PENN SQUARE BANK SYMPOSIUM

PENN SQUARE BANK—20 YEARS LATER: INTRODUCTION TO THE SYMPOSIUM

ALVIN C. HARRELL*

I. INTRODUCTION

Many of us who were in business or practicing law in the early 1980s, and are still doing so today, share a common experience: We survived, in some way or another, the effects of the failure of Penn Square Bank on July 5, 1982, the ensuing widespread collapse of the American banking and deposit insurance system, and the regulatory “reign of terror” that followed.

The effects were widespread: Over 100 Oklahoma banks failed.1 Virtually all of the major banks in Texas and Oklahoma failed. The ripple effects reached to Seattle, Chicago, and New York, affecting major national institutions. In the aftermath, the number of independent community banks in the United States declined by the thousands.2 The

* Robert S. Kerr, Sr. Professor of Law, Oklahoma City University School of Law.
1. There were 122 bank failures in Oklahoma in the ten year period following the closing of Penn Square Bank on July 5, 1982, plus 70 in Louisiana (1980-1989), and 425 in Texas including 9 of the 10 largest. See Paul R. Foster, “The View of the Aftermath From the Local Regulatory Perch—the Transition to the Brave New World of Banking Regulation,” materials presented at “Penn Square Bank—20 Years Later,” Oklahoma City University Symposium, (Oct. 3, 2002) (materials on file with Oklahoma City University Law Library) (citing Sheshunoff, Banks and S&Ls of Oklahoma, 2002); see also, 27 OKLA. CITY U. L. REV. at 983 (2003).
2. In Oklahoma, the number of banks ultimately declined by about one-half, from

945
national economy was thrown into a serious, decade-long series of economic recessions.

The American thrift industry fared even worse. Essentially the entire savings and loan industry in Texas and Oklahoma was wiped out. In Oklahoma, the only thrift institutions that survive today under the same ownership and management are the two smallest institutions in the state, and both dropped federal deposit insurance in order to escape the regulatory backlash.³ Virtually every other thrift in Oklahoma either failed or was recapitalized by new owners, or (in a few cases) was transferred to new management. The story was much the same in Texas, and soon the distress spread to other parts of the country, until the Federal Savings and Loan Insurance Corporation was also hopelessly insolvent. Nationally, eighty percent of the savings and loan industry was destroyed.⁴ The FDIC narrowly escaped a similar fate when the Federal Reserve Board (FRB) helped engineer a monetary expansion, probably designed in part to save the whole banking system from a similar fate (an effort the FRB had not been willing to make on behalf of the less-important thrift industry).

Obviously, and contrary to many press reports at the time,⁵ there was more at work than a few rogue loan officers and "S&L kingpins." In all, it was a phenomenon unprecedented since the thrift industry was federalized and the federal deposit insurance system created during the depression of the 1930s. The impact on the southwestern United States was particularly dramatic, but the entire U.S. financial system was affected; and in a sense, it all started a few blocks from the Oklahoma City University campus, with the failure of Penn Square Bank.

Of course, most of the consequences were not the fault of Penn Square Bank, or the other institutions that failed. But the failure of Penn Square Bank and the thrifs that followed became symbols of an era that

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⁴ "Nationwide, about 80% of the S & L industry (measured by total assets and total numbers of institutions) was permanently eliminated between 1980 and 1995." George Sutton, "Penn Square Bank—20 Years Later: A Personal Recollection of the Causes and Effects of the Banking and Deposit Insurance Crisis of the 1980s," materials presented at "Penn Square Bank—20 Years Later," Oklahoma City University Symposium (Oct. 3, 2002.) (materials on file with Oklahoma City University Law Library); see also, 27 OKLA. CITY U. L. REV. at 969 (2003).

ultimately embraced a fundamental restructuring of the American financial services industry and its regulatory environment, a process that continues to this day. So it is appropriate to revisit the events of the 1980s, and attempt to distinguish the facts and fictions surrounding those events, in order to better understand how the resulting policy choices continue shaping the American economy and legal system today.

As with many such events, it is all receding from memory. Today the vast majority of bankers, bank lawyers, business executives, consumers, and policy advocates have no direct knowledge of the events, causes, and effects of the Penn Square failure and its related events, though in some ways all continue to pay the price for those events.

Some prefer it that way. Many of the memories are painful, and the lessons are difficult and troubling. It is easier to forget or ignore the lessons of the past. And as the veterans of this experience pass from the scene, the collective memory of these events will be lost. Many of those in banking today were brought in after the regulatory crackdown that closed or changed so many institutions; indeed, they may have benefited from the opportunities that resulted. Even if they remember these events, they may have a very different perspective from those who went before them.

So before the veterans of the Penn Square era fade away, the twentieth anniversary of that event provides an appropriate opportunity to review again the significant events from the 1980s and 1990s that have shaped the twenty-first century American financial system. We are grateful to those participating in this symposium, for their willingness to contribute to this effort.

II. CAUSE AND EFFECTS: WHAT HAPPENED, WHY, AND WHAT IT MEANS

Painting with a broad brush, this discussion will very briefly describe, in a chronological outline, your author's view of some of the significant causes and effects of the financial melt-down of the 1980s, and its consequences.

A. Economic Conditions

The massive inflation of the 1970s, generated by oil price “shocks” and accommodative FRB policies, followed by dramatic deflation in the 1980s as the FRB in response raised interest rates and tightened the money supply, were accompanied by volatile interest rates and ultimately a collapse of the collateral values that many banking institutions relied upon. The 1970s and early 1980s were a roller coaster of volatile
government policies, interest rates, and price-level swings that would have strained any financial system.

B. Energy Policy

U.S. energy policy contributed to the extreme volatility of collateral values, e.g., by controlling most oil and natural gas prices at low levels (thereby creating shortages), but not prices for oil and gas from new discoveries. Prices for uncontrolled, newly-discovered oil and gas skyrocketed (along with real estate values in the affected areas), then collapsed as new production made it apparent that ample supplies were available after all.

C. Tax Policy

Tax reform in the early 1980s provided significant relief from high marginal income tax rates for those who invested in “targeted” tax shelters, such as energy and real estate. This encouraged massive over-investments at inflated prices. A few years later, many of these tax breaks were abruptly rescinded and suddenly the inflationary process reversed, contributing to another collapse of asset values and more collateral deflation.

D. Bank Closure Policy

Rather than allowing banks like Penn Square to liquefy themselves in an orderly fashion, to minimize the losses and related economic damage, bank regulators opted for a dramatic regional closure and liquidation policy (apparently limited to banks in some geographic areas and asset sizes). Even good borrowers at these institutions had their loans “called” unexpectedly, and were forced to seek financing elsewhere at a time when the same regulatory policy made a successful refinancing unlikely. The result was a ripple effect of defaults and foreclosures that dragged down good borrowers and arguably even good banks, and damaged many innocent borrowers and depositors. No fractional reserve banking system can survive such a policy unscathed. Ultimately, large banks in other states were treated very differently, under a “too-big-to-fail” policy (which may have created new “moral hazards” of its own). These closures and the very aggressive pursuit of financial institution borrowers and insiders, using strong-arm federal enforcement powers and apparently driven as much by a deep-pocket analysis as by the defendant’s culpability, chilled bank lending and
contributed to a severe credit crunch and economic recession during the late 1980s and very early 1990s.

E. Thrift Regulatory Policy

Federally-insured savings and loan associations had long been required by law and regulations to invest almost exclusively in long-term, fixed-rate mortgage loans. When interest rates skyrocketed as a result of the 1980s FRB anti-inflation effort, thrifts with long-term mortgage loan portfolios yielding an average of about six percent suddenly had to pay upwards of fifteen percent to retain their customer deposits. Operating losses soared, the value of existing mortgage loans sank, and almost the entire industry (and its federal deposit insurer) was immediately rendered insolvent.

In a sign of desperation, federal regulators and industry leaders urged thrifts to “grow out of” their problems by paying very high deposit interest rates to attract new funds for investment in creative real estate ventures (newly authorized by federal legislation in the early 1980s). When these ventures suddenly collapsed along with other collateral values, thrift losses were compounded. There was little capital in the thrift industry to absorb such losses, because federal thrifts had been required to have a mutual charter (thus limiting their ability to raise capital). And without shareholders, there was little incentive for thrifts to generate or retain net earnings. Federal regulators tied management salaries to asset size, further encouraging asset and salary growth that reduced capital ratios. The official line was that thrifts did not need significant capital because federal regulation minimized the risk of losses. The result was a financial and public policy disaster.

F. Public Anger

When collapsing collateral values brought down so many energy and real estate lenders, and the thrift industry and Federal Savings and Loan Insurance Corporation (FSLIC) went broke, the need for scapegoats led to intense public pressure to crack down on “S&L crooks and kingpins” and other bank insiders, prompting a regulatory “reign of terror” that further stunted lending and economic growth, in turn depressing asset values even further. The public anger, fueled by the frustration that comes with financial losses and heavily exploited by the popular media, created an emotive political environment. Your author attended an early 1990s presentation by a Congressional staffer who readily admitted that the federal response (see also Part II. H., below) was excessive, but in
defense asserted that "anything" was justified by the public clamor of the time.

G. A Media Crusade

In the late 1980s the popular media, apparently eager to head a howling mob, went wild over these issues. This further increased the public pressure for immediate and dramatic action. It was a fascinating exercise in mass psychology. But such an environment is not conducive to a deliberative solution, and Congress responded accordingly.

H. New Federal Legislation

The result was arguably some of the worst federal legislation in U.S. history (though obviously that is a bold claim). But whatever its merits, the legislative response fundamentally changed the face of the American financial, legal, and regulatory systems.

The statutory trilogy that resulted constitutes, in your author's view, some of the most misguided public policy ever enacted: FIRREA, the 1990 Crime Control Act, and FDICIA provide almost a poster child for the axiom that when Congress acts quickly and with little dissent you can be sure the results will be awful.

This trilogy of legislation reflected essentially a public crusade against the banking industry. It created a new and one-sided balance of regulatory authority in favor of the federal banking agencies, apparently on the assumption that the business acumen of such agencies is always superior to that of local bankers, making it all but impossible for any but a giant institution to resist errors of judgment by the regulators. For those of us associated with the thrift industry who believed that our institutions survived largely because of resistance to common regulatory misjudgments, this was the beginning of an exodus of community-based institutions away from the federal charter. This legislation was among the most significant and lasting legacies of the Penn Square Bank era, contributing significantly to a massive consolidation in the banking industry and a corresponding reversal of the two hundred year tradition of independent community banking in America.

A modern axiom is that direct and comprehensive federal regulation is incompatible with small, independent business enterprises. Clearly, industries that are directly and extensively regulated by federal agencies tend to be dominated by a relatively small number of large entities. Federal regulation nearly always imposes heavy compliance burdens, and a need for specialized legal counsel, that are uneconomical for small businesses. Thus a significant increase in federal regulation tends to be followed by consolidation of the regulated industry into fewer and larger entities. So it has been in banking: The number of independent community banks and thrifts dropped dramatically in the late 1980s and 1990s; the thrift industry was fundamentally transformed, with traditional thrifts virtually disappearing in many areas (such as Oklahoma). Today, the federal thrift charter is of importance primarily for use by large, nationwide diversified financial and industrial conglomerates, for the purpose of using federal preemption to override state consumer protection laws. This is very different from the nationwide system of small community banks and thrifts that was brought under direct federal regulation in the 1930s.

J. The Early 1990s Credit Crunch

By 1992 (a presidential election year), the effects of all of this were in full swing. The banking industry (including thrifts), traditionally the source of much consumer and mortgage credit (and business venture capital), was in severe retrenchment. A true “credit crunch” resulted, and the economy suffered accordingly. “It’s the economy, stupid” provided an adequate explanation for the election results.

K. The Clinton Years

Bank regulatory policy shifted dramatically in the 1990s, especially after control of Congress shifted in 1994. Even before that, however, with the election of President Clinton, the focus of banking regulation shifted from strict safety and soundness concerns to a greater emphasis

7. See supra notes 1-3.
on compliance issues including access to credit, fair lending, and community reinvestment. Almost overnight, banking institutions were encouraged to lend more rather than less. New regulatory powers designed to protect safety and soundness were used instead to promote a credit expansion. The economy quickly turned around as a new credit bubble inflated.

L. Subprime Lending

Despite the regulatory shift noted above, the effects of the 1980s regulatory policies and the 1989-1991 banking legislation continued to be felt, and the banking industry continued to consolidate throughout the 1990s, leaving some bank customers in the lurch and creating new opportunities for non-bank creditors. Compounding this effect, the credit-crunch and recession of 1989-1992 reduced the credit-worthiness of many borrowers, who could no longer qualify for prime bank credit. The subprime lending industry was reborn, or at least given a new lease on life. Even as bank regulatory initiatives involving enforcement of community reinvestment and fair lending laws were being trumpeted as the salvation of the inner cities, nonbank subprime lenders were replacing banks as the primary credit (and money-transfer) sources in those areas.

M. New Technologies

A corresponding trend was the increasing securitization of auto and mortgage loans, made easier by the technology revolution of the 1990s. This permitted thinly capitalized auto dealers and mortgage bankers and brokers to compete more effectively with banks by using the secondary markets as a funding mechanism. Almost anyone with a computer could now easily originate and sell loans. The decline of traditional community banking created a huge window of opportunity for this private use of the new technologies by alternative financial intermediaries.

N. New Financial Sales Practices

Increasing legal and regulatory complexity, and the spread of securitization as a funding source, led to increased specialization of labor

in the financial services industry. In lieu of a bricks-and-mortar “full service” branch banking network, mortgage bankers relied increasingly on mortgage brokers to generate new loans, and specialized closing agents to document and close the loans. The loans were immediately sold in the secondary market to specialized investors or trusts for securitization, with the servicing sold separately to a servicing entity. Every significant function was handled by a separate entity, with virtually no contact between the borrower and ultimate assignee. There were similar trends in vehicle finance. It was all very different from the vertically integrated “financial supermarkets” that so many predicted.

Each entity except the ultimate investor earns its income by charging a fee.10 These fees created some new incentives for those marketing financial products and services, and became a source of significant controversy and litigation at the beginning of the twenty-first century.

O. Predatory Lending

The resurgence of nonbank subprime lending and fee-generated loan marketing through brokers, as the decline of traditional community banking, generated a huge increase in consumer credit. This fueled the economic boom of the 1990s, but by the beginning of the twenty-first century had provoked a counter-movement to restrain “predatory” lending practices. Consumer advocates, who for more than a quarter-century had been demanding increased credit access for the poor, dramatically reversed course to demand that such credit be restricted. Onerous “predatory lending” legislation was enacted all over the United States during 2000-2002, and effective October 1, 2002, the FRB expanded the scope of its burdensome HOEPA regulations to cover (and discourage) a broader range of consumer mortgage loans.11 Lenders warned of an impending consumer credit crunch. Will the history of 1989-1992 be repeated?

Federal banking regulators and regulatory counsel are now touting federal preemption of state consumer protection laws as a primary benefit of federal banking regulation. The importance of bank deposits as a source of funding, and deposit insurance in obtaining such deposits, has receded somewhat as technology has made available new investment and funding sources and opportunities. A banking charter carries with it many regulatory restrictions and compliance burdens, and the bank regulators recognize that they must offer compensatory benefits or gradually lose their jurisdictional base.

Today the big marketing tool is federal preemption of state laws. The states have been cooperative, enacting burdensome and nonuniform state laws that many consider to be unworkable, and which can be preempted for those with a federal charter. Thus the modern banking charter is being transformed from the role of a local financial intermediary into a device for large nationwide institutions to use in preempting state consumer protection laws. In the meantime, community banking is being reborn partly in the guise of locally-owned and operated nonbank financial intermediaries such as finance companies, auto dealers, mortgage brokers, check-cashing and money-transfer services, rent-to-own companies, and pawn shops, albeit at the higher costs commensurate with the legal and credit risks and compliance burdens inherent in modern subprime lending.

III. CONCLUSION

It is all a far cry from the days of Penn Square Bank, when independent community banks and thrifts provided venture capital to local businesses and consumer loans to their deposit customers, and the transactions were handled by local legal counsel and governed largely by traditional state laws.

Today's system of indirect credit provided through nonbank entities, financed by out-of-state creditors and investors, serviced by a remote servicing company, originated by a dealer or broker for a fee, heavily regulated at the federal level through very complex laws and regulations.


13. Id.
requiring specialized regulatory counsel, and in turn generating a huge increase in specialized litigation, may or may not have been inevitable. The resulting problems are certainly not the fault of Penn Square Bank or the other 100-plus Oklahoma banks that failed in the 1980s, or the largely-innocent thrift managers who were caught between skyrocketing interest rates and collapsing collateral values. But clearly today's financial environment is a product of the legislative and regulatory responses to the banking crises of the 1980s.

If there is blame, some should be assigned to the federal monetary and economic policies that created extreme volatility in energy prices, real estate values, and interest rates during the 1970s and 1980s. Some of the blame also lies with a failed deposit insurance system, which exacerbated these excesses by creating moral hazards and then passing the losses to U.S. taxpayers, generating along the way a mass public hysteria not conducive to a thoughtful solution. It is probably not surprising that Congress, the regulators, and the media responded in kind and in turn created a new series of adverse longer-term consequences.

Some of the relevant policies (e.g., the moral hazard created by deposit insurance) date to the 1930s—the chickens simply came home to roost beginning in 1982. But much of the blame also lies with the Congressional, regulatory, and media responses of the late 1980s and early 1990s, which in some cases contributed significantly to the economic problems of the time and continue to have adverse consequences today. Thus, as interesting as the Penn Square Bank and subsequent bank and thrift failures were, the real significance of these events lies in the public policy responses by Congress, the regulators, and the media. These responses reveal much about our public institutions, and are reflected in current credit law and policy issues.

In effect, the public campaign to blame "crooks in the industry" (perhaps in part to deflect blame for legislative and regulatory failures and the insolvency of a federal deposit insurance program) led to very onerous federal banking legislation (FIRREA in 1989, the Crime Control Act of 1990, and the FDIC Improvement Act of 1991). These laws created new legal risks and burdens that helped drive half of the banks in Oklahoma and eighty percent of the thrifts nationwide out of business, essentially ending a two hundred year tradition of independent community banking. The real legacy of Penn Square Bank, and the

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14. Critics of this conclusion may argue that the remaining 280 banks in Oklahoma are thriving, but that is partly a consequence of significantly reduced competition and low deposit interest rates. Moreover, many of the remaining "community banks" are owned
deposit insurance crises of the 1980s, was a new regulatory regime, followed by a massive consolidation in the banking industry and a proportionate reduction in the economic role of community banking institutions.

Over the past decade, and in no small measure as a consequence of the federal banking legislation of 1989-1991, there has been a new kind of financial disintermediation, as traditional community banking has retrenched and former banking markets have turned elsewhere for financial services.\textsuperscript{15} It has been both a depositary and a credit disintermediation: Bank consolidation has meant reduced banking competition, and deposit interest rates that are lower in real terms. In response, many investors have abandoned bank deposits and flocked to alternative securities products and real estate investments; reduced bank credit availability has led to a huge growth in non-bank credit sources, including credit card debt and subprime finance company lending. Even the payments system is being bypassed to some extent by non-bank alternatives.\textsuperscript{16}

The result has been a shift of bank-like risks to nonbank parties, notably private investors and the general public, \textit{e.g.}, through securities products and pension funds. Fannie Mae is operating like a huge savings and loan association with implicit taxpayer backing.\textsuperscript{17} Many stock market investors apparently believe the U.S. government is, or should be, the guarantor of stock market investments, equating them to bank deposits.\textsuperscript{18} Much credit risk has been passed through the securities markets to private investors and their pension funds. One risk in all of this is the danger of a giant, nationwide Penn Square Bank, in which the public directly absorbs the losses incurred in a major cyclical downturn, which previously would have been restrained by responsible bank managers and absorbed in large measure by bank capital.

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\textsuperscript{15} A corollary has been a shift of consumer investment risks from federally insured bank deposits to uninsured securities products, with a proportionate increase in the risk profile of consumer assets.
\textsuperscript{17} See, \textit{e.g.}, \textit{Fannie Mae's Risky Business}, WALL ST. J., Sept. 23, 2002, at A16; William Poole, \textit{Unforecastable Shocks}, WALL ST. J., Mar. 12, 2003, at A18. Mr. Poole is President of the Federal Reserve Bank of St. Louis.
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A related danger is that the next cyclical downturn will lead to a response like that of the late 1980s and early 1990s, only this time directed not just at the banking and thrift industry but at business or creditors generally. We have already had a taste of this in the backlash against subprime lending, and the Sarbanes-Oxley Act of 2002,\(^\text{19}\) which is apparently leading some companies to forego listing their securities and/or expanding through public stock offerings. If the effects of these measures are even a fraction as great as the impact of FIRREA and its progeny on the banking system, the impact on the national economy could be dramatic.

These risks in the twenty-first century cannot be fully understood without first learning the lessons of the 1980s. A purpose of this symposium is to shed light on these lessons. We are grateful to the authors and sponsors of this symposium for contributing their expertise and resources to help make it possible.

\(^{19}\) Pub. L. No. 107-204 146 Stat. 745.