



CHAPTER 3

Penn Square Bank, N.A.

Name of Institution:	Penn Square Bank, N.A.
Headquarters Location:	Oklahoma City, Oklahoma
Date of Resolution:	July 5, 1982
Resolution Method:	Deposit Payoff/Deposit Insurance National Bank

Introduction

The failure of Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma, still ranks as one of the Federal Deposit Insurance Corporation's (FDIC's) most publicized, most difficult, and most colorful bank resolutions. Penn Square failed July 5, 1982, with \$470.4 million in deposits and \$516.8 million in assets. By aggressively making large and speculative loans, especially to the oil and gas industries, the bank had grown from \$62 million in assets in 1977 to \$520 million in assets by mid-1982.¹ Penn Square then sold majority interests in those loans to other banks (in the form of loan participations), but retained the responsibility for servicing the entire loan amount.² At its failure, Penn Square was servicing approximately \$2 billion in loans.

Of the \$470.4 million in deposits, only about \$207.5 million were insured. The bulk of uninsured deposits were funds of other banks. After extensive discussions with the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Bank (Federal Reserve), the FDIC made the decision to pay off the insured deposits of Penn Square. A payoff was deemed to be necessary to resolve the failing institution at the least cost to the deposit insurance fund. As a result, Penn Square became the largest bank failure in the FDIC's history in which uninsured depositors suffered losses.

1. Irvine H. Sprague, *Bailout* (New York: Basic Books, 1986), 112.

2. "A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead bank originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead bank (originating bank) normally retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Properly structured, loan participations allow selling banks to accommodate large loan requests which would otherwise exceed lending limits, diversify risk, and improve liquidity or obtain additional lendable funds." FDIC, Division of Supervision, *Manual of Examination Policies* (1995), 27.

Background

Penn Square, formed in 1960, operated as a small, one-office retail bank with a separate drive-up facility in an Oklahoma City shopping mall. In 1975, Bill Jennings, a former president of Penn Square, created a holding company to purchase the bank with \$2.5 million borrowed from another Oklahoma City bank and little equity. The following year, Penn Square formed a loan department for oil and gas loans. From the beginning, the bank failed to document loans properly. In addition, it based repayment on collateral value rather than on the ability of the borrower to repay, and collateral documentation deficiencies were common.

Moreover, although the OCC set lending limits on the amount of credit that could be extended to any one customer, when one of Penn Square's oil and gas customers wanted to borrow more than that limit, Penn Square would make the loan and sell a participation to another bank. In 1978, Penn Square began selling oil and gas participations to Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois. In 1979, when the Shah of Iran was forced out of his country and fears of oil shortages created panic buying and a surge in oil and gasoline prices, Penn Square began selling participations in oil and gas loans to other large banks in the country, primarily Seattle First National Bank (Seafirst), Seattle, Washington; Northern Trust Company (Northern), Chicago, Illinois; Chase Manhattan Bank (Chase), New York, New York; and Michigan National Bank (Michigan National), Lansing, Michigan.

As early as May 1977, the OCC examination of Penn Square noted concentrations of credit to oil and gas companies.³ Subsequent OCC examinations in April 1980 and March 1981 found low capital, excessive low-quality loans, inadequate liquidity, inexperienced staff, increasing problem loans, and management problems. Penn Square officials signed an OCC agreement in June 1980 pledging improved lending practices and the maintenance of 7.5 percent capital, but no changes in lending practices were noticeable. Penn Square's external auditors became concerned with the level of loan reserves and gave the bank qualified opinions in December 1977 and March 1981.^{4,5}

In 1981, the Southwest saw a huge increase in commercial loans, particularly in the oil and agricultural industries. In April 1981, oil prices peaked at \$36.95 a barrel and then began to fall. Recessions in oil-consuming nations, conservation efforts, and the

3. "Generally a concentration is a significantly large volume of economically related assets that an institution has advanced or committed to one person, entity or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution." FDIC, Division of Supervision, *Manual of Examination Policies* (1995), 46.

4. On December 19, 1977, Arthur Young and Company wrote: "Due to the lack of evidential data relating to certain real estate and commercial loans, we were unable to satisfy ourselves as to the adequacy of the reserve for loan losses." See Phillip L. Zweig, *Belly Up* (New York: Crown, 1985), 61.

5. On March 13, 1981, Arthur Young and Company wrote, "We were unable to satisfy ourselves as to the adequacy of the reserve for possible loan losses at December 31 [1980] due to the lack of supporting documentation of collateral on loans." Zweig, *Belly Up*, 174.

sale of oil by some Organization of Petroleum Exporting Countries (OPEC) members in excess of their quotas all combined to reduce oil prices in world markets.⁶ The demand for oil rigs reached its peak in the Southwest.⁷ As oil prices continued to decline during 1982, profits for the oil industry in the Southwest slowed.

The Federal Reserve maintained tight monetary policies, and interest rates remained high; therefore, Penn Square paid higher interest rates on deposits, particularly on large certificates of deposit (CDs).

In early 1982, in response to the decline in oil prices, Penn Square's participant banks began pressing Penn Square to clean up the loan participations. Penn Square had sold loan participations to 53 different participant banks; Continental alone held \$1 billion of those participations. Although Chase, Seafirst, and Northern stopped buying participations, Penn Square's new external audit firm presented the bank with a clean audit opinion in March 1982.⁸ Interest rates remained high; the Federal Reserve discount rate was 12 percent in January 1982.

In May 1982, rumors of problems at Penn Square began circulating, which caused a deposit runoff that forced the bank to rely increasingly on brokered funds.⁹ Brokered funds at the bank, which in January had been about \$20 million, reached \$150 million by May 1982.

As a result of its April 1982 examination, the OCC requested Penn Square to raise capital by \$7 million. The OCC also demanded that Penn Square charge off \$10 million in loans. By June 28, 1982, it was apparent that Penn Square would fail. All that was left to decide was how to handle the failure.

The Resolution

On July 1, 1982, at a joint meeting in Dallas, the OCC and the Federal Reserve argued that Penn Square should be sold through a purchase and assumption (P&A) transaction or given open bank assistance (OBA), while the FDIC argued for a payoff. The FDIC, the Federal Reserve, and the OCC then began meeting in Washington to discuss resolution possibilities.

Neither the Federal Reserve nor the OCC wanted to see Penn Square paid off. In the two decades before the 1980s, most failing banks were resolved through P&As that

6. Jack L. Hervey, "The 1973 Oil Crisis: One Generation and Counting," *Chicago Fed Letter*, no. 86 (October 1994), 1.

7. Energy Information Administration, *Annual Energy Review 1988*; Gerald H. Anderson, "The Decline in U.S. Agricultural Exports," *Economic Commentary* (Feb. 15, 1987), 1.

8. Zweig, *Belly Up*, 304.

9. Brokered deposits are large deposits placed by deposit brokers on behalf of their customers. Because of their size, brokered deposits typically earn higher interest rates, from which the broker deducts a fee before passing the interest to the customers.

Table II.3-1**The Last Twelve Bank Payoffs Before Penn Square**

(\$ in Thousands)

Bank Name and Location	Total Deposits	Date
Watkins Banking Company, Faunsdale, Alabama	\$1,660	07/24/78
Village Bank, Pueblo West, Colorado	5,059	01/26/79
Bank of Enville, Enville, Tennessee	3,468	06/16/79
The Farmers State Bank, Protection, Kansas	5,038	09/21/79
Bank of Lake Helen, Lake Helen, Florida	4,229	01/11/80
First National Bank of Carrington, Carrington, North Dakota	11,461	02/12/80
The Citizens State Bank, Viola, Kansas	1,872	06/04/80
The Des Plaines Bank, Des Plaines, Illinois	46,269	03/14/81
Southwestern Bank, Tucson, Arizona	4,749	09/25/81
The Bank of Woodson, Woodson, Texas	3,168	03/01/82
Carroll County Bank, Huntingdon, Tennessee	8,236	04/30/82
Citizens Bank, Tillar, Arkansas	6,723	06/23/82

Source: FDIC, *Historical Statistics on Banking: A Statistical History of the United States Banking Industry, 1934–1992* (Washington, D.C.: Federal Deposit Insurance Corporation, 1993), 615–618.

passed all deposits to the acquiring institution. Past experience suggested that depositors with uninsured funds and others (for example, general creditors) with uninsured liabilities were reasonably certain of being paid. From 1980 until Penn Square failed on July 5, 1982, the FDIC had paid off (protected only insured deposits) only 8 of 38 failed banks. (See table II.3-1.)

Before Penn Square's failure, the FDIC had taken action on several large institutions by fully protecting all depositors in P&A transactions or by providing OBA to keep the institutions open. For example, the FDIC protected all depositors, including the uninsured, when the Franklin National Bank, New York, New York, was declared insolvent by the OCC and closed on October 8, 1974. With \$1.4 billion in assets, Franklin National Bank was the largest bank failure in American history at that time. On April 28, 1980, the FDIC, the Federal Reserve, and the OCC jointly announced a \$500 million OBA package to assure the viability and continued strength of the \$8 billion First Pennsylvania Bank, N.A. (First Penn), in Philadelphia.¹⁰ From November 1981 through October 1982, FDIC provided assistance to accomplish the mergers (and prevent the failures) of 11 mutual savings banks that had total assets of \$14.7 billion and

total deposits of \$12.1 billion. The largest of those banks was the New York Bank for Savings, New York City; it had total assets of \$3.4 billion and total deposits of \$2.8 billion.¹¹

Some government officials were concerned that a payoff of only the insured deposits at Penn Square would have serious adverse effects on the stability of the banking system. Penn Square had about \$470.4 million in deposits, of which only about \$207.5 million were insured in 24,538 accounts. Among the depositors were 29 commercial banks, 44 savings and loan associations, and 221 credit unions.¹²

During the interagency meetings, the Federal Reserve, the OCC, and the FDIC discussed the various resolution alternatives. Although they discussed OBA, the FDIC would have had to determine Penn Square “essential” to its community; but with 36 other banks in Oklahoma City, the FDIC could not make that determination.¹³

Arranging a P&A transaction for the failed bank would have been difficult under any circumstance because Oklahoma laws did not permit bank branching, and few companies would have been able to bid on the institution. In the case of Penn Square, a closed bank P&A transaction might have resulted in the FDIC’s assumption of a large volume of contingent liabilities; the total amount was unknown but was believed to exceed the \$2.1 billion in loan participations sold. Because of the heavy volume of participations and questions about the accuracy of information furnished to loan purchasers, the FDIC anticipated a substantial volume of lawsuits. If the suits were successful, the cost to the FDIC of a P&A transaction ultimately would have been substantially higher than the cost of a payoff.

The FDIC’s concerns over contingent liabilities were based on what is known as “the First Empire decision.”¹⁴ When the United States National Bank, San Diego, California, failed in 1973, the FDIC had attempted to structure a P&A transaction so that certain contingent liabilities involving standby letters of credit, which had been issued to guarantee obligations of companies related to the bank’s controlling stockholder, would not be assumed by either the FDIC in its corporate capacity or by the assuming bank. Instead, the FDIC left those contingent claims in the receivership. The practical effect was that the depositors and general creditors were paid in full through the P&A transaction, and the contingent claimants were left with less than full recovery. First Empire Bank, New York, New York, the beneficiary of the standby letters of credit, sued the FDIC over that issue and won. The Ninth Circuit Court held that arranging for the

10. For further information, see Chapter 2, First Pennsylvania Bank, N.A.

11. FDIC, *Historical Statistics on Banking: A Statistical History of the United States Banking Industry, 1934-1992* (Washington, D.C.: Federal Deposit Insurance Corporation, 1993), 619.

12. Sprague, *Bailout*, 133.

13. In section 13(c) of the Federal Deposit Insurance Act (FDI Act) of 1950, Congress granted the FDIC authority to provide assistance to an open bank, “when in the opinion of the Board of Directors the continued operation of such bank is essential to provide adequate banking service in the community.” FDIC, *Federal Deposit Insurance Corporation: The First Fifty Years* (Washington, D.C.: Federal Deposit Insurance Corporation, 1984), 94.

14. *First Empire Bank v. FDIC*, 572 F. 2d 1361 (9th Cir. 1978), cert. denied, 439 U.S. 919 (1978).

payment of the depositors and general creditors without arranging for payment of the standby letters of credit violated *U.S. Code* 12, section 194, which the court held to require “ratable” distributions from a national bank receivership. The court also held that the FDIC could not structure a P&A transaction that preferred one group of similarly situated creditors to another.¹⁵ Therefore, in the resolution of Penn Square, the FDIC could not have arranged a P&A transaction taking into account payment of the approximately \$2.1 billion in Penn Square’s contingent liabilities.

The only alternative left for the FDIC was to pay off insured deposits.¹⁶ The FDIC decided to use a power given to it by the Banking Act of 1933 and established a Deposit Insurance National Bank (DINB) to pay off the insured depositors. Establishment of a DINB was a seldom-used method for handling failed banks.¹⁷ It had been used on only four other occasions in the preceding 20 years, and the two most recent occasions had been in 1975.¹⁸ A DINB, operating much like an open bank, effectively allowed the FDIC to separate the volume of insured deposits from the uninsured deposits. Customers with insured deposits were treated like customers of a normal bank; they could continue writing checks and leave their savings accounts and CDs in the bank. In addition, they did not have to stand in line to get their deposits (although many at Penn Square did), which was different from a straight deposit payoff, in which every customer had to come to the bank to get an insurance check equal to his or her insured deposit amount.

Penn Square was so much larger than any bank paid off by the FDIC in its history that it would have been difficult to pay it off in the normal manner. The volume of customers with claims for uninsured deposits also was unusually large. Normally, uninsured deposits represent a small percentage of the deposits (less than 5 percent); but Penn Square was a different story, with more than half of the bank’s \$470.4 million in deposits exceeding the insurance limit of \$100,000 per depositor.

By paying off insured depositors, the FDIC’s maximum exposure was the total amount of those insured deposits. Before closing, the amount was estimated to be \$250 million; the actual amount later was determined to be \$207.5 million. Payments to litigants, if they were successful, were the responsibility of the receiver. Had the FDIC used a P&A to resolve Penn Square, it would have had to agree to protect any acquiring bank from unbooked and contingent liabilities. To the extent that those liabilities were established in court, the FDIC would have had to pay full value on those claims.

15. Robert E. Norton, “What Uninsured Depositors Can Expect,” *American Banker* (July 12, 1982), 15.

16. Sprague, *Bailout*, 116–117.

17. A DINB was a new national bank chartered without any capitalization and with limited life and powers. A DINB essentially provided a vehicle for a slow and orderly payoff. DINBs were authorized by the Banking Act of 1933 and were the only procedures authorized for payoffs through August 23, 1935. FDIC, *The First Fifty Years*, 81.

18. DINBs were used for the failed Swope Parkway National Bank, Kansas City, Missouri, and The Peoples Bank of the Virgin Islands, Charlotte Amalie, St. Thomas, Virgin Islands, which failed on January 3, 1975, and October 24, 1975, respectively.

Because Penn Square was resolved through a payoff, the claims established from lawsuits had status in the receivership equal to other general creditors, including the FDIC.

On July 5, 1982 (a holiday), shortly after 8 p.m., the OCC determined that Penn Square was insolvent, closed the bank, and named the FDIC as receiver. Because it was the largest payoff in history, the failure quickly attracted national attention.

The Closing

Planning for the closing of Penn Square and its reopening as a DINB was difficult. Before the closing, the OCC had given little information to the FDIC. Moreover, FDIC personnel were not experienced in dealing with such a large and complex institution and, therefore, had difficulties in determining which accounts were uninsured. The decision to immediately reopen the institution as a DINB before closing out the failed institution's books further compounded the situation.

The new bank, named the Deposit Insurance National Bank of Oklahoma City, opened for business on July 6, 1982.

The FDIC announced that all of Penn Square's assets were being transferred to the receiver and all insured deposits had been transferred to the DINB. Funds deposited in interest-bearing accounts would continue to earn interest at the same rate that the failed bank had been paying. FDIC Chairman William M. Isaac was quoted as saying: "We'll keep the bank open 24 hours a day if necessary to meet the demand. We'll be in the bank all night long if we have to."¹⁹

The process for paying the depositors of Penn Square presented a multitude of problems. The bank's deposit and loan records were neither accurate nor complete, making it difficult for the FDIC to readily make insurance determinations. The FDIC had little more than 72 hours (Saturday, Sunday, and Monday) to review 24,538 deposit accounts, totaling \$470.4 million, for preliminary insurance determinations. The closing team worked around the clock over that weekend to determine deposit insurance coverage and prepare for the opening of the DINB. Even with that extraordinary effort, FDIC personnel could not fully prepare to deal with the sheer number of depositors or to thoroughly discuss what would happen to a depositor with uninsured deposits.

On the morning of July 6th, long lines of depositors waited in the hot Oklahoma sun to get their money. Reflecting on the long lines of Penn Square customers, FDIC attorney Donald McKinley said, "I'll never forget . . . [they were] lined up as far as you could see in a hot July sun out in the parking lot of this little . . . shopping center . . . lined up all the way out in the parking lot forever, waiting to get their deposits, not withstanding all the advertising from the FDIC that through the DINB, you could draw your checks. . . ."²⁰

19. Zweig, *Belly Up*, 410.

20. Donald McKinney, FDIC attorney, interview, 1995.

An Associated Press report described the scene: “Hundreds of depositors seeking their money crowded the former Penn Square Bank on Tuesday as the federal government began liquidating the 21st bank to fail in the United States this year. . . . Many of the bank’s customers paid little heed to Isaac’s assurances that depositors with accounts of less than \$100,000 will get their money back through FDIC insurance. Nearly 100 people stood outside the bank’s doors at noon, waiting to enter the lobby jammed with depositors. A continuous line of cars wound through the drive-in lanes. Bank workers handed out glasses of iced water to those waiting outdoors in the 90-degree heat.”²¹

The FDIC operated the DINB much like a full-service bank. Interest rates remained unchanged on deposit accounts for 90 days, automatic teller machines were available as before, the DINB provided a check cashing service for checks up to \$1,000, and safe deposit boxes were available. The FDIC transferred trust operations to another bank. It also advised loan customers to continue paying loans according to terms, although the DINB had no loan authority because its sole function was to pay off the insured depositors.^{22,23}

Customers with uninsured deposits received receivership certificates representing their claims against the Penn Square Bank receivership. The FDIC gave claims for uninsured deposits general creditor status, which meant that they shared in liquidating dividends with the FDIC and other general creditors from the collection of the bank’s assets by the receiver.²⁴

The Federal Reserve announced that the depository institutions that held receivership certificates could borrow against the certificates at the Federal Reserve’s discount window; the interest rate for such borrowings was 12 percent. The FDIC suggested that the certificates should be valued at about 80 percent of face value. The Federal Reserve agreed to lend up to 90 percent of that discounted amount.²⁵ The U.S. Small Business Administration (SBA) also announced that it would accept FDIC-issued receivership certificates as collateral for loans to businesses hurt in the Penn Square failure.²⁶

Another problem, although short lived, was that some of the local financial institutions would not accept the DINB insurance checks or wanted to put holds on them. That situation caused a near panic, as customers who thought they were being paid returned to the bank complaining that they could neither cash nor deposit their checks. By Wednesday that situation was resolved when the local institutions agreed to accept the DINB insurance checks.

21. Debby Shannon, “Liquidators Reopen Penn Square Bank,” Associated Press (July 6, 1982).

22. Sprague, *Bailout*, 123.

23. Sprague, *Bailout*, 121.

24. The National Depositor Preference Amendment of the Omnibus Budget Reconciliation Act of 1993 has changed the order of priority for receivership dividends. Depositors are now paid before any other class of creditors.

25. Norton, “What Uninsured Depositors Can Expect,” 15.

26. Gordon Matthews, “Court Stalls Chase’s Penn Square Suit,” *American Banker* (July 21, 1982), 3.

Table II.3-2

**Penn Square Bank, N.A.
Receivership Inception Balances**

Asset Type	Balance
Cash and Due From	\$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
Total	\$511,299,892

Note: Does not include loan participations.

Source: FDIC News Release, "FDIC Reports on Receiverships of Penn Square, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City," PR-90-82 (October 25, 1982).

Penn Square's \$2.1 billion in loan participations complicated the offset process. Initially, the FDIC determined that when a deposit was offset against a loan, the participant's share of the offset would be paid in cash. Subsequently, the FDIC determined that the transaction was a noncash transaction and that the participant's share should be paid with a receiver's certificate.²⁷

Lawyers for the banks that had bought loan participations from Penn Square sued the FDIC in an attempt to get money without waiting for the liquidation of the loans. A federal judge in Oklahoma City turned down a request by Chase to stop the FDIC from using compensating balances left at the failed bank to offset

27. Loan participants usually receive their pro rata share of any payments made by a debtor that augments the receivership estate. The same holds true if the receiver forecloses on and liquidates the underlying collateral. Loan participations may suffer a loss greater than they would otherwise incur, however, if the debtors or receivers exercise their right of offset. Because the offset does not "augment the receivership estate," there are no proceeds to be passed on to the loan participants. The loan participants are therefore left with general unsecured claims against the receivership estate for the amounts they have lost as a result of the offset. The general unsecured claims are likely to be worth far less than the 100 cents on the dollar that direct proceeds or cash is worth.

Table II.3-3

Penn Square Bank, N.A.
Principal and Interest Collections on Loans, Securities, and Other Assets
(\$ in Millions)

Period Ending	Total Collections
09/30/82	\$175.1
05/01/83	412.2
10/09/84	602.4
12/20/85	660.7

Sources: FDIC news releases—"FDIC Reports on Receiverships of Penn Square, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City," PR-90-82 (October 25, 1982); "FDIC Estimates 65 Percent Recovery for Holders of Penn Square Bank, N.A., Receiver's Certificates," PR-49-83 (June 17, 1983); "FDIC Reports on Receiverships of Penn Square, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City, Oklahoma," PR-8-84 (February 7, 1984); "FDIC Provides Status Report on Receivership of Penn Square Bank, N.A., Oklahoma City, Oklahoma," PR-133-84 (October 29, 1984); "FDIC Reports on Receivership of Penn Square, N.A., Oklahoma City, Oklahoma," PR-4-86 (January 13, 1986).

bank liabilities.²⁸ In the suit, Chase disclosed that it had \$212.2 million of loan participations with Penn Square. The Chase suit followed an action initiated by Hibernia National Bank, New Orleans, Louisiana, which had purchased \$24 million in 81 loans from Penn Square.²⁹

At the closing, the FDIC as receiver acquired \$511.3 million in Penn Square assets; the figure was later adjusted to \$516.8 million. Table II.3-2 shows the assets in the original inventory by asset type.

By September 30, 1982, insured deposits in the DINB had been reduced from the beginning balance of \$207.5 million in 24,538 accounts to \$10.5 million in 3,527 accounts. The \$10.5 million consisted of \$6.6 million in demand deposits and \$3.9 million in time deposits.³⁰ According to a December 20, 1985, news release, the FDIC had collected \$660.7 million (including amounts due participants) on Penn Square's assets and, of that amount, paid \$576.9 million dollars on liabilities of the receivership. (See tables II.3-3 and II.3-4.)

28. Compensating balances are average balances required by a bank for holding credit available. The more or less standard requirement for a bank line of credit, for example, is 10 percent of the line plus an additional 10 percent of the borrowings. Compensating balances increase the effective rate of interest on borrowings. John Downes and Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms* (Hauppauge, NY: Barron's Educational Series, 1995), 101.

29. Matthews, "Court Stalls Chase's Penn Square Suit," 3.

30. FDIC News Release, "FDIC Reports on Receivership of Penn Square Bank, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City," PR-90-82 (October 25, 1982).

Table II.3-4**Penn Square Bank, N.A.****Payments Made from Principal and Interest Collections**

(\$ in Millions)

Payments Made to:	9/30/82	3/11/83	5/1/83	8/16/84	10/9/84	12/20/85	Totals
Loan Participants	\$74.1	\$0	\$136.6	\$0	\$73.6	\$17.5	\$301.8
Federal Reserve	5.7	0	0	0	0	0	5.7
Pledged Deposits	13.0	0	3.9	0	0	0	16.9
Receivership Claimants	0	88.2	0	64.9	0.5	98.9	252.5

Sources: FDIC news releases—"FDIC Reports on Receiverships of Penn Square, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City," PR-90-82 (October 25, 1982); "FDIC Estimates 65 Percent Recovery for Holders of Penn Square Bank, N.A., Receiver's Certificates," PR-49-83 (June 17, 1983); "FDIC Reports on Receiverships of Penn Square, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City, Oklahoma," PR-8-84 (February 7, 1984); "FDIC Provides Status Report on Receivership of Penn Square Bank, N.A., Oklahoma City, Oklahoma," PR-133-84 (October 29, 1984); "FDIC Reports on Receivership of Penn Square, N.A., Oklahoma City, Oklahoma," PR-4-86 (January 13, 1986).

On March 11, 1983, the FDIC obtained court approval to begin paying the first liquidation dividend, which amounted to approximately \$88.2 million, or nearly 20 percent of proven claims.³¹ When the FDIC first announced its intention to pay a liquidating dividend on proven claims, others with claims pending in court against the receiver objected because the receiver had made no provision for the payment of their claims. As a consequence, and to protect anyone whose claim was later approved, the FDIC agreed to establish a reserve for the pending claims; the amount of the reserve was set at 85 percent of total pending claims. The court then allowed the FDIC to pay a first liquidating dividend for proven claims.³² On August 16, 1984, the FDIC paid a second liquidating dividend of 15 percent of proven claims, or about \$64.9 million.³³

On December 19, 1985, the FDIC paid a liquidating dividend of 20 percent to holders of proven claims, which brought total dividends paid to 55 percent of proven claims.³⁴ (See table II.3-5 for receivership certificate information as of that date.)

31. FDIC News Release, "FDIC Estimates 65 Percent Recovery for Holders of Penn Square Bank, N.A., Receiver's Certificates," PR-49-83 (June 17, 1983).

32. FDIC News Release, "FDIC Estimates 65 Percent Recovery for Holders of Penn Square Bank, N.A., Receiver's Certificates," PR-8-84 (February 7, 1984).

33. FDIC News Release, "FDIC Provides Status Report on Receivership of Penn Square Bank, N.A., Oklahoma City, Oklahoma," PR-133-84 (October 29, 1984).

34. FDIC News Release, "FDIC Reports on Receivership of Penn Square Bank, N.A., of Oklahoma City, Oklahoma," PR-4-86 (January 13, 1986).

Table II.3-5

**Penn Square Bank, N.A.
Receivership Certificate Information**
(*\$ in Millions*)

	As of December 20, 1985
Number of Receivership Certificates Issued	2,620
Dollar Amount of Certificates	\$459.1
Dividends Paid	\$252.5
Dividends Paid—Percentage	55%

Source: FDIC News Release, "FDIC Reports on Receivership of Penn Square, N.A., Oklahoma City, Oklahoma," PR-4-86 (January 13, 1986).

The DINB closed after slightly more than 13 months, when on August 18, 1983, the FDIC signed an agreement with Charter National Bank, N.A. (Charter National), a newly chartered bank, under which Charter National purchased the remaining \$458.4 thousand in deposits from the DINB.³⁵

The Penn Square Bank receivership was terminated on July 1, 1996. Total dividends paid were \$341.6 million.³⁶ The total cost to the FDIC for the resolution was \$65 million, or 12.6 percent of total failed bank assets.³⁷

FDIC Resolution Costs

The FDIC funded all insured deposits of \$207.5 million for the Penn Square payoff, plus \$16.9 million in pledged deposits, and placed them in the DINB. It also assumed \$5.7 million in debt to the Federal Reserve. All assets of Penn Square, totaling (after adjustments) \$526.8 million (net of participations), were retained in the receivership, and the receivership was responsible for servicing the participated loans. The FDIC operated the DINB until August 18, 1983, when it sold the remaining deposits.

The FDIC's total financial commitment and resolution costs are shown in table II.3-6.

35. FDIC News Release, "Status Report on Receivership of Penn Square," PR-133-84 (October 29, 1984).

36. FDIC Division of Finance.

37. FDIC Division of Research and Statistics.

Table II.3-6**Penn Square Bank, N.A., Resolution Costs
as of December 31, 1995***(\$ in Millions)*

FDIC's Expenses	
FDIC funding of insured deposits	\$207
FDIC assumption of pledge deposit liability	17
FDIC assumption of Federal Reserve debt	6
FDIC's Total Financial Commitment	\$230
FDIC's Recoveries	
FDIC's Recoveries on Assets	\$165
FDIC's Total Resolution Cost	\$65

Source: FDIC Division of Finance and FDIC Division of Research and Statistics.

Lessons Learned

Penn Square grew by paying higher-than-market rates for brokered deposits. FDIC Chairman Isaac, in an address before the uninsured depositors of Penn Square, explained the reasons for the FDIC's decision to pay off the insured deposits of the failed bank.³⁸

The Penn Square debacle was caused by a gross dereliction of duty on the part of the bank's board of directors and management. They were able to perpetrate their abusive practices by obtaining funds—normally through money brokers from banks, credit unions and S&Ls around the nation. These financial institutions, which held 80 percent of the uninsured funds at Penn Square, were motivated solely by a desire to make a fast buck.

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

38. FDIC News Release, "Some Straight Talk About Penn Square" (FDIC Chairman William M. Isaac, in an address before the uninsured depositors of Penn Square on October 30, 1984, in Oklahoma City), PR-134-84 (October 30, 1984).

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

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

If the FDIC had effected a P&A transaction in the Penn Square resolution, it would have strengthened the signal given by the First Penn transaction and the mutual savings bank resolutions that all deposits, at least in banks above a certain size, were, for all practical purposes, fully insured. Penn Square would have been another indicator leading to an erosion of discipline in the markets. After the payoff at Penn Square, uninsured depositors certainly became more sensitive to the possibility of loss. Some banks had difficulty rolling over large CDs. The business of brokers, who divide up large deposits and place them with several banks, was significantly boosted. Depositors generally became more selective in their choice of banks, and the public's concern about the condition of banks was increased.³⁹

Noting the strain that a payoff of insured deposits had on customers with uninsured deposits, the FDIC sought court approval to pay advance dividends.⁴⁰ Many of the customers holding receivership certificates were credit unions and savings and loan associations. Paying advance dividends would ease the strain on the individual institutions and promote the stability of those institutions. By paying advance dividends on claims of customers with uninsured deposits and general trade creditors, the FDIC believed that it would recover more money from the Penn Square receivership than it paid to insured depositors, plus the amount it spent in the liquidation process. Less than a year after closing, the FDIC paid holders of proven claims a portion of their claims, with the amount paid based on the FDIC's collections to date and a conservative estimate of future liquidation recoveries. The FDIC designed advance dividends to ease the pain of

39. FDIC, *The First Fifty Years*, 98.

40. FDIC News Release, "FDIC Estimates 65 Percent Recovery for Holders of Penn Square Bank, N.A., Receiver's Certificates," PR-49-83 (June 17, 1983).

claimants who otherwise might have had to wait substantial periods of time to receive any money above insured deposit amounts.

In many institutions during the banking crisis of the 1980s and early 1990s, brokered deposits became a problem. When institutions faced liquidity shortages, they frequently turned to brokers for large sums of cash in a hurry. The FDIC believes deposit brokering became a problem following the enactment of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980. That statute provided for eliminating restrictions on interest rates paid on deposits. That same year, Congress raised the deposit insurance limit to \$100,000. As a result of those changes, depository institutions began to compete for large amounts of deposits through the offering of high interest rates, and many depositors found the highest rates through the services of deposit brokers.

Penn Square's collapse was the largest deposit payoff in FDIC history at that time. Many investors were caught by surprise, and they began seeking full FDIC insurance on their deposits. The failure of Penn Square highlighted the problems resulting from the use of brokered funds; brokered deposits enabled the bank to grow very rapidly and to continue in operation beyond the time when normal market forces otherwise would have prevented it from getting more deposits.

Following the Penn Square failure, the FDIC and the Federal Home Loan Bank Board (FHLBB) studied the problem of brokered deposits. The two agencies sought public comment on the problem through a notice published in the *Federal Register* on November 1, 1983. The two agencies expressed their concern that the practice of deposit brokering "enable[d] virtually all institutions to attract large volumes of funds from outside their normal market area irrespective of the institutions' managerial and financial characteristics."⁴¹

The FDIC and the FHLBB jointly published a final regulatory rule on April 2, 1984. As incorporated into the FDIC's insurance regulations, the rule was effective on October 1, 1984. The rule states the following:

[F]unds deposited into one or more deposit accounts by or through a deposit broker shall be added to any other deposits placed by or through that deposit broker and insured up to \$100,000 in the aggregate.⁴²

That rule, found at 12 C.F.R. 330.13(b) (1985), eliminated "pass-through" insurance for brokered deposits, which essentially treated the broker as the depositor (subject to the \$100,000 insurance limit). Deposit insurance no longer "passed through" the broker to the broker's clients (the actual owners of the funds).

The rule was challenged in court. In 1985, in the case of *FAIC Securities, Inc. v. United States*, the U.S. Court of Appeals for the District of Columbia Circuit ruled that

41. 48 *Federal Register* 50,339 (November 1, 1983).

42. 49 *Federal Register* 13,003 (April 2, 1984).

the regulatory rule adopted by the FDIC and the FHLBB was invalid because it was contrary to the statutory insurance limit of \$100,000 per depositor.⁴³

The court ruling essentially ended the restriction on brokered deposits. In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), which limited some use of brokered deposits simply by prohibiting troubled institutions from accepting brokered deposits. In 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA), which amended the 1989 statute by prohibiting troubled institutions (that is, institutions that did not meet applicable minimum capital requirements) from accepting funds obtained directly or indirectly by or through any deposit broker. Those institutions were similarly prohibited from offering a rate of interest significantly higher than other area banks.

Effect on Future Resolutions

Seafirst, the largest bank in the Northwest, was the first big casualty precipitated by Penn Square. Losses from Penn Square forced the merger of Seafirst's holding company, Seafirst Corporation, with BankAmerica Corporation (BAC). At the time of the merger, Seafirst had \$9.6 billion in assets and BAC had \$119.7 billion. The resulting \$129.3 billion combination of assets exceeded that of Citicorp of New York by \$1 billion and created what was then the largest financial entity in the country. Seafirst and BAC completed the merger without financial assistance from the FDIC.

When deposit payoffs were conducted subsequent to Penn Square, they generally included payment of an advance dividend to uninsured depositors and other general creditors. Those "modified payoffs," as they were referred to at the time, mitigated the disruptive effects of a bank failure on a local community without providing anything more to uninsured creditors than that to which they were entitled.

In the aftermath of Penn Square the prevalent feeling was that perhaps the FDIC would be a little less ready to protect uninsured creditors at failed depository institutions than it had been before Penn Square. Purchase and assumption transactions remained the preferred procedure for handling bank failures, carrying with them automatic coverage of all depositors. Nevertheless, before Penn Square, no bank of that size had ever been handled without protecting all depositors. The next major event was the Continental open bank assistance transaction in 1984.

43. *FAIC Securities, Inc. v United States*, 768 F. 2d 352 (D.C. Cir. 1985).



**Then-FDIC Chairman
William M. Issac
announced the details
of the history making
financial assistance
package for
Continental Illinois
National Bank and
Trust Company before
a packed press
conference in the FDIC
Washington office.**

