations with uninsured deposits in Penn Square could be quite severe, the Board's current procedures for dealing with troubled institutions are quite adequate to resolve any significant weakening resulting from the Penn Square failure. One of the institutions which could be most severely impacted by the failure is currently a candidate for a supervisory merger. Any problems occurring in the other institution severely affected could also be resolved through appropriate FSLIC programs for assistance and supervisory consolidation. And even in a worst case scenario, if all fourteen associations had been severely impacted, I believe the Bank Board could have resolved any problems through our normal procedures. Indeed, the potential "worst case" supervisory caseload which could have resulted from the Penn Square failure would be minimal in relation to the workload the Bank Board has experienced in the last year and a half. Between January 1981 and October 1982, the Board acted on a total of 673 merger applications, including 256 which were supervisory or FSLIC assisted, in which there were 759 disappearing associations with roughly $93.59 billion in assets.

SAFETY OF THE SAVINGS AND LOAN SYSTEM

A number of savings and loans will ultimately experience some degree of loss due to the Penn Square failure. However, the Board believes that the current regulatory and statutory protections for insured savings and loan associations provide strong and effective safeguards on savings and loan investment. These safeguards should insure adequate protection in the future against S&L failures due to the types of problems experienced by Penn Square itself, and against unacceptably high loss of uninsured deposits invested by S&Ls in commercial banks which may fail.

With regard to the potential loss of uninsured deposits of savings and loans invested in a failed bank, the Bank Board has in place regulations which are designed to prevent overconcentration of investment in time and savings deposits of commercial banks and thrift institutions. Under the Home Owners' Loan Act, federally chartered savings and loans are currently authorized to invest, without limitation as to percentage of assets, in accounts of any bank whose deposits are insured by the Federal Deposit Insurance Corporation and the accounts of any institution whose deposits are insured by the FSLIC. Section 563.9-6 of the Insurance Regulations imposes a restriction applicable to all FSLIC-insured institutions limiting investments in the savings accounts of a commercial bank or thrift to the greater of (1) one-hundred thousand dollars; or (2) the lesser of (i) one-half of 1 percent of the deposits of the institution from which the investment is obtained or (ii) the greater of the FSLIC-insured institution's net worth or one percent of the investing institution's assets. The purpose of this restriction is to preclude excessive investment in a single source, and is analagous to the regulatory restriction on loans to one borrower (12 C.F.R. § 563.9-3).

Three of the fourteen associations which are expected to incur losses as a result of the Penn Square failure had exceeded the limit set out in this resolution. Nevertheless, we believe that the regulatory and examination process is generally effective to prevent losses which would result in the substantial destabilizing of an institution. In the past, the Bank Board examination process has uncovered few significant violations of this regulatory limit. For example, between January 1, 1980, and July 21, 1982, there were only eight occasions on which the Bank Board issued warnings, through supervisory letters, to associations that had certificates of deposits in other financial institutions in excess of limitations imposed by state or federal regulation, or that had deposits or investments generally considered to be excessive or risky.

In this regard, it should also be noted that the current provisions of section 563.9-6 reflect an amendment, effective November 3, resulting from the Board's decision to reevaluate the potential risks in this investment area and make appropriate changes after seeking public comment on proposed revisions. Furthermore, in response to the kinds of problems resulting from the Penn Square failure, the Board is now planning to issue a supervisory bulletin reminding examiners to closely scrutinize association investments in the deposits of other banks and thrifts.

Regarding the more general problem involved in the Penn Square failure—massive deficiencies in the loan portfolio chiefly due to rapid expansion and poor quality energy loans—the Bank Board believes there is very little likelihood of widespread S&L failures from problems of this type. As of October 31, 1982, roughly 79 percent of all FSLIC-insured savings and loan assets were invested in mortgage loans and mortgage-backed securities. The asset quality of these loans is extremely high in relation to other loans, due both to the unique nature of the collateral and to pervasive statutory and regulatory restrictions designed to insure their high credit quality at origination. These types of loans also tend to be small individually, and provide good diversification of risk.

Although there is a great deal of evidence that S&Ls will continue to be primarily housing lenders, the failure of Penn Square naturally raises some concern that savings and loans may use the liberalized statutory mortgage investment authority, and the new commercial lending power, unwisely. However, the Board believes that S&Ls will proceed cautiously in exercising their new powers, and that the Bank Board's regulatory safeguards and planned examinations process for commercial lending will minimize any risk in this area.

LESSONS OF PENN SQUARE

The Bank Board is confident that the current statutes and regulations governing the investment authority of savings and loans, as well as our power to enforce the laws where serious violations occur, provide adequate and effective safeguards for the stability of savings and loans insured by FSLIC.

However, as the Penn Square failure demonstrates, the efficiency of our system of financial regulation is necessarily limited by our role as supervisors. No matter how stringent a system of statutory safeguards Congress may erect, ultimately, we have learned that the process must depend on the abilities, good faith and cooperation of the executives and officers of the financial institutions we regulate for its effectivesss.

There has been no evidence of widespread abuse of the trust which the Congress and federal supervisors have historically placed in the financial institutions which would warrant a significant change in the current supervisory structure. Given the very competitive environment in whch regulated depositories are now conducting business, it would be a grave error to artificially restrict the abilities of all financial managers to control the very few who may abuse their positions or mismanage their institutions. Thus, the Board does not believe that across the board statutory controls over management conduct are a desirable means of addressing the types of problems leading to the Penn Square failure.

Moreover, given the unique conditions and circumstances resulting in the Penn Square failure, the Board believes it would be a serious mistake to halt or slow deregulation of financial institutions in an effort to create a more "failsafe" regulated financial system. Even with deposit insurance, credit relationships may be affected by bank failures, resulting hardship to the business community.

The potential negative consequences of a bank failure, however, are far outweighed by the public benefits of deregulation and the problems which might arise from attempting to create a failure-proof system. The deregulation of the financial industry will be enormously beneficial to all segments of the public, from consumers to business entities of all kinds. Deregulation will allow market forces to winnow the weakest competitors from the marketplace, and will result in more efficient competition, thus giving the public a wider range of choice and better quality in services and products, higher yields on deposit investments, and lower costs of borrowing.

Given these considerations, the Board believes that deregulation should proceed without expansion of the traditional role of federal supervision of insured depositories. However, this continued commitment to deregulation should be carefully balanced by a thorough and ongoing review of the efficiency of current supervisory procedures. by continuously strengthening these procedures in response to the types of problems seen in the Penn Square failure, we can achieve the goal of minimizing disruptive liquidations without sacrificing the marketplace efficiencies and consumer benefits which have been so important in sustaining a strong, stable financial structure in the last five decades.

Thus, rather than imposing new statutory controls on the financial industry, the Bank Board believes our resources can best be spent in revising the regulatory process in four ways. First, we should strive to improve the supervisory and examinations procedures to obtain better and more timely information. Second, we should encourage better general disclosure of the financial condition of regulated depositories. Third, we should reevaluate the accounting system applicable to insured institutions. The Board is currently reviewing the accounting system used by FSLIC-insured institutions and has appointed a task force to study throroughly the issues involved. The Board welcomes any assistance and comments in this area from the accounting profession and other interested parties. Fourth, we should study possible ways to reform the current deposit insurance system. The Bank Board also believes that the current deposit insurance system may be strengthened by a partial or pure variable-rate schedule for insurance reserve premiums. The Board has recently proposed to implement a variable-rate rebate program, and is studying the desirability of a pure variable rate premium assessment scheme pursuant to section 712 of the Garn-St Germain Act. A risk-variable insurance premium would internalize risk-taking by institutions and encourage marketplace discipline to replace in part the less efficient, more cumbersome structure represented by federal supervision.

The CHAIRMAN. Mr. Conover and Mr. Isaac, I would like you both to comment on this first question.

We often have the tendency in this country to credit the large money center banks with a great deal of sophisticated financial understanding, good management, expertise and so on. Yet we find that some of our country's best known banks in this situation, institutions that have very large, well-trained staff, highly paid in many cases, find themselves holding $2 billion of Penn Square loans.

HUGE LOANS ACCEPTED BLINDLY

Now with this background that we all expect of these sophisticated, well-managed banks, how did they get themselves in that kind of situation? It's one thing for a small suburban bank that grows very rapidly to make bad loans, but why in the world would our big money center banks be picking up $2 billion of them?

Mr. CONOVER. If I may, I think it's a situation in which those large banks saw the opportunity to participate in what they regarded as an energy boom without expending a significant amount of effort on their part.

Clearly, their control systems broke down and they found themselves saddled with a large volume of relatively worthless loans. I think they have paid significantly for their mistakes in this regard. Their stocks have been battered. Some of them have had difficulty funding themselves in the financial markets. Officers of several of those banks have been dismissed or resigned and their reputations have been tarnished.

The CHAIRMAN. Mr. Isaac.

Mr. ISAAC. I don't know what I could add to that except I think in several instances you probably had an excessive concentration on growth and earnings. There was probably too much incentive for officers to make loans and not enough regard to the soundness of those loans. The banks have paid a dear price and have learned some lessons, and I would assume in the future we will see more caution exercised in placing loans on the books whether done directly or through participations.

The CHAIRMAN. I'm amazed that they so blindly accepted some of these loans and in such large amounts, in contrast to the way they in "Scrooge-like" fashion, look over a small consumer loan and run all the credit checks on an individual that wants to borrow $1,500 and then turn him down because it might be a bad loan. I don't really know that you have any answer to my questions, but I don't understand how they can accept these huge loans in such an apparently frivolous manner and be so tight on some of the small consumer loans that would be very small change for them even if they did turn out to be bad.

Mr. CONOVER. You know, it's a well known common banking practice that one ought to exercise the same diligence and judgment in obtaining a loan participation as one would in making a loan directly. Obviously, they did not follow that principle.

The CHAIRMAN. I suppose I really won't open this can of worms, but it would also include—some day we are going to talk in this committee about some of these large loans to foreign countries that many of our fine banks seem to have made without the same concern for whether they be repaid or not. But again, I won't start that today. That's a big subject for another day, but we will be looking into it.

Mr. Conover, it's my understanding the president of the Penn Square Bank had little, if any, control over the lending activities of the oil and gas division. The oil and gas division represented some 80 percent of Penn Square's lending activity.

Isn't it one of the functions of a bank examiner to evaluate the management of an institution? Isn't this something that possibly was overlooked, that the president of the bank had so little effect or authority over such a large portion of his bank's lending activities?

Mr. CONOVER. It is the responsibility of a bank supervisor to evaluate the management. When the new president, Mr. Beller, was brought in, it was our understanding that he was to have control over the entire operations of the bank. We got that impression from him directly in a meeting in Dallas in our regional office. Yet there were conflicting pieces of evidence. Although the heads of the oil and gas division were shown to report to Mr. Beller on the bank's organization chart, in fact, it turns out that his position description, which we did have, indicated otherwise. That he did not have authority over the oil and gas division. It is true that we did not nail down that inconsistency.

The CHAIRMAN. The Penn Square Bank had been operating under a formal written agreement with your office for the period from September 9, 1980, until June 30, 1982. The Comptroller's Office issued a cease and desist order shortly before the bank's failure.

DISCLOSURE REQUIREMENTS

It's my understanding that the disclosure of a cease and desist order is mandatory for any SEC registered bank that goes to the market to raise capital.

Do you believe that such information should be disclosed even if a bank is not SEC registered?

Mr. CONOVER. I think the basic principle ought to be that banks that are SEC registered and other banks ought to have approximately the same disclosure requirements. We are considering what aspects of our enforcement actions ought to be disclosed.

The CHAIRMAN. What's your position on the disclosure of formal written agreements, as an example, the September 9 agreement?

Mr. CONOVER. I think that it does not really matter whether it is a formal agreement or whether it is a cease and desist order. I think that the existence of such an agreement probably is a disclosable incident under SEC regulations, although generally what we do in that regard is leave it up to the bank and the bank's securities attorneys to advise them on whether or not those matters ought to be disclosed.

Generally speaking, however, I think that we could do with the discipline that we would obtain by having greater disclosure for both formal agreements and cease and desist orders. As I indicated, we are trying to figure out precisely what aspect of that ought to be disclosed because there may be some things that could be damaging to the bank and would cause it harm rather than aid in its rehabilitation if disclosed. It is not a simple black and white question.

The CHAIRMAN. Well, do you think that potential investors would be deterred with disclosure of this type of investing in the bank?

Mr. CONOVER. I think potential investors may be deterred. I think depositors may very well be deterred and other banks that might be buying participations from them might be deterred. That would be a very healthy turn of events.

The CHAIRMAN. Gentlemen, if any of you have any comments on any of these questions—Mr. Conover is going to get the brunt of them because his agency is primarily responsible—but if you have anything you wish to add on any of them, please feel free to do so.

REMOVAL OF BANK OFFICERS

Mr. Conover, at hearings held on the Penn Square matter by the House Banking Committee there seems to be some disagreement between the FDIC and the Comptroller regarding your authority to remove officers for activities which may be willful violations of law which fall short of demonstrating personal dishonesty.

Have you and Mr. Isaac resolved your differences over those interpretations, if there were any?

Mr. CONOVER. I think there was a misunderstanding on our part as to the specific terms under which we have the authority to remove officers. We have resolved our differences both with Mr. Isaac and with Chairman St Germain on that issue.

I think that the basic question is: Why did we not take action to remove officers in the Penn Square Bank prior to its failure? As has been indicated before, we felt and management led us to believe that they were in compliance or working to get into compliance with the formal agreement that they had entered into with us. For that reason and because of the bank's overall performance, we saw no reason to initiate removal proceedings.

Had the bank not failed by the middle of April 1982 examination, we might very well have had grounds for removal of officers as a result of some of the findings of that exam, but we did not feel that we had such justification prior to that time.

The CHAIRMAN. Mr. Isaac, it's my understanding that the FDIC was only given about 5 days warning of the collapse of Penn Square. If that's true, would a longer notice of these problems have given you an opportunity to have maybe found a merger partner to help save the situation rather than having to pay it out of the FDIC fund?

Mr. ISAAC. It's true that we were given about 5 days notice of the seriousness of the problems and the fact that FDIC involvement would be required. If we had been given more notice, it's possible that we could have worked out another way to handle the transaction. It would have been very difficult because of the potential for large contingent claims that might be asserted in connection with a merger.

The CHAIRMAN. Senator Riegle.

COST OF FAILURE TO FEDERAL GOVERNMENT

Senator RIEGLE. Thank you, Mr. Chairman.

I would be interested in asking first what is this failure costing the Government in dollars? Gentleman, you indicated in your presentations that many people have been working a long time trying to sort this thing out, so obviously we have to pay for that effort. But beyond that, in terms of any other costs that have been involved, what would be the best and the most accurate and full estimate of what this failure has ended up costing the Federal Government?

Mr. ISAAC. The people costs are shown in our report, and to some degree those costs are being borne by the receivership and, thus, the uninsured creditors of the bank. The primary cost is going to be the losses the FDIC takes in the receivership. We paid off the insured deposits.

Senator RIEGLE. Why don't you give me the numbers, either the specific figure or your closest estimate?

Mr. ISAAC. I believe the insured deposits were in the vicinity of $200 million. The exact number is in our report.

Senator RIEGLE. So your estimate on that item is $200 million?

Mr. ISAAC. That's not the loss. That's what we paid out to the insured depositors. Then we will make collections on the loans and we will share those collections pro rata with the uninsured creditors. It's too early to say what our losses will be. We do intend sometime in the next few months to give our preliminary estimates of what we expect the recoveries might be and thus what the losses might be.

I might add that the FDIC is entirely self-funded and so none of the money, to the extent we experience losses, is coming from the taxpayers. We are funded by the banking system through premiums and by interest on our investment portfolio.

Senator RIEGLE. In other words, it's not a complete washout. When you have a failure and lose $100 million or $50 million or whatever the final figure may be, you make it sound as if nobody incurs a loss. Let's be realistic—who finally does incur the loss here?

Mr. ISAAC. The losses will be shared. The uninsured creditors are going to share in losses and that is——

Senator RIEGLE. That obviously affects your insurance premiums.

Mr. ISAAC. That's exactly right.

Senator RIEGLE. And that affects the other banks in the system who have not failed and they have to reflect that in their cost of service to borrowers. So eventually, this will increase the interest rates and service fees that consumers must pay.

Mr. ISAAC. To the extent the FDIC bears losses, two things happen. One, our insurance fund doesn't grow as rapidly as it otherwise would; and, second, our insurance premiums go up a bit. And all banks bear that cost and presumably they pass at least a portion of it on to customers of banks.

Senator RIEGLE. I know you're going to make formal estimates later after sorting this out—it's a tangled situation—but is it likely that the losses are going to exceed $50 million?

Mr. ISAAC. It wouldn't surprise me that the losses will exceed $50 million. I would not want to be very precise about it at this time because I don't want to get ahead of our folks who are trying to make the estimates. I would say that we thought going into Penn Sguare in July that it was a bad situation and that the losses would be significant. Everything we have learned of the bank since then indicates that it's far worse than we expected.

BANK FAILURE RATE

Senator RIEGLE. Over the last few years how many other failures have occurred that would fall into this category of failed banks?

Mr. ISAAC. How many bank failures?

Senator RIEGLE. Yes, in the last 2 years?

Mr. ISAAC. This year so far we have had 40 bank failures and last year we had 10.

Senator RIEGLE. From year to year that sounds like a big jump.

Mr. ISAAC. The failure rate has been running about 10 to 12 a year for the past 10 to 20 years. This year it is at 40 to date. The previous high since 1940 was 16 banks in 1976. So the failure rate this year is significantly higher than normal. It is likely to continue at a high rate through next year. How much longer it will remain at this level, we don't know. I believe the failure rate is a function of two factors. First, the economy. We have had 4 years of virtually no growth and very high and very volatile interest rates that are having an effect on bank customers and thus banks. Second, we are coming into an intensely competitive, deregulated environment and that certainly has to have some effects. We don't believe we are going to get back to the days any time soon where we have seven or eight bank failures a year. I think we should expect a higher than normal number of bank failures, if normal is what we have experienced over the past 10 to 20 years.

Senator RIEGLE. Recognizing again that we are just discussing preliminary numbers here, if the ultimate cost of the Penn Square failure is in excess of $50 million and if you take all 40 banks that have failed and try to make some kind of estimate as to the aggregate loss, what's that figure going to be? Are we talking about $300 million, $500 million?

Mr. ISAAC. I wish we were. It's much higher than that. Over the past 14 months—this is going a little bit beyond the 40 banks this year and into the tail end of last year—we have handled the failure of 11 large mutual savings banks with assets totaling $15 billion. Our estimated cost in handling those 11 transactions was $1.7 billion. In most of those mergers, we entered into the transactions which involved income maintenance payments to cover the negative interest rate spread on the assets acquired from those institutions. We made calculations of what those income maintenance payments might be over the life of the agreements—which tended to be in the 5- to 10- year range—on the assumption that interest rates would continue at the same levels they were at when we entered the transactions. Rates were very high, as you recall, toward the end of last year and the earlier part of this year. So it was a very conservative investment. We now are revising our estimates and the numbers will come down. We probably will reduce the estimate by $350 million.

Senator RIEGLE. Is that just for the 11 large ones or all of them?

Mr. ISAAC. That's for the 11 savings banks that we handled, roughly $1.3 billion.

Senator RIEGLE. If we consider the 40 or so that failed over the last 2-year period, what would be the estimate?

Mr. ISAAC. We will have those estimates shortly too. We are working up those numbers for our yearend statements. They shouldn't be of much consequence, apart from the Penn Square.

Senator RIEGLE. Are we talking about losses in the range of $2 billion or thereabouts?

Mr. ISAAC. It depends on our Penn Square estimate. I don't think we could possibly approach $2 billion. That's way too high I would guess.

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Senator RIEGLE. So it's probably between $1.5 billion or $2 billion.

Mr. ISAAC. I would say less than $1.5 billion.

The CHAIRMAN. Would the Senator yield just a moment?

AGENCIES COMPLIMENTED FOR HANDLING DIFFICULT SITUATIONS

I'd just like to say at this point that the FDIC has an unusual situation. The major problems have been with those institutions that have had long-term loans, primarily housing and primarily due to interest rate ceilings, that borrow short and lend long. That problem has fallen on the FSLIC, and poor Chairman Pratt came in at a time when most of his work was trying to create mergers and save dozens and dozens of thrift institutions. The FDIC gets into the situation of having mutual savings banks that are essentially a thrift in many characteristics, but not under the FSLIC, which have developed many of these same problems. I'd just like to comment that Chairman Isaac was just incredibly good at keeping me informed at all steps of the way of these various institutions primarily last year and early this year when interest rates were still high and the pressure had not been relieved somewhat. I would just like to say both for the FSLIC, the Fed and the FDIC, with some unusual problems over the last 2 or 3 years, with staffs that really had never had to face so many problems all at the same time, under the circumstances the potential losses that were there were much, much higher than the range you and Chairman Isaac are talking about had they not been able to arrange some of these mergers. I've taken a lot of criticism, a lot of mail, on why in the world are they wasting their money, and I think the type of losses, whatever they amount to in the end, at this particular time are far, far less than they could have been. I'm not one who's often complimentary of regulatory agencies, but I have followed this very carefully and the potential losses were so much more than what they have all collectively, with their various responsibilities, been able to put together in mergers rather than simply having to bail out the depositors through the insurance funds. So I just wanted to interject that and I appreciate the Senator yielding because it's an extremely difficult and scary period and, fortunately, the lower interest rates have relieved a great deal of that pressure. I think all of you are deserving of a great deal of credit despite a lot of the criticism for handling an extremely difficult situation, and minimizing those losses rather remarkably.

Senator RIEGLE. Well, let me just say that I think the chairman makes some good points there. My concern at this point is that I'm not convinced we are yet out of the woods.

The CHAIRMAN. No, I'm not either. I'm just saying the pressure has been relieved. It's better than it was considerably, but we're not out of the woods.

Senator RIEGLE. The concern I have, and you will recognize this during my next line of questioning, is that we are seeing some lowering of interest rates. We all want that and it's going to help in some respects and we hope it will start to revive the economy at some point, but things look pretty bad out there right now. There's not much sign of an economic recovery that anybody in the administration or that any outside economists can put their finger on. And there is great apprehension because the problem is worldwide in scope.

The concern I have at this point is that the leveling off of interest rates seems to be a response to the fact that the economy has been shutting down and those two often tend to be connected. We want to get the economy revived and hopefully we can keep interest rates from taking off at the same time, but there's no sign of an economic recovery at the moment. So I think the financial stress and pressure is going for continue for many institutions despite the fact that interest rates are down.

We have a large number of nonperforming loans, many of them domestic loans and very large foreign loans that the chairman has spoken about, and I agree with him that we get into that issue, not today because that's not our purpose, but at an early date, because I think this is a serious problem.

HOW MANY MORE PENN SQUARES EXIST?

My real concern is how many other Penn Squares are there out there right now that may be waiting to happen and are we in a better position today to identify these banks than we were in the case of Penn Square? I think we were late in responding to Penn Square and we must try to reconstruct why that was. It seems to me that the regulatory agencies were not on top of this problem and while a good job may have been done in picking up the pieces and sorting through the wreckage here, the real test of our system is to try to prevent these things from happening. That's why we regulate. We failed in this particular instance and we have in the case of others.

Now we're not going to prevent all bank failures, but when we jump from an annual average of a dozen banks failures to suddenly 40 this last year, I think it suggests that we take another look at whether or not our monitoring mechanisms are sufficient and whether our early warning mechanisms are adaquate so that we can move in on a problem situation before the roof caves in because the fact that we bail it out with insurance I am not comforted by, nor do I believe we somehow deserve a lot of credit for the fact that the insurance system is there and it sort of absorbs the loss. I think it is an economic loss. I think the country is poorer for the fact that it happens and I think it's damaging to public confidence in our system. Every time a bank failure occurs it makes it tougher to get an economic recovery going.

In fact, my own view is that part of the increase in the savings rate is that people are saving because they're not sure what the future looks like. Even though we all want and have wanted for some years to see higher savings rate, that's not the kind of motivation that we ought to have.

So I think the question is, how many more Penn Squares are there out there right now and how many banks do you have on the problem list right now and can you tell us how the problem list sorts out? In other words, how do you differentiate between banks that are in grave danger and those that are on the radar screen as problem situations but are not in severe trouble?

Mr. ISAAC. Before I respond to that, if I might just clarify one point with respect to our earlier dialog. We were, I believe, talking about two different numbers, and I want to make sure we're clear on it.

In discussing the 11 savings bank failures, I jumped back into last year. You were focusing on the 40 banks this year when you were asking the cost numbers, and we agreed that the losses would be less than $1.5 billion. If you're only talking about this year, and you don't include the three savings banks handled last year, you're talking about the losses being more in the billion dollar range. That's still a lot of money and more than we care to spend in a given year, but I want to note that the insurance fund, despite extraordinary losses over the past 2 years, has been growing and remains strong. The fund began 1981 at $11 billion in size and today it exceeds $13 billion, despite absorbing the full impact of all of these failures. Our annual income is currently running at $2.5 billion a year. So whatever comes up, we feel we are in a good position to deal with it effectively.

As far as whether there are any more Penn Squares on the horizon, I can't be positive there aren't. I don't know of any. But, on the other hand, we didn't know of Penn Square much before it occured. It's always possible that we will be surprised by a situation, but that doesn't happen very often.

Senator RIEGLE. How many banks are on the problem list?

THE BANK PROBLEM LIST

Mr. ISAAC. Currently we have 345 banks. That is up from 220 banks at the beginning of this year. We expect the list to keep on rising. It remains below the levels it reached in 1976 where it peaked out at 385 banks.

The problem bank list is a lagging indicator and it continues to rise after the economy begins to improve.

Senator RIEGLE. My time is up here and I want to yield and then wait for my next turn, but let me just pose a question that I'd like to get into later so you can be thinking about it. That is, I want to take a closer qualitative look at the situation with the 345 problem banks we have now versus the picture we saw in 1976 which was the last time we had a large number of banks in these circumstances, and I'd like to know if the anatomy of the problem is pretty much the same as it was then or are we looking at a situation that is different?

The way that we grade banks and we grade problem situations, has that system changed so that we have to know more before making comparisons between the two time periods, and also just qualitatively is the nature of the problem that is now upon us in this time frame somehow different than it was then. If so, how could you help us understand the difference? Do we now have a larger number of the broader kinds of nonperforming loans, is there international versus national activity, and what can you tell us about the anatomy and the profile of that problem in the aggregate? That's what I would next like to discuss. My time is up but I wanted you to have a chance to think about my concerns.

The CHAIRMAN. Governor Partee, let me just follow up for a moment Senator Riegle's line of questioning and apply it to bank holding companies which the Fed regulates. You don't regulate banks. You regulate the bank holding companies.

Can you just give us a brief overview of the problems along this line you see in the holding company area?

Mr. PARTEE. Well, I think it mirrors the kind of impression that Chairman Isaac gave. That is, we have a rising number of problem holding companies. The figures wouldn't be much different than he has except that the numbers would be smaller because there are fewer holding companies than there are banks. But the movement would be just exactly the same. I'm sorry to say I don't have the exact number nor do I for the group of banks that we do directly regulate, but I think we are all experiencing very much the same kind of indication of growing difficulty and, of course, in Washington and in the field the banking regulators are doing everything they can to coordinate and to compare notes and to try to ride herd on these developing problems as they become apparent to us.

The CHAIRMAN. Well, don't apologize for not having the figures. You were all called to testify on the specifics of Penn Square and obviously we can't isolate that problem from the overall economy so we are expanding beyond that to get a picture of what the general problem is and if there are things that you as regulators should be doing to avoid other Penn Squares. So don't feel badly about not having all the figures on subjects you were not invited to testify on.

Mr. Conover, I certainly agree with you that we cannot afford or even design a system in which a bank cannot fail, but I think you would agree that we need to insist on a system where a bank failure will continue to be viewed as an isolated aberration and not a general thing by any means.

On reviewing the procedure for classification of Penn Square as a 3, your supervision of all banks classified as 3 in 1980, you have shown that 66—percent of them have improved, 23 percent are still rated 3, 7 percent have deteriorated to 4 or 5, 3 percent have been merged out of existence, and 1 percent are insolvent and placed in receivership.

That presents a pretty good picture. Most of them are improving. Only 1 percent insolvency. But in the course of that kind of a review, have you ever performed an aging of classifications similar to an aging of accounts receivable done by companies so you can determine how quickly those banks in the 66-percent category improved? In other words, what I'm getting at, to give you a closer view rather than these general categories and suddenly they drop from one to another, do you have a better handle or is it possible for you to have a better handle on those shifts?

Mr. CONOVER. Yes, it is possible. We could track by looking at the banks and when they became 3's and how long they stayed 3's or changed to either a lower or higher rating. I don't know that information off the top of my head, but we would be pleased to submit it for the record if you would like.

[The following was received for the record:]

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

February 18, 1983

Dear Mr. Chairman:

During the Senate hearings of December 10, 1982, you requested an aging of banks that were "3" rated as of August 12, 1980 (the date of the first Priority Bank Summary which included Penn Square Bank, N. A.). In response to your request, two charts have been prepared tracking banks that were rated "3" as of December, 1979. Using this date permitted us to expand our test group of "3" rated banks and permits comparisons at successive year ends.

As of December, 1979, there were 220 "3" rated banks. Of this segment or test group, the large majority became "3" rated after December 31, 1976. Chart A details changes in their ratings as of each year end, over a three year period. As shown in the chart, 42% of the group improved to a "1" or "2" rating by year end 1980, and 61% had done so by year end 1981.

Of the population of 220 banks, 51 became "3" rated during 1979. Chart B focuses solely on this sample of banks and tracks their disposition over the same three year period. The purpose of this chart is to provide a general idea of the time period a sample of banks remain in a "3" rated status before the condition improves or deteriorates. As illustrated in the chart, the majority of these banks shifted into an improved category over a two year period of time, with 65% improving to a "1" or "2" rated status while 23% maintained a "3" rating. By year end 1982, the improved group increased to 68% and the group of "3" rated banks declined to 14%.

Sincerely,

Todd Conover

C. T. Conover

The Honorable
Jake Garn, Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Enclosures

AGING OF 220 BANKS RATED "3" AS OF 12/79

12/79

220 BANKS
RATED "3"

	12/80	%	12/81	%	12/82	%
1 OR 2 RATING	93	42	135	61	134	61
3 RATING	105	48	54	25	43	19
4 OR 5 RATING	12	5	12	5	19	9
CONVERTED OR MERGED	10	5	19	9	22	10
DECLARED INSOLVENT	0	0	0	0	2	1
	220	100%	220	100%	220	100%

A

AGING OF "3" RATED BANKS THAT WERE PLACED IN THE SPECIAL PROJECTS PROGRAM DURING 1979

12/79

51 "3" RATED
BANKS PLACED IN
PROGRAM DURING 1979

	12/80	%	12/81	%	12/82	%
1 OR 2 RATING	17	33	33	65	35	68
3 RATING	31	61	12	23	7	14
4 OR 5 RATING	3	6	3	6	5	10
CONVERTED OR MERGED	0	0	3	6	3	6
DECLARED INSOLVENT	0	0	0	0	1	2
	51	100%	51	100%	51	100%

B

The CHAIRMAN. We would appreciate that.

Also, what methods might you use, if any, that you could pursue the seriousness of a management's agreement to follow their signed agreement or prudent banking practices after they are in a category 3? In other words, you testified Penn Square signed an agreement. You thought things were coming along. Six months later, pow; they didn't follow the agreement. They didn't do what you had outlined for them to do and went completely in another direction.

Mr. CONOVER. I think monitoring compliance with agreements or cease-and-desist orders or memoranda of understanding for that matter is something that is getting increased attention in our office as a result of the Penn Square situation. I don't think there is any question about that.

The CHAIRMAN. You indicated that special exams are usually limited to previously criticized loans or loan problems. Doesn't this type of examination make it more difficult to really evaluate management's sincerity and their dedication and willingness to correct any underlying problems? Aren't some managers, in other words, likely to correct only those items that you have reviewed?

FREQUENCY OF EXAMINATIONS

Mr. CONOVER. That's precisely right. There is that danger in doing an examination that only follows up on deficiencies uncovered in the previous examination. For that reason we have spent considerable time reviewing both the scope and the frequency of our examinations. And, as I indicated earlier, we are upping the frequency of full-scope examinations on troubled banks to avoid precisely that kind of problem.

The CHAIRMAN. In order to improve the results and efficiencies of the exams that you do, shouldn't financial examiners insist on good internal controls and then penalties—stiff penalties for failure to achieve those internal controls?

Mr. CONOVER. One of the things we focus on——

The CHAIRMAN. In other words, you simply can't be there following a bank day after day with 15,000 banks in this country and so on. You've got to insist they have some internal controls, and if they don't, some penalties for not instituting them.

Mr. CONOVER. That is precisely right. The method of examination has to some degree shifted in recent years from being what might be described a bottom-up approach, in which you get into each individual transaction, to a top-down one in which the examiners satisfy themselves that sufficient systems and control mechanisms are in place. Then they do a limited amount of testing to insure that the system itself works.

So the examination approach that we are following now is very much oriented toward identifying good control mechanisms and systems, making sure that they are effective and that they are updated to meet changing conditions.

The CHAIRMAN. What about the complaint that I often hear from banks that have been in existence for a long, long time, not new ones like Penn Square, not rapidly increasing in size—good old, long-time banks that have been around forever, so to speak, who feel they are being harassed by you and yet for 6 months you didn't know what was going on with Penn Square. Wouldn't your resources be better used to follow the problem banks on a shorter time frame rather than harass—and I use that term in quotes—harass those who have never given you any problem, never been in trouble, good old stable management. You know the type of situation I'm describing because you undoubtedly have heard it far more than I have.

Mr. CONOVER. Exactly. We think that it is important to focus our resources on banks that represent the greatest potential risk to the system. That means by definition larger banks and troubled banks, and so as we look at our exam priorities in terms of how frequently we examine different categories of banks. We intend to shift them and we are shifting them away from small, well-managed banks toward larger ones and toward problem banks so that we can focus on the areas that need the greatest attention.

The CHAIRMAN. Did the Comptroller's Office ever conduct any surprise examinations at Penn Square?

Mr. CONOVER. Not in the sense of a surprise audit, no, we did not.

The CHAIRMAN. Do you think that those type of examinations ought to be increased in frequency for a bank like Penn Square that isn't performing as rapidly in previous examinations as they're supposed to?

Mr. CONOVER. It might offer the potential of finding a condition that you might not otherwise find. The alternative I suppose to the surprise exam is a more regular involvement with the bank itself on a continuing basis. I suspect that both techniques are appropriate and we will give consideration to the concept of surprise examinations in the future.

DISCLOSURE PROBLEMS OF SMALL TOWN BANKS

The CHAIRMAN. You have also indicated that more public disclosure of financial condition of banks will exert a marketplace discipline and I have received several complaints from small banks that say, well, that may be fine for the big banks in a big metropolitan area but in a small town you start publicizing about one of the citizens of the town that everybody knows, that type of thing, and are you exerting marketplace discipline or are you causing problems?

Again looking at the small banks there are unique situations compared to something that can be swallowed up in New York if you start publishing the names of people who are delinquent on their loans. There nobody cares except those who are involved, but it's different in the small market area. I assume you have received some of those inquiries.

Mr. CONOVER. Yes, we have. I think it's a natural tendency for bankers not to want to disclose their financial results. Of course, the plan is not to disclose the transactions of any individual borrowers. It will not be possible to discern——

The CHAIRMAN. You need to make that very clear.

Mr. CONOVER. Is there some misunderstanding about that?

The CHAIRMAN. Yes, there is some misunderstanding about that.

Mr. CONOVER. OK. The idea is that the increased disclosure will be in aggregate dollar terms by the individual banks. For example, as far as the pass through loan categories are concerned, there will be different ages of pass through loans and loans will be broken down according to whether they are real estate, commercial, consumer, and the like, but no individual borrower will be named. Because of the way the data is aggregated it will be virtually impossible for even the most clever analyst to discern the identity of an individual borrower from the data that is going to be prepared.

The CHAIRMAN. Even those who are not confused, whether they be individuals or what, claim that in the small towns that that's impossible for you to do. They simply know each other so well that there's no way you can disguise it. I'm serious. I have had those kind of complaints and I suppose if my mother were still alive, talking about her little town of 600, she would agree because she knew everybody in town and it was amazing her intelligence system about that little town.

Mr. CONOVER. I just do not see that the data that is going to be produced in the new disclosures could provide anybody with sufficient information to identify the affairs of any individual borrower. If there is that misunderstanding, we certainly want to correct it. I just do not think that is the case.

The CHAIRMAN. My time is up, but let me just follow up on the other side of the coin. It may exert some market discipline, but what about the other side of the coin; if the disclosure creates panic, that suddenly you get a run on the bank because people don't like what they're seeing and you precipitate having to close down a situation where you might not have to. There are two sides to that coin.

Mr. CONOVER. Yes, and I think it is the other side of the coin, or the potential for the other side of the coin, that provides some of the needed discipline. Most banks in this country are well managed. Their financial conditions are in pretty good shape and they have nothing to fear I think from increased disclosure. Those whose affairs are perhaps in not such good shape today have some time to try to do something about it and to figure out how they will explain their financial condition when those disclosures are made.

Mr. ISAAC. Mr. Chairman, I would like to say a couple of things on the issue of the small towns and knowing what's going on with respect to borrowers. I don't see how that comes from the call report data, but being from a small town myself that's only somewhat bigger than your mother's home town, I suspect that in many cases people in the town know who is paying their bills and who isn't.

The CHAIRMAN. You think the disclosure has already been made?

Mr. ISAAC. That's correct. It has little to do with the report that may be filed and maybe there is some market discipline in that.

As far as whether there would be more instability caused by the disclosures, I think in given situations it could bring a matter to a head more quickly than otherwise would be the case, but if I look at the alternative of what would happen in a deregulated climate where banks are permitted to pay whatever they wish for deposits and engage in a broader range of activities, I believe we would have a very unstable system in the absence of disclosure. You can't move into a deregulated environment and not couple it with some market discipline and you can't achieve market discipline without adequate disclosure. So I think disclosure, viewed in the context of a deregulated environment, will bring us a much more stable system than we will have in the absence of disclosure.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I want to go back to our earlier discussion. We talked about the present number of problem banks and we were about to compare them to the experience in 1976. What would be the asset value of the banks that are in trouble today or on the troubled list?

Mr. ISAAC. The total assets of the banks on the problem list today versus 1976? I don't have that number on the top of my head, but I'm certain it's lower today.

Senator RIEGLE. Would that be because the size of the average bank that is now in difficulty is smaller than the average troubled bank back in 1976?

Mr. ISAAC. Well, for one thing, there are fewer banks on the list at this point than there were in 1976 and, second, in 1976 we had at least a couple of fairly large institutions on the list and we don't today.

Senator RIEGLE. How about the profile of the problems that are facing the banks? Are they roughly comparable? Are we looking at 1976 all over again or are we looking at a different mixture of problems.

Mr. ISAAC. I think the situation is different. I don't know how to compare it in terms of severity because it is different. In 1976 we had problems that were more focused in specific sectors such as real estate. We had a boom in real estate which came to an end in a hurry. We had other specific industries such as the shipping industry which got hit pretty hard in 1976. In the 1976, 1975, 1974 period, we had a very sharp recession that was of comparatively short duration compared to what we are experiencing now where we have had 4 years of stagnation and high and volatile interest rates, coupled with deregulation. So the situations are different.

I can't say that today is any worse a problem for us than 1976. The number of banks that have actually failed is higher, but that doesn't mean the problems are any worse. The number of banks on the problem list remains lower, although we could yet exceed the earlier period.

IMPROVEMENTS IN MONITORING PROCEDURES

You asked earlier about monitoring systems and whether the current problem bank list is comparable to 1976. If anything, I would hope that our monitoring systems are better today than they were in 1976. I'd like to think we get better at it as time goes along. I know the Penn Square Bank has caused some improvements in our monitoring systems. So, if anything, I would hope that the problem bank list today is a more accurate reflection of problems than it was in 1976.

Senator RIEGLE. I think it would be good to have you submit for the record what specific changes have been implemented in our monitoring procedures since Penn Square.

Mr. ISAAC. Sure. I would be happy to.

[Information subsequently supplied for the record can be found on p. 100.]

Senator RIEGLE. Now I think your points about the nature of the problem situation at this time is a very interesting analysis because we have experienced four years of virtually no growth in the economy combined with the other problems that you speak about, such as a more intensive competitive environment.

My question is, again, to reframe it, where are we, where are we going and what are we likely to be facing? Are we prepared sufficiently to deal with problems either from the point of view of monitoring arrangements or the capacity to absorb a higher rate of failure should that come about, and let's hope that it doesn't?

According to your little summary, if the economy does not snap back most of the problems bearing in on the industry are likely to remain. I mean, the competitive pressures of deregulation are likely to become even more intense. It's going to be more intense even between each other with the ceiling rates off and so forth.

So I'm wondering, in the absence of economic recovery how many banks are there that are in trouble and that are essentially going to be ground down to failure. Let's say the economy stabilizes; we just continue to bump along in sort of a protracted recession or with an absence of real strong growth. Can these banks that are on the problem list just tread water over that period of time or are we likely to find that their problems will worsen and other banks may join the list?

Mr. ISAAC. If the economy remains flat for the next couple years and we don't see a significant improvement and we couple it with the pressures brought about by deregulation, it seems likely that the problem bank list will continue to grow in size and that the failure rate will be higher than the 10 to 12 we've been accustomed to over the past 10 to 20 years. At the FDIC, we have to plan for various types of contingencies. There is no contingency that concerns me in terms of our ability to cope with it. We are certainly in a position to deal with anything that we believe might happen.

You can't place too much emphasis on the problem bank list because the typical bank on the list gets off within a year or as its condition improves. New management is brought in or new capital is placed in the bank or policies in the lending area are corrected. There's a great deal of turnover on the list and there will continue to be.

Senator RIEGLE. There have been lots of warning signals recently and rather urgent steps taken by our government and other governments to try to cope with what appears to be a deteriorating or more difficult problem of our world financial system. The chairman mentioned some of the countries involved, but more and more stories are being written about it. I'm being visited by members of the administration that have a great sense of urgency about beefing up our commitment to the International Monetary Fund. So there are all the signs that those problems are getting more severe and there's great stress out there and efforts should be made to try to do something about it.

At what point do those pressures start to, in a new way, bear in on our domestic problem? If the problem of nonperforming foreign loans continues to increase and more and more countries need additional credit, are we approaching a point here where that problem could begin to have an impact on what you're dealing with that we should at least start thinking about it, or are you feeling that the international problem is sufficiently detached from the Penn Square type failure that now is not the time to discuss it?

Mr. ISAAC. Well, I'm not sure I could tie that problem very directly to Penn Square, but I think——

Senator RIEGLE. We're now talking about the future Penn Squares.

DEALING WITH DOOMSDAY SCENARIOS

Mr. ISAAC. Certainly the FDIC has to give thought to what could occur in this area. I hear and read a lot of doomsday scenarios on this and that and one flaw I find in all of them is they forget that we have a number of institutions in place to deal with precisely these kinds of matters; and they all presume that the managers of commercial banks and the people who run institutions like the FDIC, the Federal Reserve, the Comptroller of the Currency, the IMF, the Congress and others are not going to react rationally; indeed, aren't going to react at all it seems from some of the doomsday scenarios.

If we look at what's been taking place over the past several months, I think we're seeing people behaving in a rational fashion and dealing with the problems as they come up. I'm sorry that Chairman Garn has stepped out because after that nice compliment he paid me I wanted to return it in his presence. As an example of what I'm referring to is the Garn-St Germain bill, which I know you were quite helpful on, Senator Riegle. That bill was a reaction by the Congress to the request of the regulators to enhance our authority to deal with large banks that might get into difficulty. We talked with Chairman Garn, yourself and others and said, we believe we ought to have this kind of standby authority, and you agreed and we received the legislation.

Arrangements are being made to deal with the problems in Mexico. The IMF, commercial banks, the central bank and others have been involved in that process. Secretary Regan has been over in Europe this week. There are steps being taken to deal with problems as they come up. We have safety nets in place and they will be used rationally and intelligently.

Senator RIEGLE. Let me give you one. We are in the midst of terrible economic problems in this country. It comes as no news to you. I mean, it's in every day's news on the front of every newspaper's business section and it's on the very front pages of many of the newspapers in the country.

But to bring it home, I happen to come from Michigan which is one of the largest states. The unemployment rate as of last Friday in Michigan was 17.2 percent. That's an understated rate because we don't count people when they stop seeking unemployment. So our unemployment rate in Michigan is about 20 percent. When you think about what that means either in sheer numbers or personal economic impact, it's a depression level really. We have a population which is larger than the populations of 12 of the 50 States. In the trade area, Michigan and the rest of the Nation is being absolutely demolished. I'm talking about the flow of goods in and out of the United States, it's a major problem and continues to get worse.

As these other countries who feel they need to borrow more money both from the United States and other nations do that, they are being asked to make certain other tough disciplinary steps within their own domestic economies which press back on those economies in terms of consumption levels, taxation and higher unemployment and so forth. It gets very, very difficult for those countries to succeed. It's very difficult for us to do the same.

I frankly don't have as much confidence as I'd like to have in foreign governments. Are they going to be able to secure additional credit? If they can't, one of the ways they are going to have to change is they are going to have to export more, which means more foreign goods in this country and more American workers displaced. We have got a disastrous problem in this area now and it all gets to the same bottom line, and that is that the world economy is now interconnected and we are part of it. It's gotten to the point where one country pulls itself up at the expense of another and before long it creates almost impossible consequences, and I think we are very close to that point in this country right now.

As a matter of fact, I'll give you another interesting illustration. We are going to put in the new highway jobs bill, both in the House and Senate, a Buy American provision on steel used in construction projects on the highway system. We've got a major issue cooking on domestic content, which is the issue in another form. So I think we may very well find that we are getting right out near the end of the string here in terms of our ability to lever our way out of this problem unless we get some real growth going again and I think all this relates to the bank problems here.

NONPERFORMING LOANS

Let me ask you this. What percentage of nonperforming loans are you seeing today versus 1976? In other words, is there an equivalence in terms of the fact that we are just looking at *x* percent of nonperforming loans versus the 1976 experience.

Mr. ISAAC. I can't give you the exact number in terms of nonperforming loans today versus 1976. I can certainly get that for you. I can tell you that the loan charge-offs are lower today. It's my recollection that the loan charge-offs in 1976 were in the vicinity of 0.56 percent of loans. Today they are running about 0.35 percent of loans which is roughly the same as they were last year and the year before. So I can only presume that the number of troubled or nonperforming loans is likewise lower than in 1976. But the number of problem loans is on the increase, and I'm sure that it will continue to increase for a while.

Senator RIEGLE. Has any sectoral analysis been done of the nonperforming loans to compare the number of nonperforming loans coming out of the manufacturing sector versus, for comparison, those coming out of the agriculture sector. Because more and more Members of Congress who come from predominantly agricultural States are in a state of almost total apprehension about the future because so many farm areas of the country and farm loans at the moment are nonperforming. We have an enormous buildup of sectoral problems in that particular area unlike what we would have seen I think in 1976.

In other words, what I'm getting at—and I could cite other sectoral areas—it seems to me that nonperforming loans are building up in different areas of the economy that I think are in very serious trouble and that are likely to cause more jeopardy if we don't get a recovery soon. And I cite all this not to just raise everybody's concern level but for the reason that I'm not sure we are sufficiently aware of the dangers that may be confronting us now and whether or not our safety nets, as you speak of them, are really sufficient for the kind of problem that we may face not today but out over the next 12 months or 24 months if we continue to limp along in terms of both the national economy and the world economy.

I think the overhanging problems as I see them are so severe and of enough disparity that unless we start making measurable real growth progress we may find that the nature of our banking problems could start to change on us faster than we could deal with them. And I just tell you frankly that I'm very concerned about that and I am not just talking about Penn Square, but Penn Square is important in terms of the next set of Penn Squares that are likely to happen. That's why we're really here.

Mr. ISAAC. In the answer I gave earlier, in terms of comparing 1976 to today, one of the things I said was we had a more specific set of problems than we are facing today. Today's problems arise from a variety of sources and are harder to predict.

I would like, before the time is up, to respond to a point you made earlier about whether we are doing all we should be doing to cope with the new climate. My response to that is that we are probably thinking about all the things we need to be doing, but there hasn't been adequate followthrough yet in a number of areas.

AREAS IN NEED OF IMPROVEMENT

One, I believe that bank supervisors must improve their supervisory techniques. We began that process well before Penn Square and it is continuing, but more needs to be done. They include refocusing our examinations away from the smaller, nonproblem banks and paying more attention to the larger banks and to the banks that are exhibiting difficulties, improving our offsite monitoring and surveillance systems—the new call information will be terribly valuable in that respect—and improving our computer capabilities. We also need to retrain our people to get them to focus on interest rate sensitivity and other such matters instead of focusing so much attention on credit problems and balance sheet analysis.

Second, there are some legislative issues that must be considered. As we remove the restrictions on competition, such as regulation Q, and broaden the powers of financial institutions, what is going to replace the controls?

In our opinion, we have two choices. We can either put examiners full time in every bank in the country and participate in every decision of any import the banks make—which in our judgment would be a very bad policy to pursue and we don't recommend it—

or we can look for ways to increase market discipline. Fuller disclosure is one way to increase market discipline. Additionally, we should look at the deposit insurance system as we've been directed to do under title VII of the Garn-St Germain bill. This includes risk-related deposit insurance premiums, risk-sharing by merging insurance funds and so forth.

There are some very important legislative issues that should be considered in the next year or two if we're going to deal successfully with this new deregulated climate.

REVOLUTION IN FINANCIAL SERVICES INDUSTRY

The CHAIRMAN. Chairman Isaac, along this line of thinking again, there have been several comments today indicating that in a deregulated environment this is part of the problem. Obviously there are pluses and minuses, but, as a matter of fact, you've heard me say many, many times that there's a revolution going on in the financial services industry not only nationally but internationally. I have been accused by some bankers, particularly small bankers, and some people involved in S. 1720, the so-called Garn-St Germain bill, of causing a revolution. I don't consider that the case at all.

In the 8 years I have been on this Banking Committee the markets have been changing dramatically and, in my opinion—regulators, supervisors, Congress, administrations—the revolution has been there and we have all been behind the power curve. We haven't been responding to it.

So I think what you're saying about thinking these things through—I'm pleased that you are looking at new supervisory regulatory techniques, but S. 1720 or its successor barely scratch the surface. There are a lot of legislative things we've got to take a look at. We simply have to catch up.

None of us are starting anything, at least in my opinion. We are not causing it. I didn't cause $230 billion of money market funds. I didn't have anything to do with it. I didn't even have enough money to invest in it, not with seven children and two houses and all that. And it seems to me we're starting to catch up but we are still well, well behind.

I don't want to leave the impression that deregulation is causing the problems. In my opinion, it is an attempt to try and address some of those changing market conditions and it must continue. It's totally apart from the problems of the last 4 years of no growth, of high interest rates and all that. We have to look at the situation in its totality. For example, the changes through technology—I was just over to a conference in England on electronic funds transfer, and the technological changes in the way we do business are dramatic. Again totally apart from deregulation, there are changes going on in the marketplace and we've got to address them. We can't simply sit back and continue doing the business of regulating and supervising the way we have for the last five or six decades and say that's sufficient. And that's the hardest point I've had to try to educate people on and achieve over the last couple years and that is taking place more rapidly every day. I never cease to be amazed at how rapidly the markets are changing and we've got to run very fast to try to modernize and keep up with those changes because they will occur no matter what we do because we are not causing the changes.

I assume you all agree with that.

Mr. ISAAC. I couldn't agree more. Technology and the economy have forced deregulation. Deregulation is simply a reaction—and it has been a delayed reaction at that. With the Garn-St Germain bill and some of the things we are trying to do now, maybe we'll begin to catch up a bit.

The CHAIRMAN. Well, it's only a small beginning. Too many people talk about Garn-St Germain as some big cure-all. It's the tip of an iceberg. It's just a very small part in what I think we need to do.

Mr. ISAAC. It's an important first step but it must be recognized that it's just that—a first step.

Mr. CONOVER. If I may add to that, Mr. Chairman, I would just like to say that we have touched on deregulation a couple times this morning as if it were something we were causing or could stop if we wanted to stop. I see it very much as the marketplace phenomenon that is going to take place whether we are agile enough to get out of the way or not. If you look at some of the problems that we face today, particularly the mutual savings banks' problem that Chairman Isaac and Senator Riegle were talking about earlier, in a very real sense the problems of the mutual savings banks are the result of regulation. They are the legacy that an overregulated system has left us.

So I think that there is an awful lot more to be done in a deregulatory way in the months ahead.

Now one of the things, of course, that that brings is it will put pressure on managements because they will have to behave in a way and make decisions on subjects that they have never had to deal with before. One of the things I think we have to do is recognize that phenomena as we go and encourage managers and banks and thrifts and other financial institutions around the country, who recognize the changes that are taking place around them, to come up with ways to cope with those changes in their own institutions.

I think, most of them will be able to do that effectively. Some won't and we will end up with a shakeup to some degree in the financial services area. We will end up with institutions that look very different in the future than they look today.

The CHAIRMAN. Let me ask just another couple of specific questions of Mr. Sebastian and Mr. Vartanian.

DISCOVERING EXCESSIVE ASSETS OR IMPRUDENT LOANS

Do either NCUA or the Federal Home Loan Bank Board have procedures that would allow you to discover excessive concentrations of assets or imprudent loans? In other words, I'm looking at some of your members who were involved with Penn Square or other concentrations that might have occurred. Is there any way you have that you could have been alerted to some of your membership being involved in that sort of thing?

Mr. SEBASTIAN. As we examine credit unions we can look at their investments and see if they have too much of their money in a particular institution, but we have no way of looking at the other institutions to see if they have too much credit union money.

We haven't gone over every single case, but I'm aware of one instance where, just by luck, we were in a very large credit union about a week before Penn Square and saw that in our examiners' opinion, they had too much money in Penn Square. They wrote that fact in their comments as they left the credit union and the credit union in fact took a substantial amount of money out right before the closing, and that was without any foreknowledge. It was just that there was too much concentration in our opinion.

We feel very strongly that getting credit union examiners into credit unions at least every year and more often in problem credit unions is the best way to monitor that kind of activity.

The CHAIRMAN. Mr. Vartanian.

Mr. VARTANIAN. Yes, Mr. Chairman. We are also in the same position as the credit union regulators. We have a regulation in effect which limits interdepository deposits to the greater of $100,000 or certain minimum percentages of the borrowing institution's deposits, or the investing institution's assets or net worth. We think that regulation will be effective.

The question then becomes monitoring that regulation. We do monitor that regulation through the exam process.

With respect to the three institutions who had exceeded and violated that regulation because of the size of their investments in Penn Square, one of them had received a warning from the Federal Home Loan Bank Board prior to the failure of Penn Square.

Our enforcement procedures essentially focus on the examination process. There are basically four different types of composite ratings for institutions, and those result in four different frequencies of examination. The level 1 institutions, which are the best, are examined every 16 to 20 months. For level 2, generally they are examined from between 12 to 16 months. Level 3 institutions which begin to get into the more severe problems are examined every 9 months, and level 4 institutions are examined every 6 months.

So hopefully the existence of the regulation and that examination schedule will be effective in finding any problems. As I said before, in the period between January 1, 1980, and July 21, 1982, we did find only eight such concentrations which were in violation of Federal or State regulation, or were generally considered to be excessive or risky.

The CHAIRMAN. Thank you.

Governor Partee, what was the level of debt to First Penn from Penn Square in relation to Penn Square's equity base?

Mr. PARTEE. The holding company was funding the bank to a goodly extent, an increasing extent as a matter of fact. As 1981 went on and into 1982 and toward the end, they had a rather high total debt-to-equity ratio. I can find it if you like, but I don't know exactly what it was.

The CHAIRMAN. You can supply it for the record.

[Governor Partee subsequently furnished the following information for inclusion in the record of the hearing:]

SUMMARY FACT SHEET FIRST PENN CORP. (APPROVED BY FEDERAL RESERVE DEC. 23, 1975, FORMED JAN. 24, 1976) PARENT COMPANY ONLY

[In millions of dollar]

Date	Assets	Long term debt	Short term debt	Total debt	Parent equity
Jan. 24, 1976	3.9	2.5		2.5	1.4
Dec. 31, 1976	4.4	2.5	.1	2.6	1.8
Dec. 31, 1977	4.6	2.5		2.5	2.1
Dec. 31, 1978	5.2	2.3	.2	2.4	2.8
Dec. 31, 1979	10.4	3.2	.8	3.9	6.8
Dec. 31, 1980	39.2	8.6	14.6	23.2	14.2
Dec. 31, 1981	73.4	10.0	38.7	48.7	25.1
May 31, 1982	86.3	9.8	49.5	59.2	26.5

Mr. PARTEE. The holding company sold commercial paper and was using the proceeds almost entirely to buy deposits in Penn Square and toward the end for loan participations, just like these other banks.

The CHAIRMAN. Do you feel that the relationship between Penn Square and its holding company strengthened the bank?

Mr. PARTEE. It began strengthening it because as a result of the holding company substantial capital was developed and was put into the bank in 1981—and there were plans for more capital in 1982 that was being handled by the holding company. But, as I say, in evaluating our holding company inspection, our view is that the holding company didn't create the bank's problems, but it certainly didn't prevent them either.

The CHAIRMAN. In denying Penn Square further access to the discount window over the July 4 weekend, the Federal Reserve Bank of Kansas City was then not acting as the lender of last resort. Do you believe that decision was proper, and what criteria does the Fed use for making that kind of decision?

Mr. PARTEE. As I stated in my testimony, Mr. Chairman, the Reserve Bank did not attempt to withdraw lending until it received notification from the Comptroller that the institution was not viable. That is technically the point—assuming there is some collateral to be used for the lending—at which we withdraw, when we get the chief supervisor's warning that the institution isn't viable any more. We got that on the 5th. We had loaned them what they wanted on the 2d. We got the Comptroller's letter on the 5th and would not have renewed the loan on the 6th had they opened up.

The CHAIRMAN. Thank you.

Senator Riegle.

INDEPENDENT OUTSIDE AUDIT COMMITTEE

Senator RIEGLE. There are just a couple other items I hope you can cover briefly here. Let me ask you what do you think of the idea of perhaps setting up a new mechanism, setting up an outside, independent audit committee that would come into being in the case of problem banks that are in severe trouble and that are being told they have to make certain changes to conform to recommendations and requirements that you're putting upon them as you try to help them work out of their difficulties. A mechanism to insure that, for the most troubled situations, compliance is taking place and that has an ongoing monitoring capability? What about setting up in those instances an independent audit committee with the expertise to monitor requirements and agreements and to make absolutely sure that they were taking place so that the regulatory people would not have to camp on the doorstep of the institutions each day to see in fact whether the corrective steps or the modifications were taking place. And if there were a failure, to so report so that we could make sure that we were on track with the recovery program.

How would you feel about that?

Mr. CONOVER. Senator, we have within the Comptroller's Office a special projects group which is a nice name for the problem bank group, a group of people who focus on monitoring and tracking the affairs of problem banks. So we have concentrated within our office a group of people who specialize in that.

Senator RIEGLE. Let me just stop you a minute. I want to make sure you understand what I'm saying. I'm saying if you've got a problem out in any part of the country that you would set up an independent audit group in that community, people in that area, who don't have any tie-ins to you as such and who are not your internal people, but an absolutely detached outside independent group.

Mr. CONOVER. I understand the question. The point is, when we do enter a formal agreement with a bank that's in some difficulty specifying corrective action to be taken, we generally require that a compliance committee of the board of directors be established and that it be at least headed by and a majority of the members of that committee be outside directors, not part of the day-to-day management of the bank. It is their responsibility to monitor compliance throughout the agreement and to report to us on the progress that they are making in their compliance efforts.

It seems to me that since the agreement is between, in this case, the Comptroller's Office or the supervisor and the board of directors of the bank, that that is appropriately a responsibility of those directors and I think that is the way it ought to be done. I think we accomplish the same end as you suggest by this mechanism rather than by having some outside party being involved in it.

Senator RIEGLE. Did we have that in Penn Square?

Mr. CONOVER. Yes, we did. We had a committee and they did report to us on a monthly basis, as a matter of fact, at least through the September 1981 exam. You recall that we indicated that we thought they were making progress in achieving compliance with the agreement through that date.

Mr. ISAAC. Senator, if you can't count on the board of directors, you ought to run them out of the bank and bring new directors on to the board. There are a couple of disadvantages in working through outsiders. One, the directors are more competent to do this job than outsiders and, second, if the directors don't do their job they are going to have legal responsibility. It's hard for me to envision how you would place the outside group in the same position with respect to potential legal liability.

The FDIC has been pretty aggressive in recent years in terms of pursuing officers and directors, accounting firms and others after a bank fails. I believe that has had a therapeutic effect, and I assure you we are pursuing those investigations vigorously in Penn Square.

Senator RIEGLE. I would like you to submit for the record whether such an audit committee was established in each case of the banks that have failed over the last 2 years. These presumably were insider monitoring groups headed by or composed of so-called independent directors or directors who were not in the day-to-day management of the particular bank in question. I would like to know in each case how well that worked. I'm not sure that is a sufficient monitoring device for the kinds of problems we're seeing now.

I mean if we used that device in Penn Square and we come along after the fact and run people down in court on possible misconduct, that is sort of an after-the-fact remedy, and we should bring charges if there's that kind of problem, but what I'm looking for here is a way to try to find these situations before they become so advanced and so aggrieved that we have to go through the wringer.

Mr. ISAAC. That's the problem, though. If you find a problem situation, you can deal with it without a committee. If its a situation you don't find, you would never have occasion to set up the committee.

Senator RIEGLE. I have great regard for you, but I share the reservation that I believe the chairman expressed earlier and I don't want to put words in his mouth, but I think regulatory agencies from time to time shuffle their feet as well. Even with the best of intentions, you want to be able to work something out if you can. However, I've seen regulators who are aggressive and tough to too great an extreme, too confrontational and too combative, and I've seen others from time to time who will let problem situations continue until finally they are beyond the point where maybe something constructive could be or should be done.

I think the public has some right to be certain that there is a monitoring device that can insure that if agreements have been made that they are kept and that things don't slide and the clock continues to run and the problems do not become more severe until finally we wake up having to shut down the bank literally overnight. Everybody says, well, we really didn't anticipate this; 5 days ago we didn't see this coming and now, bang, it's here. We ought to see it more than 5 days ahead of time.

If our monitoring and auditing devices are not sufficient to give us more than 5 days leadtime, we ought to be drafting one that does a little better job. I think one way to do it, and a fair and square way is to have competent professionals monitoring severe problem situations where certain corrective actions have to be taken to make sure they are being done so the whistle gets blown if it needs to be blown. Maybe it needs to be blown on the regulators. You certainly don't bat 1.000. We don't and nobody does. The gravity of the situation is such that I think it's important that the public be able to know that we are doing everything we possibly can to find these problems before they blow up in our face. I don't think anybody is covered with glory by what happened in the Penn Square case.

I think our obligation is to spot problems early enough in the game, intervene and be able to do something about it before we are left with full-blown bank failures. I think bank failures do damage. I think they damage the system. I think they damage people's confidence and to the extent we can head some of them off I think that would be useful.

So I'm interested in seeing how that monitoring device you speak of has worked in each of the cases of the bank failures we have seen over the past few years.

[The following letter was received for the record:]

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

January 27, 1983

Honorable Donald Riegle
Committee on Banking, Housing,
and Urban Affairs
United States Senate
505 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Riegle:

We are pleased to supply supplemental information you requested for the record of the Senate Banking Committee's hearing into the failure of the Penn Square Bank N.A. of Oklahoma City.

Question No. 1:

Please submit for the record, what changes in monitoring procedures have been implemented since the Penn Square failure.

Answer to Question No. 1:

Since the failure of Penn Square Bank, we have taken the following steps to improve our monitoring procedures:

(a) FDIC policy relative to the priority, frequency, and scope of examinations has been modified to provide more effective supervision and surveillance of banks rated 3, 4 and 5. Previously, banks rated 4 and 5 were required to be examined at least once each 12 months and banks rated 3 at least once every 18 months. Additional examinations and/or visitations were encouraged and generally performed; however, this was discretionary on the part of our Regional Directors. Recent revisions require that an examination or a visitation be performed quarterly on banks rated 4 and 5 and that off-premise reviews of banks rated 3 be performed in any six-month period when an examination is not conducted. To free up resources for this purpose the examination interval for smaller 1 and 2 rated banks was increased from 18 months to three years with visitations or off-site reviews to be conducted in intervening years when no examination is performed.

(b) The FDIC has, for many years, operated a memo system relative to problem banks (currently defined as banks rated 4 and 5). This memo system provides a financial summary, a definitive description of the nature of a bank's problems, and a discussion of the corrective program being pursued along with other information. This memo system is the focal point for our oversight and internal communications relative to problem banks. Since the Penn Square failure, we have extended this system to include all banks with assets of $250 million or more which are rated 3.

(c) New procedures have been adopted jointly with the Comptroller of the Currency to improve interagency identification and communication relative to national banks likely to involve FDIC in a financial assistance transaction. It is hoped that similar procedures can be worked out with the Federal Reserve.

(d) Several changes have been and are being made in our computerized surveillance system in conjunction with the availability of new data. The Federal Financial Institutions Examination Council implemented its Uniform Bank Performance Report (UBPR) in 1982 and, earlier this year, agreement was reached among the regulatory agencies to substantially improve the Call Reports submitted by banks. Beginning with the December 31, 1982 reports, all banks will submit data regarding their nonperforming assets. On March 31, 1983, accrual accounting will be extended to banks with assets between $10 and $25 million, and on June 30, 1983, all banks will provide information regarding the volume of their rate sensitive assets and liabilities. Our surveillance system has already been modified to provide compatability with the UBPR and new test ratios are currently being developed to utilize the new information which will soon be available. The UBPR, which is generated on a quarterly basis, has enabled us to formalize the "off-site" analysis program mentioned earlier which allows us to evaluate the condition of banks more frequently between examinations. Our early warning system, which identifies banks failing critical financial tests, is being revised to take advantage of the new Call Report data. In addition, a separate specialized surveillance system for larger banks is also being developed which will improve our ability to monitor these banks in recognition of the potentially greater insurance risk they pose to the Corporation.

(e) In addition to the above, a review of all 4 and 5 rated banks which are not subject to formal enforcement actions has been performed to determine if such actions are appropriate, and FDIC's Board of Directors has delegated some of its authority with respect to enforcement actions to improve our efficiency in the use of these powers. Also, we have started advising banks in the report of examination of composite ratings (1 through 5) assigned under the Uniform Financial Institutions Rating System together with the narrative definition of what the rating means. This latter step will provide improved communication to banks as to their precise supervisory status with FDIC and serve to formalize our oral discussions with banks rated 3, 4 and 5 as to the seriousness of their problems.

You may wish to note in the response that we have interpreted your request literally and that not all these actions were directly related to the Penn Square failure. Specifically, Items 1(a) and 1(d) were in process prior to the failure of Penn Square. Also, the points in Item 1(e) dealing with delegations of authority on Section 8 actions and notification to banks of their ratings were either in process or under discussion prior to Penn Square.

Question No. 2:

Request that we review our files on banks that have failed over the last two years and advise if an audit committee was established (apparently with the express purpose of monitoring the bank's efforts at resolving its problems) and, in each case, how it worked.

Answer to Question No. 2:

A review has been conducted of the files of banks closed during the last two years to determine the use of audit or oversight committees to monitor the banks' efforts to correct their problems. This review disclosed only one such instance which involved the use of an independent consultant to aid in the resolution of the bank's problems. There may have been other instances where committees of outside directors or outside consultants were used; however, these were not readily apparent from a review of the files.

The FDIC has not heretofore required or even encouraged the use of committees or consultants as a means of achieving correction of a bank's problems. We are aware that bank boards frequently appoint such committees; however, we have not generally sought to work through or communicate with them directly. While a conscious posture in opposition to the use of such committees has not been adopted, our approach to this matter has been largely influenced by two factors. First, the FDIC has sought to establish responsibility and accountability with the full board of directors and has structured its communications and enforcement activities accordingly. Secondly, our experience with problem banks has taught us to be very skeptical of information reported by a bank indicating corrective actions which are taking place without independent confirmation by examiners. Frequent progress reports from banks are always required and are helpful to our efforts; however, these are not used in lieu of but rather in conjunction with on-site visits or follow-up examinations.

While steadfast in our belief that full board accountability and frequent examiner contact are necessary to effective supervision of problem banks, we do not reject the idea that productive use can also be made of oversight committees. We are presently taking a serious look at this idea to see if it can be productively employed in problem bank rehabilitation.

Question No. 3:

What percentage of nonperforming loans are you seeing today versus 1976? Has any sectoral analysis been done of nonperforming loans?

Answer to Question No. 3:

The attached table indicates that the two primary measures of nonperforming loans reported by banks -- past due loans and nonaccrual loans -- are higher today as a percentage of total loans than in 1976. Furthermore, the nonperforming percentage of each separate loan category has been increasing substantially since 1980 after a slight downward trend during the period 1976-79. The most notable increases in nonperforming loan ratios have occurred in real estate and commercial and industrial loans.

Sincerely,

William M. Isaac
Chairman

Attachment

LOAN PERFORMANCE OF COMMERCIAL BANKS[1]

* Past Due % of Loans By Type	3/76	6/76	9/76	12/76	12/77	12/78	12/79	12/80	12/81	3/82	6/82	9/82
Real Estate	3.4	3.2	3.3	3.3	3.0	2.9	3.1	3.6	4.3	4.6	4.6	5.0
Commercial & Industrial	4.2	3.9	4.0	3.8	3.8	4.1	4.0	4.5	5.4	5.7	6.0	6.5
Individuals	3.2	3.0	3.0	3.1	3.2	3.1	3.4	3.8	3.9	3.8	3.7	3.9
Total Domestic **	3.3	3.1	3.1	3.2	3.1	3.0	3.2	3.7	4.2	4.4	4.4	4.7
Foreign Offices	NA	NA	NA	NA	0.0	1.0	1.0	1.3	4	1.7	2.2	3.0
* Non-accrual % of Loans	NA	NA	NA	NA	NA	.86	.83	.85	1.07	1.21	1.41	1.69

* The past due and non-accrual loan information is for national banks only. Non-accrual loan information is only reported by national banks of over $300 million in assets. The determination of past due status is as follows:

(1) Single payment notes--These shall be considered past due 15 days or more after maturity.

(2) Single payment loans, with interest payable at stated intervals, and demand notes--These shall be considered past due when an interest payment is due and unpaid for 15 days.

(3) Consumer, mortgage, or term business installment loans--These loans are past due in whole after one installment is due and unpaid for 30 days or one month. When an installment payment is past due, the entire unpaid balance should be reported as past due.

(4) Overdrafts are considered past due when not paid in 15 days.

** Also includes loans to other financial institutions, agricultural loans, and loans for purchasing or carrying securities.

[1] Averages of individual bank ratios.

INCREASE IN FOREIGN LOANS

Senator RIEGEL. The final thing I'm interested in is can any of you tell me what percentage of bank lending has now made its way abroad? In other words, what percentage of our bank lending today by banks in this country, through whatever number of transactions, actually ends up overseas. If you can give me a percentage in the aggregate that I might compare, say, with what that figure might have been 5 years ago, 2 years ago, 1976 or 1975, the last time we went through a severe wringing out problem. Where do we stand today? How much money has made its way out of the country into foreign loans of whatever sort?

Mr. CONOVER. Senator, we can supply that specific percentage for the record. I believe the number is that U.S. banks have a total foreign exposure of approximately $320 billion today and that number is up significantly I think by approximately 80 percent over the yearend—I do not remember if it is 1977 or 1978 figures—but there's no question that in the past 4 or 5 years, U.S. bank exposure in the form of foreign loans has increased significantly.

Senator RIEGLE. What is that as a percent of lending today versus what it would have been in previous years?

Mr. PARTEE. One clarification, it isn't necessarily money coming from this country. A large amount of this is raised in the foreign branches of U.S. banks and re-lent abroad.

Senator RIEGLE. How close can you get to an answer today? This can't be a new subject for you. Somebody must have some idea what the percentages look like.

Mr. CONOVER. I know the numerator but not the denominator or the fraction, so we'll have to provide it for the record.

Senator RIEGLE. Is it your impression——

Mr. PARTEE. My guess would be that it's on the order of 10 percent, but I don't have a figure in mind. I didn't come with this in mind.

Senator RIEGLE. Mr. Isaac, would you have an answer to that question?

Mr. ISAAC. I believe it's higher than 10 percent, but I'm not going to get into guessing what the exact percentage is.

The CHAIRMAN. Rather than deal in guesses, if you can supply the exact figures for the record.

[The following information was subsequently supplied for the record:]

Foreign loans as of June 30, 1982

	In billions
Extensions of credit to foreign borrowers	$343.7
Net claims of U.S. banks on their foreign branches	5.3
Total credit to foreign borrowers	349.0
Deposits of foreign offices of U.S. banks	320.2
Deposits of foreign governments in domestic U.S. offices	7.0
Total foreign deposits	327.2
Foreign loans minus foreign deposits (Net)	21.8
Total assets of U.S. banks (foreign and domestic)	2,071.1
Net as percent of U.S. bank assets	1.05

Senator RIEGLE. I would just say in conclusion that I think that's something that we need to know and I think it's something that you folks ought to know. We need to know what fundamental changes and shifts are going on that bear on larger pressures and events.

My concern here is what's likely to happen in the next year and 2 years, how many more Penn Squares are there, and how different is today's climate from what we saw in 1976, the last time we saw a significant number of bank problems? I'm not even sure we've got that fully sorted out. Not that we can do it all in one hearing, but it seems to me that if we've got fundamental changes that have taken place and you have enumerated many of them, Mr. Isaac, and I agree with you about deregulation and other things, I think we're going to have to do a better job of adding all this up and deciding what this means in terms of the overall pressures and stress on our financial and banking system. We must know if we are into a period and circumstance and condition that may be new and different, and sufficiently so that we may need to understand it better and we may need to consider whether the mechanisms that we have developed out of past experiences are really sufficient to what we may see in the next 2 years. That's what I'm principally concerned with.

Mr. ISAAC. If I might just say a couple words. First, we know quite well what is happening in foreign lending. The fact that we can't come up with that exact ratio right now does not mean we don't know what is happening. We know which banks have what exposure.

Senator RIEGLE. And you're going to provide that for the record.

Mr. ISAAC. Second, I am troubled by the comparison of Penn Square and what's going on in the international arena and in banking generally. We cannot lose sight of the fact that Penn Square is a unique situation. We had a small shopping center bank that grew from $50 million in size to $500 million in size in 5 years. In addition, it had originated another $3 billion in loan participations, outstanding letters of credit and loan commitments. In other words, it went from $50 million to $3.5 billion. It grew 70 times in 5 years. It concentrated its loans in high-risk lending areas and didn't diversify. It relied on expensive, volatile money purchased in money markets at above market rates and the bank was fraught with abusive insider transactions and irregularities. Are we going to have a lot more banks like Penn Square? The answer is clearly no.

Occasionally we will have banks like this. This one got a lot of publicity because it was bigger than most and involved other banks that bought loan participations, but there have been smaller Penn Squares over the years.

We are talking two different things. One, what is happening in the economy generally and how are those factors coupled with deregulation, affecting banking? The other is how do you stop abusive situations like Penn Square. The two issues are not related.

Senator RIEGLE. Well, I think you make some useful points there and let's consider them both.

When we talk about Penn Square, you, yourself, in describing what took place at this bank have given me a very powerful set of reasons as to why we should have seen the failure coming. We, the regulators, the people in Government, can intervene much earlier to do something about it.

Whatever the reasons for the failure in that respect, whether the mechanisms weren't adequate, whether the people didn't do the job or whatever, what you have just outlined, that should have been an advance sign that somebody should have been paying very careful consideration to the situation.

I think we were late responding to that problem and I think our response was not sufficient.

The second point I want to make relates to the other issue. If we only had one bank failure recently, whether a Penn Square sort or any other sort, I don't know if it would have been necessary for us to meet, but as a matter of fact, in the last year we have had 40 bank failures of a variety of different circumstances. I'm not here to suggest they were all of the Penn Square sort There's a variety of circumstances. But the fact is we have had 40 this year.

Your recollection was that we had a low number last year, whether it was 7, 12, 15, somewhere in that range, and when you were using a 20-year average I believe it was to talk in terms of roughly a dozen or so that have been occurring each year. We have seen a sudden increase in the number of bank failures of which Penn Square happens to be only one kind of situation.

So, yes, we are interested in both things, absolutely, and I'm just as glad to make a differentiation as you are. We want to find the abusive Penn Square type situations and try to head them off earlier in the game than we were able to do or succeeded in doing this time but, second, we want to understand what's bearing in on the whole system that's creating not one or two bank failures or not the averages we have seen over the last several years, but 40 in the current year. That is very worrisome and very alarming and that's why we are looking for answers to both problems.

PROJECTED BANK FAILURES

Mr. ISAAC. If I might make a couple points on the latter problem. I asked our regional directors at the beginning of this year to project the number of bank failures they expected during 1982. They predicted that we would have between 40 and 50 bank failures this year. Right now we are at 40. So I don't believe what's happening is unforeseen or not understood. I think we knew what might happen, were prepared for it, and dealt with it successfully.

As far as Penn Square goes, did we get on top of it too late; yes, in my judgment, we got on top of it too late.

PRIMARY RESPONSIBILITY OF PENN SQUARE

But having said that, I think you've also got to take into account that ours is a privately owned, privately operated banking system and there has to be a limit on the Government's involvement in it. The primary responsibility for Penn Square does not lie with the regulators. It lies with the shareholders who purchased stock in that institution and elected certain people to be directors of it. It lies with the directors who didn't do their job properly. It lies with the management the directors selected. It lies with the accounting firm which issued an unqualified statement on that bank after an earlier accounting firm had issued a qualified statement. It lies with the correspondent banks, the S&L's and credit unions which funded it, and the participants who bought loans from it. That's where the primary responsibility lies.

The regulatory agencies reacted pretty well. In all honesty, I would have to say we would like to have been on top of the situation at an earlier stage than we were and closed it down earlier. But in our free enterprise system of banking we should hesitate before we say that the regulatory agencies are the real culprits and should take primary responsibility. That would require some fundamental changes in our system of banking in this country—changes that I'd hate to see made.

Mr. CONOVER. I think I need to respond to at least a couple of points that Mr. Isaac made. Remember that through September 1981 the bank was making significant progress. Remember that between September 1981 and April 1982 is the time in which they originated some $800 million of new loans and the very major portion of the loans that were ultimately categorized as lost and led to the insolvency of the bank were made during that very brief time period. I don't think that any regulatory system could have prevented the binge that they went on from happening.

BANK CLOSED AT PRECISELY THE RIGHT TIME

As to whether or not the bank could have been closed down earlier, we regard the declaration of insolvency and the closing of the bank as a very serious step, one that is not to be taken until it is clearly demonstrated that the losses that exist in a loan portfolio exceed the capital of the bank and that the bank cannot fund itself from private funding sources.

We have been asked on a number of occasions why we did not close the bank down on Friday—it must have been the second—or why we didn't close it down on Saturday or why we didn't close it down on Sunday. The simple fact is that we were working on analyzing that loan portfolio and discussing loans with the management of other banks to verify that, yes, those were in fact losses.

The bank was closed at precisely the time it should have been closed which was the time when we were confident that losses exceeded the bank's capital and it was therefore insolvent. Any time earlier than that would have been, I think, not only unfair to the depositors and the shareholders, but also illegal. So I think we closed it down precisely when we ought to have closed it down.

Senator RIEGLE. Let me just say, Mr. Conover, I don't think that's the critical question, quite frankly. It is an important question. The critical question is, what might have been done earlier to have prevented it having to close down on that day or 2 days later or 2 days earlier? I'm not here to challenge the issue of whether or not you closed it at precisely the right moment. The question is, what might we have done weeks or months earlier and more effectively.

Might a way have been found to have avoided the final outcome in this situation or even, if it was going to happen, to have prevented some of the abuses that took place once it was well known that this bank was in trouble and that there were difficulties here?

I'm just simply saying that to say it closed at precisely the right moment, that's fine and dandy, but if you think that's sufficient, then I think you miss the point of a lot of today's discussion.

Mr. CONOVER. Senator, the fact is, that as we indicated earlier, any supervisory effort in dealing with a bank has got to depend on the compliance of the management and the board. Of course, if we tell them to do something and they do it, that's fine. For the most part, 99.9 percent of the banks with which we deal, we ask them to do something, whether it's been in the course of an examination or through a formal agreement or cease and desist order, they comply. But there's no question that if a management or a board tells you that they are working toward compliance and submits evidence that indicates that they are working toward compliance when in fact exactly the reverse is the case, then there is very little that any supervisory agency can do about it. I do not think that we ought to have a system that would enable us in the near term to detect such instances of bad faith on the part of managements or directors.

Put another way, our system has got to be based on a fundamental premise that directors and managers are honest and want to comply with the law. If we have a system that is based on the reverse assumption, we have an horrendous regulatory system.

Senator RIEGLE. I think you view it the wrong way, if I may say so. It isn't just a question of somebody who's lying to you and who's dishonest or who has criminal intent. You may also have situations where people can't respond or the circumstances change and so they find themselves in an impossible situation and things that ought to be done or were to be done were not. Maybe they are identified or maybe not; but the notion that we are just going to wait in the end until things sort of fall in on themselves and that you don't have any way of improving the monitoring or making sure that things that you think are going to be done or you think ought to be done are in fact being done and that no changes are needed along that line, I just find that a very weak line of argument.

Mr. CONOVER. I am not saying there are no changes that are needed along that line. What I am saying is that as we deal with banks in our normal supervisory process, if a bank finds itself in a situation in which it cannot comply with the request that we make, in whatever form that we make it, most managements and boards will come to us directly and say, "I'm having this kind of difficulty; what can we do about it?" The nature of the process is not simply that we tell them to do something and disappear from the scene and hope that they do it. There is then a constant dialog and supervisory activity that takes place.

The CHAIRMAN. Mr. Conover and gentlemen, the precise time has come to close this hearing. I do appreciate very much your willingness to come and testify today. I would suggest that we constantly have to review our regulatory and legislative agenda to make sure we are doing the best job possible. I do believe there are some improvements that can be made in the system to try and do a better job and I'm sure you're working on that and I'm sure we can't solve all of those problem, here today. There will be additional, more specific detailed questions that we would like to send some or all of you for your response for the record in writing, but we do thank you very much for your testimony here today.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

[Additional material received for the record follows:]

13-540 O - 83 - 8

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

January 27, 1983

Honorable Jake Garn
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
505 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

We are pleased to respond to your request for answers to supplemental questions regarding the Penn Square Bank failure. You also submitted three questions on behalf of Senator Tower. The first two questions submitted by Senator Tower relate exclusively to the Comptroller of the Currency. We understand he is responding to the same questions so we will defer to his office for this and confine our response to his third question.

Questions No. 1, No. 2, and No. 3:

1. Call reports for commercial banks have recently been revised to require quarterly reporting of data on past due nonaccrual and renegotiated loans. In addition, beginning with the June report, the Federal supervisory agencies will make these reports available to the public. If the reporting of such past due loans is now being added to banks' Reports of Conditions and Income, what were the procedures prior to such changes for gathering data on, and monitoring, delinquent loans?

2. Presuming that these new reporting requirements will be of valuable assistance to the regulators in earlier detection of future "Penn Squares", what is the need to go the extra yard and require public disclosure of such data?

3. Do you share the concern that such public disclosure would be easily misinterpreted by the public, could further damage a troubled institution and would erode public confidence in our financial system?

Response to Questions No. 1, No. 2, and No. 3:

The FDIC is upgrading its offsite computerized monitoring system and reducing the burden placed on well-managed banks with respect to frequent onsite examinations. Similar efforts are underway at the Office of the Comptroller of the Currency and other regulatory agencies. The newly-instituted report on past due, nonaccrual, and renegotiated loans and lease financing receivables is critically important to these efforts which should not only improve our surveillance of banks but also lower our costs and reduce the overall supervisory burden on banks.

An excessive volume of past due and nonperforming credits is a common trait of "problem" banks and is frequently the precursor of increases in loan and lease losses. This, in turn, is one of the predominant reasons for bank failures. Prior to the implementation of this new report, complete current information on all forms of nonperforming credits was available only from that fraction of insured commercial banks that had recently undergone onsite examinations. Our offsite monitoring of problem credits was largely limited to analysis of Call Report generated information on increases in the reserve for loan losses and actual loan losses recognized by reporting institutions.

Current public policy in this country calls for deregulation of the banking industry thereby markedly decreasing the government's involvement in the banking business. Banking is a business that relies heavily on public trust. Heretofore, the public has relied on strict government regulation to ensure that its interests are not compromised by excessive risk taking by banks. In a deregulated environment, the government will no longer determine what interest rates banks may pay and will play a smaller role than at present in determining the services banks may offer. We must, in this kind of environment, seek new ways to control excessive risk taking.

In our view, the market mechanism holds significant potential for acting as a safeguard against mismanagement or abuses. However, the market can only play this role if it has sufficient information to judge performance. Our decision to make public the information on nonperforming loans is intended to facilitate this process and provide a foundation for the market to substitute, at least to some degree, for the regulatory authorities in determining how well industry participants have carried out their duties. The market will reward the good performers and encourage the marginal performers to improve.

We share, to some degree, the concern about misinterpretation of the data by the media. This could happen on occasion, but on the basis of our extensive dealings with the media throughout the nation, we believe the press will generally be cautious in its use of the data. Banks and bank holding companies whose securities are registered have disclosed similar types of information for many years with no dramatic effect on public confidence in those institutions. We firmly believe that sound, well-managed banks have nothing to fear -- in fact, have much to gain -- as we implement these new requirements.

Questions No. 4 and No. 5:

4. There are legal requirements applicable to loans to insiders and their related interests which require that they be on nonpreferential terms, that the bank's Board approve loans above a certain threshold and that they be reported. (These reporting requirements are now being revised by the agencies, as mandated in the Garn-St Germain Act.) Similar requirements apply to loans to insiders of correspondent banks. To what extent were loans to insiders and their related interests, both by Penn Square and its correspondent banks (i.e., Continental and Seafirst, etc.) a factor: a) in the Penn Square failure; and b) in the purchase of participations which created large losses for the purchasing banks.

5. Do you believe there should be special lending limits applicable to insiders that are more stringent than the single borrower limits?

Response to Questions No. 4, and No. 5:

The FDIC has over the years paid special attention to bank insider lending and its ramifications. This attention has been reflected in both the regulatory and supervisory processes. It has been our experience that most bank transactions with insiders and related interests involve no abusive or preferential treatment. A bank directorate is often composed of the most reputable and creditworthy individuals in the community. Their businesses will, in many instances, necessitate bank loans, and these will ordinarily be among a bank's better assets.

On the other hand, there have been cases where improper loans to officers, directors and their interests resulted in serious losses or embarrassment to banks. It is, of course, these cases that have led to the enactment of regulations, reporting requirements and increased supervisory focus.

Existing regulations prohibit the granting of preferential loans to insiders and their interests (including insiders of banks which maintain correspondent balances with the lending bank). Under the Garn-St Germain Depository Institutions Act of 1982, the bank supervisory agencies are responsible for setting insider lending limitations, thresholds for approval of such loans by a bank's board of directors and reporting and disclosure requirements.

Recognizing the inherent potential for conflict of interest in insider lending, we nevertheless believe there is no need for regulatory lending limits applicable to insiders (other than executive officers, to whom we believe no credit should be extended) that are more stringent than lending limits for comparable transactions with regular bank customers. Rather, it is our feeling that this potential risk can be effectively self-regulated by appropriate requirements for board approval and disclosure of insider loans. The banking agencies provide adequate monitoring and supervision via the processes of offsite review and onsite examination as well as by enforcement actions.

The FDIC has temporarily placed a $25,000 limit on insider loans without prior board approval; however, we are working with the Office of the Comptroller of the Currency and Federal Reserve to arrive at an appropriate uniform standard for all banks. The objective is to assure that bank directorates are aware of, and will strive to regulate insider loan demands. It is our intent also to work with the other two banking agencies to improve reporting and disclosure requirements on insider lending as set forth in FIRICA for better offsite monitoring by the agencies and more effective market discipline, through disclosure, without imposing an undue reporting burden on the banks.

The combination of self-regulation by board awareness and approval, marketplace discipline by disclosure and agency supervision by offsite analysis of reported data, onsite examinations and enforcement actions will, in our opinion, permit effective regulation and supervision of insider lending practices in banks.

Question No. 6:

6. Many credit unions and thrifts have experienced substantial losses as a result of the Penn Square failure. Did the FDIC consider the impact of a deposit payoff on these institutions before advocating that route?

Response to Question No. 6:

The failure of any large banking institution can be, and usually is, a disruptive economic event. It will seriously impact depositors (large and small alike), other creditors, loan customers and often the local community itself. With the protection of federal deposit insurance and liquidation procedures enabling an orderly transition, the impact of a bank failure is substantially eased. As with any business failure, some creditors will incur losses; however, the FDIC's function is to minimize the consequences of such an event rather than to prevent all bank failures. While we are not insensitive to the impact of individual losses, we must carefully weigh the available alternatives in choosing a course of action.

Before a final decision in the Penn Square situation was made, our Washington headquarters staff analyzed the incoming data from our onsite investigators to consider all possibilities and alternatives. These efforts left us, essentially, with three choices:

(1) Pay off insured depositors. This alternative is a simple and straightforward means of handling a bank failure when other less dramatic arrangements cannot be effected. In a bank the size of Penn Square, however, such a payoff can be time consuming and disruptive. Because we were concerned about the adverse public reaction and effects on public confidence, a more favorable alternative was desirable.

(2) Effect an emergency purchase and assumption transaction. This often utilized tool will permit, with FDIC assistance, the transfer of all of the liabilities of the troubled institution to another operating bank, effectively insulating all depositors and creditors from loss. In such situations, the FDIC indemnifies the purchasing institution against all contingent claims. In the case of Penn Square, these claims had the potential to become massive. Accordingly, we concluded that a purchase and assumption transaction was not justifiable on a cost basis. Moreover, we were deeply concerned about the long-range impact on market discipline that such a bailout might have had if employed in a situation as egregious as Penn Square.

(3) Creation of a Deposit Insurance National Bank. As you know, we finally settled upon a solution whereby a deposit insurance national bank was created, and insured deposits were transferred. This course of action permitted immediate access to insured funds and, importantly, allowed us to continue to honor checks drawn upon individual accounts up to the insured limit. In order to further minimize the public impact and to facilitate an orderly transition phase, we chose to continue to pay interest on time and savings deposits for a 90-day period.

Our procedures and decisions in the Penn Square Bank failure resulted in what we believe to be the most favorable course of action possible, given the particular set of circumstances and time frames involved. Each bank failure is different with its own unique characteristics requiring difficult choices; we can assure the Committee that the FDIC always weighs carefully all viable alternatives and is cognizant of the potential ramifications of these decisions.

Question No. 7:

7. Estimates of the amount that may be paid on receiver certificates have ranged from as high as 80% to as little as 25%. Can you give us any idea at this time of how may cents on the dollar uninsured depositors will ultimately recover?

Response to Question No. 7:

It is too early to make any reliable estimate of the total recoveries likely on Penn Square's assets. Several major claims have been made in actions brought against the FDIC as receiver of Penn Square, and the outcome of litigation related to these claims may affect the recovery to common creditors. First estimates of possible recoveries will probably be completed in the first half of 1983 and, once made, will undoubtedly be subject to significant change as the liquidation progresses.

Question No. 8:

8. In rethinking your decision to close Penn Square and pay off its insured depositors, do you wish that the FDIC had the authority to effect a solution which would produce more marketplace discipline than arranging a merger but less costly and severe than a pay out? Should the FDIC be given the authority to arrange an acquisition of an institution where only a portion of the uninsured liabilities would be transferred to the acquiring institution?

Response to Question No. 8:

Under our current method of effecting an emergency purchase and assumption transaction in a failing bank situation, all depositors (both insured and uninsured) and other creditors are effectively insulated from loss, with the net consequence of ultimately spreading the increased costs throughout the banking system by means of a higher net insurance premium. This, some would argue, is inequitable as it serves to insulate high risk takers while penalizing prudently managed institutions. Further, over time, such a practice erodes normal market discipline as depositor/creditor perception of the danger of loss from a bank failure and deposit pay-off is reduced. Many now perceive that no large bank will be allowed to fail, per se, and therefore, there is less need to equate risk with yield when placing funds with a large insured institution.

We feel strongly that market discipline can be a desirable check upon imprudent bank management practices, and that it can play an increasingly important role in a deregulated banking environment. Implementation of some consistent form of loss sharing arrangement in emergency purchase and assumption transactions woud help to restore this discipline and, we believe, may be desirable.

As you know, these issues are broached in Section 712 of the Garn-St Germain Depository Institutions Act of 1982 and they will be more thoroughly explored in our April 15, 1983 response to the questions posed therein. Our staff is currently working to develop a viable means to permit an equitable loss sharing arrangement.

Question No. 9:

9. In your analysis of risk-based insurance premiums of depository institutions, doesn't the rapid decline of Penn Square from September 1981 to April 1982 indicate that improvements in the method of assessing risk of failure are needed?

Response to Question No. 9:

Certainly we have learned from the Penn Square Bank failure, but we feel obliged to say that the current system of evaluating risk is generally quite successful. As part of our analysis of a risk based insurance system, we have looked closely at bank failures and assistance cases since 1970 and found most were clearly identified as high risk operations well before they failed. Of course, as the banking industry changes, so must our techniques for assessing risk. Identification is only part of the problem though -- the key is to reduce risk to acceptable levels before it is too late. Usually we are very successful in doing that, but not always. The problem quite simply is that risk can be increased very quickly and in many different ways. It is much easier to increase risk than it is to reduce it.

We are continuously striving for better ways to identify and reverse risk trends before the problems become too severe. Whenever a bank fails, we try to learn from the experience; however, we are not likely to ever have a foolproof system. There will be failures and some will be surprises; the purpose of regulation and deposit insurance is not to prevent these occurrences, only to ensure they are isolated events whose impact is minimized to the extent possible.

Senator Tower's Question No. 3:

3. It appears that in our heavily regulated banking environment that our "early warning systems" have broken down. Tell me what you believe to be bank regulators' role in a deregulated world?

Response to Senator Tower's Question No. 3:

In a deregulated environment, it is clear that the risk of failure will increase as institutions engage in newly authorized activities and compete to a much greater extent based on price. As a result, supervision must become more sophisticated and better focused. The frequency and scope of examinations of relatively small, well-managed institutions are being reduced. Increased emphasis is being placed on examining larger institutions where the magnitude of exposure is greater, and on resolving known problem situations where the risks have become evident. Examination techniques and approaches are being developed to review credit quality more efficiently and additional attention is being focused on other areas of risk, such as asset and liability mismatches and interest rate sensitivity. Offsite monitoring and surveillance systems are being improved, data processing capabilities enhanced and examiner training broadened and improved. A greater effort is also being made to more consistently strike that delicate balance, which is perhaps the essence of effective supervision, between allowing management every reasonable opportunity to voluntarily correct known problems or adverse trends and proceeding to a formal enforcement action without undue delay to achieve the results desired.

We believe greater reliance must also be placed on public disclosure and the marketplace to discourage unsound practices and prevent or limit losses. While the marketplace cannot entirely supplant supervision, the marketplace and the discipline it imposes can be of major assistance in achieving supervisory objectives. There is a need as well for improved communication, coordination and cooperation among federal and state regulators in achieving supervisory and regulatory objectives.

The FDIC is moving forward in these areas along the lines indicated with the fundamental objective of minimizing failures and losses while preserving public confidence in the banking system and the vital role it plays in our economy. This is the traditional role of the supervisor and it will continue to be in a deregulated environment although, as indicated, the techniques and approaches must change. We do not believe that we can or should strive for a fail-safe banking system; any such attempt would be intrusive, involve excessive costs, and be doomed to failure. The regulatory system, however, can and must be made more effective and efficient; we believe we are making considerable progress in that direction.

We appreciate this opportunity to expand on the issues addressed in the hearing.

Sincerely,

William M. Isaac
Chairman

cc: Honorable John Tower

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

J. CHARLES PARTEE
MEMBER OF THE BOARD

January 7, 1983

The Honorable Jake Garn
Chairman, Committee on Banking
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Garn:

Thank you for your letter of December 10, 1982, requesting written responses to additional questions from the Committee concerning Penn Square and related issues. The following responses correspond to the questions contained in your letter. I would also like to take this opportunity to thank the Committee for the opportunity to discuss the Federal Reserve's role in the Penn Square episode. If I can be of further assistance to the Committee, please contact me.

1. Certain banks, in fulfilling the credit needs of their particular trade areas, characteristically have loan concentrations to a particular industry. Banks in agricultural areas, for example, often have relatively heavy concentrations in this particular sector as they serve as financial intermediaries in the agricultural community. I believe that limitations on such concentrations could seriously hamper the ability of such banks to service the needs of their communities or particular trade areas.

2. Prior to the recent revision of the call report, the primary source of information regarding delinquent loans at commercial banks was the report of examination. Examiners review the level and trend of delinquent loans during the on-site examination and include summary data regarding the delinquencies in their written report. In addition to reviewing and judging the potential collectibility of delinquent loans, the examiner will make written comment if the trend or level of such loans is adverse. Because on-site examinations are relatively infrequent events, however, it seemed to the supervisors highly desirable to supplement the on-site information with more timely periodic reports.

3. The banking agency members of the Federal Financial Institutions Examination Council determined to make certain information on aggregate past due, nonaccrual, and renegotiated loans available to the public as an aid to individual depositors, investors, and the general public in making decisions concerning their deposits or other business relationships with a particular bank. Public disclosure of this type of information is not entirely a new requirement in the banking industry. Bank holding companies with significant numbers of public investors have been required by the rules of the Securities and Exchange Commission for several years

to make public disclosures on the amounts of their nonperforming loans. In making this information available to the public, the agencies believe that the disclosure requirement will help promote an enhanced marketplace discipline during this period of substantial deregulation.

4. The bank regulatory agency members of the Examination Council are aware of the concern that the public availability of the loan data to be released may be subject to misinterpretation and that the disclosure could conceivably result in problems for some individual banks with particular kinds of lending experience. Against these concerns, the right of uninsured depositors--those with deposits in excess of $100,000--other nondepository creditors and investors to know about any developments that may materially affect the condition of the bank were weighed. As previously indicated, the primary reason to provide this information to the public is to assist in making knowledgeable decisions about deposit and other business relationships with a particular bank.

    The concerns that you mention were carefully reviewed and the Examination Council decided to delay the release of this information to the public until the reporting period of June 30, 1983, to permit time to resolve problems that may arise in the reporting and processing of the data. The Council also decided to maintain the confidentiality of data on the amount of loans that are only moderately past due--that is, past due from 30 to 89 days. This will remove from public attention a large and volatile number that potentially could be subject to misuse and misinterpretation, and at the same time conform the public disclosure standards more closely to the existing SEC required disclosure for bank holding companies.

5. The Board believes that the present statutory restrictions on loans to executive officers, principal shareholders, and directors are adequate. With respect to your question, the Board notes more stringent limits on loans to insiders already exists. Section 22(h) of the Federal Reserve Act requires all loans to executive officers and principal shareholders of insured banks to be aggregated with loans to their related interests for purposes of determining the bank's legal lending limits to these individuals. The Federal Reserve has reviewed the circumstances surrounding the failure of Penn Square Bank, N.A., and continues to believe that the current statutes, regulations, and supervisory tools available to federal bank regulators are sufficient to oversee the safety and soundness of the banking system.

6. From its formation on January 24, 1976, through the initial inspection report at the end of 1979, the holding company, First Penn Corporation, was essentially a shell corporation. The holding company's assets consisted primarily of its investment in the subsidiary bank and receivables relating thereto, while its liabilities were limited to acquisition debt and accrued expenses. Consequently, the holding company was placed on a three-year inspection cycle. During this period, the Federal Reserve Bank of Kansas City monitored the condition of First Penn Corporation by analyzing the holding company's annual report (F.R. Y-6) and examination reports of Penn Square Bank performed by the Comptroller of the Currency.

The initial inspection of First Penn Corporation was conducted as of December 31, 1979, and thereafter the holding company was subject to an annual inspection. A total of four inspections were conducted by the Federal Reserve Bank of Kansas City.

7. All of these reports of inspection by the Federal Reserve Bank indicated that the holding company's condition paralleled that of the subsidiary bank. There was no evidence that any of the activities of the holding company contributed to the difficulties encountered by the Penn Square Bank. As previously stated to the Committee, the inspections of First Penn Corporation showed that practically all of the parent company's assets consisted of its investment in, deposits with, or loans purchased from the Penn Square Bank.

8. Through receipt and review of bank examination reports, the inspection of the holding company, and discussions with the Comptroller's office, the Federal Reserve had been aware of the nature of the problems at the Penn Square Bank and the efforts of the Comptroller's office to address them since the bank was determined to require more than normal supervision in 1980.

In mid-June, the Regional Office of the Comptroller of the Currency informed the Federal Reserve that the problems of the Penn Square Bank, then under examination, had intensified and that the bank's overall condition had rapidly deteriorated. As a result, an inspection of the holding company was immediately commenced. In addition, Federal Reserve examiners initiated a review of the bank's loan portfolio to identify eligible collateral in anticipation of a borrowing request. During this period, daily communications were made with the Comptroller's office.

9. The Federal Reserve continues to believe that the current tripartite bank regulatory system is working reasonably well. The banking agencies have and should continue to make good progress in coordinating their policies, procedures and examinations. The Federal Reserve is of the opinion that consolidating the supervision of a bank holding company and its banks under the jurisdiction of one regulator could have perverse consequences. First, a single regulator would be more inclined to abrupt shifts in supervisory policy. One of the advantages of the present tripartite system is that it contains certain checks and balances that tend to guard against such extreme shifts. Second, the growing incidence of significant nonbanking activities in the holding company structure is better subjected to supervision on a functional industry line basis, especially since such activities are not usually restricted geographically. Finally, there has been considerable concern expressed in recent years about regulators becoming unduly responsive to the industries that they regulate. While one should not assume that a single bank regulator would necessarily be swayed by such pressures, consolidating the supervision of a bank holding company and its banks would tend to increase that risk.

10. For almost half a century, all debt and equity instruments issued by a bank have been exempt from the registration and reporting requirements of the Securities Act of 1933. However, since 1964, banks with 500 or more stockholders have been subject to substantially the same rules of disclosure as are mandated by the SEC for bank holding companies and for corporations, in general. In addition, equity securities and nondeposit deposit debt instruments of all banks are subject to the anti-fraud provisions of the securities laws. In Marine Bank v. Weaver (U.S.S.C. No. 80-1562, decided March 8, 1982), the United States Supreme Court determined that the holder of a certificate of deposit issued by a federally regulated bank is "abundantly protected" under comprehensive federal banking laws and that, therefore, there is no need to subject issuers to anti-fraud liability under the Securities Exchange Act of 1934.

In considering any new regulation, one must weigh the costs as well as the benefits and consider whether there are alternative means to reach the same goal. Viewing the exemptions from securities laws for deposit obligations that have existed over the past 50 years, I would have to conclude that the existing system has worked reasonably well and that elimination or limitation of the exemption at this time would not be cost efficient.

The bank regulatory agencies have recently taken significant steps to increase public availability of information concerning the financial condition of banks. As I previously mentioned, publicly held banks and bank holding companies are already subject to comprehensive disclosure requirements. In addition, since 1973, the reports of income (as well as the balance sheets) of all banks have been publicly available. This past year, under the auspices of the Examination Council, the FDIC has developed and will make available (for a nominal fee) a financial profile on any bank which compares that bank to its peer group. As previously described, increased disclosure will be available beginning in June 1983 with respect to delinquent loans. And late in 1983 the banking agencies expect to have available new reports on a bank by bank basis that will analyze interest rate exposure and set forth selected contingent liabilities not now included or disclosed in the balance sheet. These sources of information will, I believe, be quite helpful to both investors and depositors alike and will provide an effective substitute for any further extension of direct coverage by the securities laws.

Sincerely yours,

J. Charles Partee

J. Charles Partee

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

CA/RJB:kes
December 29, 1982

Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
U.S. Senate
Washington, D.C. 20510

Dear Mr. Chairman:

In response to your letter of December 14, I am pleased to submit the following responses to Committee questions from the hearings on the Penn Square Bank failure.

Question 1. Call Reports for commercial banks have recently been revised to require quarterly reporting of data on past due nonaccrual and renegotiated loans. In addition, beginning with the June report, the Federal supervisory agencies will make these reports available to the public. Does your agency have comparable reporting requirements on past due loans for your institutions and is the information available to the public? If not, why not, and do you contemplate adopting similar requirements in the near future?

Response: Credit unions have been making such public disclosures since 1936. Therefore, the agency plans no changes in the near future. Due to the fundamental difference between credit unions (member owned and operated cooperatives) and the other financial institutions, extensive disclosure of their financial operations have been made publicly available since their inception. On pages 5 and 6 of the NCUA testimony are copies of a standard disclosure form posted monthly in credit union lobbies. Among the many items of disclosure is the information on overdue loans which is found on page 6, item #74 a.-e. As can be noted, aggregate data is disclosed for delinquent loans in the time periods of 0-2 months, 2-6 months, 6-12 months, and 12 months and over. Further the agency requires that aggregate data on overdue loans be reported to the agency on a semi-annual basis.

In reality, the new disclosure by banks would be less than is presently required for credit unions.

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

Question 2. Since credit unions are by statute generally limited to government guaranteed obligations or to deposits in insured institutions, do you believe that their investment in uninsured jumbo CD's should be limited?

Response: No. The inter-institutional activities of credit unions are quite a different matter from member deposits and, in our opinion, such activities should not be governed by consumer derived limits. Loan losses remain the major operating expense for credit unions, and ceilings on deposits in banks would not alter significantly the credit unions' costs of doing business, but might well affect their earnings capability.

Question 3. It does not appear that your disclosure forms distinguish uninsured deposits from insured deposits. Do you believe that such a delineation would be helpful in supervising credit unions compliance with more thorough investment policies?

Response: No. We do not find the term "uninsured deposit" to be very meaningful. A deposit in a good institution is a good investment regardless of the amount of insurance. Insurance should not be the substitute for prudent investment choices. We do, of course, caution against any over-concentration of investments and encourage the adoption of such investment policies.

Question 4. In your opinion, do credit unions or other potential investors have access to sufficient information and financial data to make an informed investment decision?

Response: Yes. In our opinion there exists a good supply of information. Penn Square taught the lesson that all of this available information must be utilized and that investment policies must be constantly reviewed. It might be helpful if existing information could be consolidated by investment advisors or others. As further changes take place in financial markets, information will have to continue to be refined, and such changes will be most useful.

Sincerely,

Wendell A. Sebastian

WENDELL A. SEBASTIAN
Executive Director

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

QUESTIONS AND ANSWERS

QUESTION 1

The Garn-St Germain Act, enacted in October, increased the single borrower limits of National banks to 15% of capital and surplus, plus an additional 10% if the transactions are fully secured. This same limit was also applied to the new commercial lending powers granted to federally chartered S&Ls. While these limits protect against concentrations to a single borrower, there is nothing that protects against loan concentrations in a particular industry. Do you believe there is a need for limitations on industry loan concentrations, in addition to individual borrower limits?

ANSWER 1

Consistent with the Bank Board's support of deregulation of the savings and loan industry, I believe the answer to the question is no. First, supervisory oversight cannot guarantee or replace prudence in loan underwriting. The vast majority of lenders have adopted prudent loan underwriting standards with respect to loans to one borrower, collateral, industry diversification, and borrower qualification. I believe it unwise to selectively substitute the judgment of regulators for the judgment of managers.

Second, while firms within a given industry face similar conditions of price and demand, it does not follow that loan rescheduling by one firm in an industry need imply loan rescheduling by others. The ability to repay a loan depends in large measure on the cumulative decisions of management of a given firm concerning such factors as expansion, capitalization, and diversification. It seems inappropriate to curtail profitable lending opportunities by regulatory fiat without considering firm-specific factors.

Finally, certain lenders may find it profitable to prudently specialize in lending to a small number of industries. This would increase operating efficiency by allowing lending officers to spend less time in assembling credit information. Although I do not necessarily recommend this course of action, I note that some lenders may find it in their interest to concentrate on a small number of industries. Specifically, savings and loan associations initially might concentrate their lending to the construction industry because they know it best. A diversification requirement that would prevent such lending could well be counterproductive.

QUESTION 2

Call Reports for commercial banks have recently been revised to require quarterly reporting of data on past due, nonaccrual and renegotiated loans. In addition, beginning with the June report, the Federal supervisory agencies will make these reports available to the public. Does your agency have comparable reporting requirements on past due loans for your institutions and is the information available to the public? If not, why not, and do you contemplate adopting similar requirements in the near future?

ANSWER 2

The Federal Home Loan Bank Board does not have any reporting requirements for past due loans precisely comparable to the banking agencies' call reports. Instead, our reporting requirements are for "scheduled items". This is considerably more extensive than "call report" requirements and is more closely analagous to "classified" assets, as that term is used by bank regulators in connection with supervisory examinations. That is, "scheduled items" are assets that are reported, not within the simple context of delinquency as with the banking agencies, but after the application of a series of formulas, which incorporate the degree of delinquency and other factors having a direct bearing upon the inherent risk characteristics of each loan and/or asset type.

The "scheduled items" report is considered confidential and not available for public disclosure, just as the banking agencies would not disclose supervisory examination findings with respect to "classified" assets.

Further, as stated previously, our reporting requirements are currently more extensive than the banking agencies' call reports and we do not contemplate reducing these requirements in the near future.

QUESTION 3

Do you believe that supervision and examinations of savings and loans should include an analysis of the interrelationship such institutions have with financial institutions with a 3, 4, or 5 rating?

ANSWER 3

I feel that an analysis of the interrelationship between an association and other financial institutions should be conducted on all supervisory examinations, regardless of such financial institutions' ratings. However, sufficient information concerning financial institutions other than savings and loan associations has not generally been available in the past to enable performing such an analysis. Consequently, in an effort to analyze an association's activities for risk and unsafe or unsound practices, our examination procedures require the obtaining and review of available information in many areas, including:

(1) Loans-to-one-borrower limitations
(2) Liquid and non-liquid investment limitations
(3) Loans made to and/or loan participations with other financial institutions
(4) Depository relationships with other financial institutions
(5) Transactions with affiliated persons and/or other possible conflict of interest situations.

It should be noted that Section 432 of Public Law 97-320, October 15, 1982, amended the Right to Financial Privacy Act of 1978 (U.S.C. 3412) to permit:

"... the exchange of financial records or other information with respect to a financial institution among and between the five member supervisory agencies of the Federal Financial Institution's Examination Council ..."

It is anticipated that this new opportunity, which will be used in conjunction with the aforementioned examination procedures, will greatly improve the Bank Board's capability to analyze the interrelationship between financial institutions.

QUESTION 4

Do you believe that financial institutions should be required to disclose the amount of funds solicited or investments made through the use of money brokers?

ANSWER 4

The Bank Board's current examination procedures require that the association disclose data on broker originated funds in a savings questionnaire during each examination. Examiners are required to review this information and to determine the safety and soundness of an institution's policy regarding the solicitation and use of brokered funds. Any material concerns are required to be included in the report of examination for supervisory review and/or action.

In addition, each association files with the Bank Board semi-annually a "Federal Home Loan Bank Board Management Information System Semiannual Financial Report" which provides for disclosure of the number and aggregate amount of brokered deposits. This report is available to the public for a small fee (with certain data other than brokered deposits excluded).

Beyond these disclosure requirements, we do not believe that additional disclosure requirements are necessary.

13-540 O - 83 - 9

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

March 1, 1983

Dear Senator Garn:

We appreciated having the opportunity to participate in your Committee's hearings on the failure of the Penn Square Bank. We have reviewed the list of questions the Committee has sent us and welcome this further opportunity to provide the Committee with our views.

1. Do you believe there is a need for limitations on industry loan concentrations, in addition to individual borrower limits?

Answer:

No, we do not. A limitation on "industry loan concentrations" would be very difficult to define and to enforce. Furthermore, such a limitation would have an undesirable impact in areas which are predominately agricultural or in towns which are dominated by one company or industry. Although a policy of loan diversification is certainly a sound one, we do not believe it is a prerequisite to sound banking operations. If a bank has a particular expertise in an area and, most importantly, exercises sound credit judgment on each loan made within that area, a resulting "concentration of credit" should not present an unwarranted risk to the bank.

2. As far back as Penn Square's 1977 specialized exam, and in each subsequent exam, a concern was expressed over the heavy concentration of lending to oil and gas concerns and the need for Penn Square to develop a system to prevent such concentration. However, no formal action appears to have been taken to require greater diversification and such a requirement didn't appear to be included in the Formal Agreement of September, 1980. Since these concentrations were of concern to the OCC examiners, why wasn't more emphasis placed on this aspect of Penn Square's operations in the Formal Agreement?

Answer:

The formal Agreement between the OCC and Penn Square addressed the subject of concentrations of credit in general. Thus, specific reference to concentrations of credit in the energy area was not deemed necessary.

With respect to concentrations of credit to individual entities, Article II, paragraph 4, of the Agreement reiterated the restriction on the bank from lending money in excess of the legal lending limitations. And Article VI, paragraph 14, required the bank to review and revise its lending policy to ensure that the policy included guidelines on the "types of loans to be considered for participations" and that the policy identify "the categories of loans, if any, where concentrations of credit will be permitted and the limits thereto." In conjunction with these provisions (and perhaps most importantly), the Agreement stressed the need for detailed and sound credit judgment. When the bank chose to ignore these dictates of the Agreement between examinations, it accumulated the large volume of poor quality loans which led to its demise.

3. Call Reports for commercial banks have recently been revised to require quarterly reporting of data on past due nonaccrual and renegotiated loans. In addition, beginning with the June report, the Federal supervisory agencies will make these reports available to the public. If the reporting of such past due loans is now being added to banks' Reports of Conditions and Income, what were the procedures prior to such changes for gathering data on, and monitoring, delinquent loans?

Answer:

The reporting of past due and nonaccrual loan information is not new for the OCC or for national banks. Actually, the OCC has been collecting similar data from all national banks since 1975. The new requirement applies basically, with some modification, to state member banks (FED) and state non-member banks (FDIC). The collection of information on renegotiated loans and the public disclosure of this data will be new for the OCC and national banks.

The OCC has used, on a quarterly basis, past due loan information from our call reports to monitor changes in the volume of delinquencies of individual banks as well as the national banking system. Generally, banks that reflected significant variances in the amount of delinquencies were identified for further review and possible action, including the initiation of an examination. A form of these figures was also made available publicly, stated as an average bank ratio. The ratios were calculated based on the size and regional location. This information was used in various publications and acted as the only public source for monitoring the trend of delinquent loans.

4. Presuming that these new reporting requirements will be of valuable assistance to the regulators in earlier detection of future "Penn Squares," what is the need to go the extra yard and require public disclosure of such data?

Answer:

We are moving steadily in the direction of a more deregulated environment for the banking industry - an environment in which banks will have greater freedom to make business decisions without government interference and to offer more services in response to public demand. This reduction in government regulation, however, must be replaced by the discipline of the market place. Since the effectiveness of market discipline is dependent upon the adequacy of information available to its participants, we decided to make information on past due loans publicly available and, thus, increase the information base available to the market.

5. Do you share the concern that such public disclosure would be easily misinterpreted by the public, could further damage a troubled institution and would erode public confidence in our financial system?

Answer:

Although it's impossible to predict public reaction to past due loan data with any degree of certainty, I have confidence in the public's ability to deal intelligently with additional information about banks. Moreover, consideration must also be given to the fact that if banks know that information regarding problem loans will become publicly available, they may act to avoid these problems before they occur. Thus, the discipline of the marketplace will act to replace restrictive government regulation. In the less regulated environment that banks are seeking, the loosening of government regulation must be replaced by some other form of discipline because banks cannot take on increased flexibility and powers without also accepting an increased responsibility. We believe that increased public disclosure is an appropriate form of discipline and safeguard for the market.

6. To what extent were loans to insiders and their related interests, both by Penn Square and its correspondent banks (i.e. Continental, Seafirst, etc.) a factor: (a) in the Penn Square failure; and (b) in the purchase of participations which created large losses for the purchasing banks.

Answer:

(a) Losses on loans to Penn Square insiders were substantial and, consequently, a contributing factor to Penn Square's failure. During the final examination of the bank, national bank examiners discovered approximately $49,000,000 in total losses. Of this amount, approximately $9,100,000 (or roughly 19%) were attributable to insiders of the bank. One should note in connection with these figures, however, that since the closing of the bank, the FDIC has identified more losses (this Office stopped reviewing loans once it determined the bank was insolvent) and has identified additional insider affiliations which were not apparent earlier.

(b) As of December 31, 1982, the four major upstream correspondent banks reported loan losses relating to Penn Square of $411,000,000. This figure is broken down as follows:

Continental Illinois	$191,000,000
Seafirst	108,000,000
Chase	75,000,000
Michigan National	37,000,000
	$411,000,000

These totals include loans to Penn Square insiders which these upstream banks not only purchased, but, also, made directly on their own. We are unable, however, at this time to provide more detailed information on these credits.

7. Do you believe there should be special lending limits applicable to insiders that are more stringent than the single borrower limits?

Answer:

Such limits already exist under the provisions of 12 U.S.C. §§375a and 375b. This issue, however, is again under review by the bank supervisory agencies as the result of the recent amendment to 12 U.S.C. §375a in the Garn-St. Germain Depository Institutions Act of 1982. As you know, that Act authorizes the supervisory agencies to set appropriate limits on general purpose loans to executive officers. Since this matter will be the subject for public comment and further discussion and debate within the agencies prior to a final decision, it does not appear appropriate to comment on it at this time.

8. The Board of Directors at Penn Square appear not to have received several communications sent by the Comptroller's Office to them through officers in the bank. Do you think

it would be worthwhile to send these communications directly to the members of the Board rather than through an intermediary whose interests may be at stake?

Answer:

The OCC is not aware that the Board did not receive several communications sent by the Comptroller. Quite the contrary, the OCC is of the firm opinion that the Board of Directors of Penn Square was fully aware of the bank's problems. Not only were there repeated written communications to the Board detailing the bank's problems, the OCC twice brought the full Board to the OCC's Dallas Regional Office for the express purpose of reviewing these problems. In addition, the Committee should note that the directors are under a legal obligation to "diligently and honestly administer the affairs" of the bank. (12 U.S.C. §73) As set forth in numerous cases, directors are expected to retain and exercise general supervision over the affairs of the bank. They cannot discharge their duty by reposing the entire administration to officers selected by them, without supervision or examination. Gibbons v. Anderson, 80 F. 345 (W.D. Mich. Cir. 1897). Failure to exercise reasonable supervision over the conduct of such officers and the affairs of the bank will result in personal liability on the part of the directors for losses which may occur. Bowerman v. Hammer, 250 U.S. 504 (1918).

Consequently, regardless of the communications from the OCC, the Board had a legal and fiduciary duty to monitor the affairs of the bank and to be aware of any problems.

In spite of their clear responsibilities, the directors, in their testimony before the House Banking Committee in Oklahoma City, contended that they were unaware of the problems in the bank. They also stated that they had not read the OCC's Reports of Examination on the bank which detailed those problems. Such claims are disingenuous and self-serving. As noted above, the directors had been personally informed of the problems in meetings with OCC personnel. In addition, all of the directors signed statements stating that they had "personally reviewed the contents of the Reports of Examination dated [February 29, 1980, September 9, 1980, December 31, 1980 and September 30, 1981]." Either these signed statements to our Office or their testimony before the House Committee was false.

In response to the specific question of whether we think it worthwhile to send communications directly to directors of a bank, we should point out that, on occasion, we have done so. But such action is rare since our Reports of Examination and other correspondence contain confidential and sensitive material. In most instances, we can be assured that the directors are informed through meetings with the Board and by requiring the signed statements referred to above indicating that the directors have personally reviewed the Reports of Examination.

9. Do you think that financial regulators should establish automatic penalties for a failure to improve basic practices over a prescribed period?

Answer:

No, we do not. Automatic penalties would significantly hinder the regulators in analyzing situations on a case by case basis. This type of analysis is essential to the equitable and effective supervision of the banking system. While penalties and other forms of administrative action are often necessary and appropriate, one cannot determine in advance either the nature or severity of the administrative action which might be appropriate in any particular case.

One should keep in mind, however, that where an ongoing problem is discovered, we already have the authority to condition corporate and capital approvals on the correction of the problem. In many cases, we also have the authority to assess civil money penalties for the failure to correct the problem. When warranted, we have not hesitated to use these administrative remedies.

10. What disclosure requirements are non-registered banks (like Penn Square) exempt from which in your opinion they should not be?

Answer:

The issue of what disclosures required of registered banks should also be required of non-registered banks comes up periodically. In addition, we frequently face the issue of what new disclosures (such as in the area of administrative actions) should be required of all banks. At this time we are reviewing the disclosure question to determine whether additional information should be disclosed by registered or non-registered banks.

11. As interest rates are deregulated, it would seem that diversification of a loan portfolio not only among borrowers but among industry types will become more important. Do you agree? Do you plan to give increased weight to loan portfolio diversification in your classifications?

Answer:

The OCC has always believed that diversification in a bank's loan portfolio is good. But, as stated in response to the

Committee's first question above, the OCC has rarely sought to impose diversification on a bank. Diversification in many banks is possible only to a limited extent. Obtaining total diversification might well force a bank to extend credit beyond the limits of its trade area, a practice which is seldom desirable.

The specific question of whether we plan to give increased weight to loan portfolio diversification in our classifications must be answered two ways. First, the classification of any loan is more a reflection of its credit quality than of its bearing with other loans in the bank. A single loan to one entity should be judged on its own merits and not upon the merits of loans to a completely different borrower. Second, what does need to be addressed in banks concentrating heavily on one type of lending is the foundation upon which they build their credits. If the bank exercises sufficient credit judgment on the individual loans and possesses sufficient expertise to justify the larger positions, then the regulator's action should be minimal. If, however, the bank is imprudently generating its loans without sufficient credit analysis or review of the industry risks, then some restrictions should be placed upon the bank.

We are responding to Senator Tower's letter under separate cover, but enclose a copy for your information. If we may be of further assistance, please let us know.

Sincerely,

C. T. Conover

C. T. Conover
Comptroller of the Currency

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Enclosure

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

March 1, 1983

Dear Senator Riegle:

I am pleased to provide you with the information you requested pertaining to the number of administrative enforcement actions issued by the Office of the Comptroller of the Currency (OCC) during the period 1980-1982, and the extent to which compliance committees were utilized to monitor compliance with these actions. The OCC issued 434 administrative enforcement actions during the period 1980-1982, 1/ the breakdown of which is as follows:

	1980	1981	1982	Total
Orders to Cease and Desist:	36	21	33	90
Agreements:	54	64	93	211
Memoranda of Understanding:	48	42	43	133
Total:	138	127	169	434

Ninety-eight (98) of the enforcement actions taken during this period required the appointment of a compliance committee (twenty-nine (29) actions in 1980; thirty (30) actions in 1981; and thirty-nine (39) actions in 1982). It should also be noted that although board compliance committees are ordinarily established pursuant to an enforcement action, they have on occasion been established on the bank's own initiative or in response to suggestions from this Office.

The "typical" compliance committee consists of three to five members of the bank's board of directors, the majority of whom are required to be independent, non-officer directors.

Although there is no mandatory language utilized by the OCC to require the establishment of a compliance committee, the following example is a representative provision:

1/ Omitted from this listing are Notices of Charges, Notices of Intention to Remove from Office, Notices of Suspension from Office, and Civil Money Penalties.

Within ten (10) days, a Compliance Committee of the BOARD shall be appointed. This Committee shall consist of at least five (5) directors, a majority of whom shall be non-officer directors of the BANK. The chairman of this Committee shall be a non-officer director of the BANK. The Compliance Committee shall be responsible for monitoring adherence to the provisions of this Agreement.

Within thirty (30) days and every thirty (30) days thereafter, the Committee shall submit to the BOARD a written progress report detailing:

(a) the actions taken to comply with each Article of this Agreement; and

(b) the results of those actions including dates for implementation of any recommended corrective action.

Upon completion of review by the BOARD, copies of the written progress reports, and a statement of any action taken by the BOARD based upon such reports, shall be forwarded to the REGIONAL ADMINISTRATOR.

The BOARD shall forward to the REGIONAL ADMINISTRATOR any reports prepared by outside consultants, or other advisors, to assist in actions that relate to matters addressed by this Agreement.

With respect to Penn Square Bank, N.A., Oklahoma City, Oklahoma, the September 9, 1980 Agreement with the Bank did not require the appointment of a compliance committee. The Agreement required extensive involvement by the full board of directors in correcting the Bank's deficiencies. The Penn Square Agreement required the board to, among other things:

* develop a capital growth program;
* develop a program to remove the grounds of criticism for each criticized asset;
* review, revise, monitor, and enforce the lending policy;
* conduct a management study and develop a management plan;
* review the Allowance for Possible Loan Losses;

* develop a written liquidity, asset, and liability management policy; and

* submit monthly reports to the Regional Administrator on actions taken to correct criticisms in the examination report, on actions taken by the Bank to comply with the Agreement, and on the results of those actions.

We have found success both in requiring the use of a compliance committee or in requiring the full board to monitor compliance. The specific circumstances of each case dictate which method should be followed.

In light of the duties and responsibilities of the board of directors, we believe the ultimate duty of monitoring and ensuring compliance with an administrative enforcement action rests with the board. Absent a demonstrated need to require a special investigation or audit through the use of an independent counsel or auditor, we do not believe it is necessary or appropriate to turn the compliance or monitoring responsibility over to an outside person.

I appreciate your continued interest in this matter, and trust that this information will be suitable to your needs.

Sincerely,

Todd Conover

C.T. Conover
Comptroller of the Currency

The Honorable
Donald W. Riegle, Jr.
Committee on Banking,
Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Comptroller of the Currency
Administrator of National Banks

Washington, D. C. 20219

March 1, 1983

Dear Senator Tower:

Thank you for the statement and giving us the opportunity to respond to various concerns about the Penn Square Bank and the Abilene National Bank.

1. The statement suggests that the OCC spent a relatively long time analyzing the situation at Penn Square before taking administrative action, but only waited a few days before taking administrative action against the Abilene National Bank. The timing of the cases, however, was very similar. The final examination at Penn Square started on April 19, 1982, and the Temporary Order to Cease and Desist was issued against the bank on June 30, 1982, approximately 10 1/2 weeks later. At the Abilene National Bank, the final examination started on May 17, 1982, and the Temporary Order to Cease and Desist was issued against the bank on July 23, 1982, approximately 10 weeks later.

In both cases, national bank examiners spent considerable time and effort in reviewing the condition of the banks and in establishing violations of law and unsafe and unsound practices. Once the necessary evidence as to the condition and practices of the two banks was gathered, and we were satisfied that we had a legally supportable basis, the Office took quick and decisive action.

2. The statement asks why Mr. Poole, the Regional Administrator of National Banks for the Eleventh National Bank Region, made the following public statement ten days before the OCC issued the Temporary Order to Cease and Desist:

> Abilene National Bank is not in receivership and the Office of the Comptroller of the Currency has no plans to place it in receivership.

Mr. Poole made this statement, after consulting with and obtaining the approval of OCC's Washington Office. The OCC had received reports from the bank during the day that local Abilene

TV stations might report on the evening news that the bank was to be closed. This was not true and the bank and the OCC were concerned that such reporting would set off a run on the bank's deposits from which the bank could not recover. The OCC released the statement to avoid the panic that could have occurred. In making the statement, Mr. Poole made it clear he could make no representations as to what might happen to the bank. He indicated, however, that based on the information we had at the time, the OCC had "no plans to place it in receivership." Although there was the possibility that the condition of the bank might worsen, failure was not imminent. In fact, even though the bank's condition subsequently worsened, the rescue package arranged by the OCC and the FDIC averted the OCC's having to place the bank in receivership.

3. In response to the comments about the consistency of bank regulation, we would like to assure you that, during the course of the examination of the Abilene National Bank, we strived to give equal and fair treatment. Although there were many dissimilar features between the situation at the Abilene National Bank and that at Penn Square, we were sensitive to the similarities pertaining to the banks' concentrations of credit in the energy industry. For that reason, we detailed a special team of examiners to assist in the Abilene examination. The team included two senior national bank examiners, one of whom also participated in the Penn Square examination.

With reference to the concern about the OCC's "early warning systems," please be assured that they did not "break down." The computer analysis of the condition of banks has proven to be invaluable in numerous instances. The system, however, cannot, and is not designed to, identify all the potential problems which can arise in the national banking system. With respect to the problems which arose at Penn Square and at the Abilene National Bank, even the placement of examiners in the banks on a full time basis might not have prevented their failures.

Last, our opinion is sought on the role of bank regulators in a more "deregulated world." We believe that the ultimate role of bank regulators in a more deregulated environment is the same as it has always been - to assure a safe and sound banking system. The difference is that deregulation requires regulators to use different tools. To that end, we are seeking better and more detailed information about bank condition, particularly concerning past due loans, interest rate sensitivity, maturity structures, etc. We intend to make more information about individual banks public, so that the market can play an increased role in disciplining those banks that are poorly managed or take unnecessary risks. We will continue to devote significant resources to those portions of the industry that pose the greatest risk to the system.

As we move into a more deregulated environment, the role of bank regulators will be particularly important in smoothing the transition. Regulators will continue to be responsible for the safety and soundness of the banking system as a whole. Individual bank managements will continue to be responsible for managing their banks. The difference will be that the management will be held more publicly accountable for their decisions.

Sincerely,

C. T. Conover

C. T. Conover
Comptroller of the Currency

The Honorable John Tower
United States Senate
Washington, D.C. 20510