Mr. HAUGLAND. As I say, I have not seen or heard anything official from the Comptroller's Office relative to the examination that was started on April 19, so I really don't know.

Mr. WORTLEY. I would ask any of you, when did you first become aware that the internal loan review program was precluded from reviewing energy credits?

Mr. COOK. Well, I think I just heard that right now because I remember this spring there was a review of the internal loan review program. Mr. Dunn reviewed that program, and energy credits were included in the reviews that he had conducted to date, if I am not mistaken. I also remember that he was asked if the profile of loans of the bank that had not yet been reviewed would be in any different distribution in terms of poor quality versus good quality loans compared to the profile of the loans that had been reviewed, and he said he had no way of knowing but he didn't believe that was the case. So I assume the loan review program was in fact covering energy loans and that it was going along well. It wasn't going as fast as we wanted it to, but he was working on a number of potential chargeoffs, and he had not been able to devote as much time to it as I think many of us would have hoped he would have been able to.

Mr. WORTLEY. But in fact, the energy loans were being precluded from the overall review of the credit policy.

Mr. COOK. That is news to me.

Mr. RANDOLPH. I was going to confirm that that is news to us. We were not aware that it was excluded, that he made restrictions on reviewing energy loans.

Mr. WORTLEY. I wonder if the president could comment.

Mr. BELLER. Yes, sir. I don't know where you came by that information. The energy department was not precluded in my knowledge, and I would add to that that the loan review function, after we were able to get it in place, started reviewing the loans, and we attacked those loans that had been classified by the Comptroller's Office first, and reviewed those loans and charged off the ones that were classified substandard, doubtful, et cetera. That was the place where obviously we reviewed them.

So as soon as we assembled the people to do it, that is what we attacked, and there was, to my knowledge, we were never precluded in any way from reviewing energy loans. It was just that we had not gotten to those reviews yet.

The CHAIRMAN. Mr. Barnard?

Mr. BARNARD. Thank you, Mr. Chairman.

Ladies and gentlemen, you have been most cooperative today, as well as patient and enduring, and for that reason I will make my questions as brief as possible.

Mr. Cook, did you know that the Penn Square Bank very frequently made venture capital loans for new oil ventures?

Mr. COOK. No, I didn't.

Mr. BARNARD. Let me rephrase it.

Do you have any knowledge that they made that type of loan?

Mr. COOK. No, I do not.

Mr. BARNARD. Mr. Haugland, as a banker, and in Muskogee, Okla., where I would imagine you would be confronted with the same opportunities for business as the Penn Square Bank, is it a customary practice for banks to involve themselves in venture capital for new wells and new drills, new rigs.

Mr. HAUGLAND. Sir, we have very little oil activity in that part of Oklahoma. So our customer base is quite a bit different than the banks that you would look at here in Oklahoma City.

Mr. BARNARD. Is it not customary for those larger banks who have been in the oil business or energy business for many, many years to specialize not in venture capital loans but in collateral of wells and rigs and operations that are already in being and making a profit?

Mr. HAUGLAND. I guess in response to that, I would say that a venture capital oil loan would be like any other venture capital, that if there were additional collateral forthcoming to justify the credit advance, it would be done, but do you mean just by the venture itself?

Mr. BARNARD. Well, it was pretty widely known, at least suspected that Penn Square was making brandnew loans to brandnew people in the business, which was contrary to what I understand to be the practice in other banks who have had many, many years of experience in the oil-lending business. That story was written up rather at length in the American Banker of April 26, 1982, and somewhat corroborated by Mr. Jennings. When the gentleman writing the article asked him if he was actually providing venture capital, Mr. Jennings said he would like to be, noting that he was thinking about forming a venture capital subsidiary. It was reported that Penn Square was pretty much involved in new ventures, which I understand is somewhat contrary to normal banking practice

Mr. HAUGLAND. If it was, sir, I was not aware of it.

Mr. BARNARD. Back in 1979, we passed a bill in Congress called FIRA, and in that particular law it required that insider loans, loans to members of the board of directors or to correspondents, had to be reported to the board of directors.

Was any such report ever made to you all about a schedule of loans made to your directors?

Mr. HAUGLAND. Yes, sir.

Mr. COOK. Yes, at every meeting.

Mr. ROSS. Yes, sir.

Mr. BARNARD. At every meeting that was done?

One of the things that interests me is that all of you seemed to be very, very surprised that the bank closed. You suspected that additional capital had to be raised and possibly according to some of you, $4 million or $5 million might be needed, and then all of a sudden $40 million in loans were charged off.

Mr. RANDOLPH. Someone from your bench said that.

Mr. BARNARD. You had no forewarning, no indication at all from the Comptroller of the Currency that this requirement was going to be made on the bank?

Mr. RANDOLPH. No, sir, not until the last weekend.

Mr. BARNARD. Not until the last week, and yet you had had how many meetings with the Office of the Comptroller of the Currency?

Mr. RANDOLPH. We as a board did not meet with them at all during the last examination.

Mr. BARNARD. But you had been to Dallas twice, right?

Mr. RANDOLPH. Well, in 1980 and 1981.

Mr. BARNARD. But in those discussions, the ultimate results of what could happen if you did not turn the bank around was never discussed?

Mr. RANDOLPH. I don't understand what you mean.

Mr. BARNARD. Well, general, it is like talking tough to a recruit. They did not say something like if you do not turn that bank around we are going to close you up? Nothing like that was ever said?

Mr. RANDOLPH. They made those comments, but as we have told you over and over again that based upon their examinations in the fall of 1981 and their report to us in January 1982, that we were making progress to clear up those deficiencies that they were concerned about, further collaborated by the auditor's report to us in April.

Mr. BARNARD. So you felt comfortable?

Mr. RANDOLPH. Yes, sir, we did. We felt that the bank was in fact improving and the fact that they came in in April of this year and started an examination and we had no contact with any members of that examining group until the last week, on the first of July.

Mr. BARNARD. And they felt so comfortable about it in April that the just took a little vacation.

Mr. RANDOLPH. Well, I read the testimony that they found after 2 or 3 weeks that it was so horrible they ran to Washington with it, but we didn't have a chance to take a swing at the bat, so to speak.

Mr. BARNARD. Well, we are going to give them a swing at the bat when they come before us.

Mr. Haugland, I believe that you have been very close to the Rooney family, if I am not mistaken.

Mr. HAUGLAND. Yes, sir.

Mr. BARNARD. And my information is you replaced Mr. Rooney on the board of Penn Square after his death in 1980.

I understand that there was a relationship between the Rooney family of Muskogee and the Rowsey family of the Mahan-Rowsey Co.

Do you know much about that relationship?

Mr. HAUGLAND. I know both families. Mr. Rooney, deceased, Larry Rooney, happens to live next door to the Rowsey-that-you-are-mentioning's father, but I don't think that outside of that, they serve on different bank boards.

Mr. BARNARD. Is Mr. Rooney on your board? Is there a Rooney on your board?

Mr. HAUGLAND. Yes, sir.

Mr. BARNARD. Which Rooney is it?

Mr. HAUGLAND. The son of Lawrence Rooney.

Mr. BARNARD. Can you tell us anything about the Mahan-Rowsey debt at Penn Square?

Mr. HAUGLAND. No, sir, I don't know anything about it except that we had an extremely large line of credit granted to them that was a participation of credit with either Chase or Continental.

Mr. BARNARD. All right. Thank you, sir.

Mr. Chairman, I have no further questions.

The CHAIRMAN. I am going to ask each and every one of you to answer this question. We have been trying to get to this, and perhaps we will try to twist the question around.

The Comptroller's Office was in Penn Square and indeed called the FDIC in, alerted Chase Manhattan and Continental, finally admitted to the Federal Reserve Board, after they asked about it, that there was trouble in the streets of Oklahoma City, particularly at Penn Square Bank.

There is a question about the fact that some customers of the institution withdrew substantial amounts of funds at the "advice of a mystical financial consultant."

You people are on the board, or were on the board of directors of the Penn Square Bank.

Did you, Mr. Smelser, can you state to this committee that the Comptroller's office and the representatives of the Comptroller's Office alerted you and apprised you of the severity of the situation at Penn Square Bank on Thursday and Friday of the week—that was the last 2 days, the Thursday and Friday that that bank was open?

Mr. SMELSER. Did they apprise us of the severity?

The CHAIRMAN. The severity of the situation and the impending doom that laid ahead.

Mr. SMELSER. Well, they apprised us of the severity, but I don't think they apprised us of the impending doom.

The CHAIRMAN. Well, let's put it this way. Did you feel as a result of those meetings that at the next board meeting with the management of Penn Square, that there was a whole lot that had to be done that had not been done to date, despite those glowing reports from Peat, Marwick & Mitchell and the Comptroller's Office in January of 1982?

Mr. SMELSER. Yes.

The CHAIRMAN. Yes what?

Mr. SMELSER. Yes, I did feel there was a lot to be done.

The CHAIRMAN. There was a lot to be done as a result of meetings on Thursday and Friday?

Mr. SMELSER. That's correct.

The CHAIRMAN. But prior to that you were not aware of it?

Mr. SMELSER. No, sir.

The CHAIRMAN. This was the first point at which you felt it was that serious?

Mr. SMELSER. The severity of it, yes, sir.

The CHAIRMAN. And Mr. Richardson, I believe you had some loans, rather substantial loans with Penn Square?

Mr. RICHARDSON. That's correct.

The CHAIRMAN. Would you pull the mike a little closer? That had to be renegotiated once Penn Square was closed, correct?

Mr. RICHARDSON. No, I just moved them out of the bank.

The CHAIRMAN. I am sorry, I used the wrong term. You had to go someplace else to get those loans.

Mr. RICHARDSON. That is right.

The CHAIRMAN. I ask you, did the Comptroller's Office in your opinion keep you properly apprised of the severity of the situation at Penn Square Bank?

Mr. RICHARDSON. I would say on Thursday they apprised us pretty heavily. They gave us 1 week to raise enough capital, until the 9th, to more or less stay in business.

The CHAIRMAN. OK. Prior to that.

Mr. RICHARDSON. No. That is the first meeting we had.

The CHAIRMAN. Was that the first inkling you got that things were that severe and that serious?

Mr. RICHARDSON. Yes, that is correct.

The CHAIRMAN. Mr. Ross?

Mr. ROSS. I was out of town on Thursday the 1st, and my first knowing of the problem was on July 2, on Friday when I returned back to town, but prior to that I had no knowledge or any expectations as has been testified here about its closing.

The CHAIRMAN. Well, I think you get the most—well, not the most, but certainly very glowing testimony and testimony very difficult to contradict that in view of the loss you sustained.

Mr. ROSS. Yes, sir.

The CHAIRMAN. So it is fair to say that until that Friday, because you could not be there Thursday, you were not aware of the fact that Penn Square was as severe as it was?

Mr. ROSS. That is correct.

The CHAIRMAN. So either the Comptroller held it from you or hid it from you, or the Comptroller did not know it either.

Mr. ROSS. Yes, sir, I would say that is fair.

The CHAIRMAN. Is that a fair conclusion?

Mr. ROSS. That is a fair statement.

The CHAIRMAN. Ms. Coe?

Ms. COE. Yes.

The CHAIRMAN. Do you agree?

Ms. COE. I did not know anything until I attended the July 1 meeting.

The CHAIRMAN. So either those facts were not made available to you——

Ms. COE. They were not.

The CHAIRMAN. Or/and were hidden from you, or the Comptroller's office did not know it either.

Is that a fair summation?

Ms. COE. I think that's fair.

The CHAIRMAN. Mr. Cook, do you agree with that summation?

Mr. COOK. I would concur with that.

The CHAIRMAN. Mr. Randolph?

Mr. RANDOLPH. Yes, sir, I knew nothing prior to the meeting. I did not attend the meeting because I was out of the country. I did learn about the need to raise capital in order to keep the bank open from talking to Mr. Smelser by phone on Thursday evening, and I later learned—I didn't learn the bank closed until the following Thursday. So I was somewhat out of touch.

The CHAIRMAN. But prior to the meetings of Thursday and Friday, July 1 and 2, you as a rather—as a businessman, again, whose I think business acumen is pretty good, were not aware of it. You were not appraised of it.

Mr. RANDOLPH. No.

The CHAIRMAN. So the conclusion is either the Comptroller hid it from you or the Comptroller did not know it either.

Mr. RANDOLPH. I guess I really don't know how to characterize the facts.

The CHAIRMAN. Now we get to our star here, Mr. Haugland, who is also not only a member of the board of directors but is also a member of the financial institutions industry, so to speak.

Were you aware of the severity of the situation prior to July 1 and 2?

Mr. HAUGLAND. Only to the extent that in our June regularly called board meeting that our management speculated from what he had been able to determine in his meetings with the representatives of the Comptroller's Office that our losses were going to be somewhere in the $5 million to $6 million area.

The CHAIRMAN. That was your management, right, your management telling you that?

Mr. HAUGLAND. Yes.

The CHAIRMAN. How about the Comptroller's Office?

Mr. HAUGLAND. Nothing. We knew they were in the bank and had been there since April 19, I believe.

The CHAIRMAN. You know, you were called to Dallas a few times, and here is what I want to know before we hear from the regulators, and I am going to be straight out with it.

You went to Dallas, and we got the impression from the Comptroller's briefing that by cracky, you people on the board should have known how bad things were because they laid it all out on the table for you.

Do you think that is an accurate picture of the meetings that you had in the Dallas office of the Comptroller on those two occasions? Did anyone feel as though it was all laid out for you and made clear to you that things were real bad?

Mr. RANDOLPH. I think with that meeting in Dallas they probably attempted to convey to us that there were some problems there, and they gave us the scenario of what they wanted us to do. But I guess I don't really know.

The CHAIRMAN. Did you come away from that meeting say, by cracky, I am on this board of directors, I own stock.

Do you own stock or does your family own stock in the bank?

Mr. RANDOLPH. Yes, that is correct.

The CHAIRMAN. By cracky, I am going home to Oklahoma City and I am going to talk to my fellow board members, and by golly, we have got a lot of work to do to turn this thing around and we have got to do it rather expeditiously.

Did you have that feeling when you came home from that meeting?

Mr. RICHARDSON. I think that to some extent, yes, but then maybe that is wrong. However, from that day on in the board meetings we were constantly questioning the fact that we had this letter of agreement—and how we were getting along with it, and felt that things were getting done to work towards its solution.

Mr. SMELSER. Mr. Chairman, we speak of the severity of the situation, were we aware of it. The Comptroller classified Penn Square as a class 3 bank and not a 4 or 5 which makes a tremendous difference as to what the supposed severity of the situation is.

The CHAIRMAN. I just repeat that Mr. Richardson says he came back feeling things ought to be done. You know, on a scale of 1 to

10, how excited were you about the fact that you had to come back here, motivated, excited?

Mr. COOK. I remember talking to Eldon Beller and asking him how serious the problem was, and he said it was damned serious. He said the next step will be a cease and desist order—this was in the summer of 1981. He said the next step was clearly going to be a cease and desist order. But again, as I think all of us have said, that was 1981. Then we get the examination in late 1981 and we have got the Comptroller saying to us in January that we have gone a long way toward solving the various items that were in the compliance letter, No. 1, and No. 2, that there is a reasonable chance—and that is in our minutes—I believe there is a reasonable chance that we will get out from underneath that compliance letter at our next audit, that things are in that good a shape.

The CHAIRMAN. So at that point you were lulled into a sense of security?

Mr. COOK. I wouldn't say we were lulled because we still felt—I mean, after all, we didn't want to be a No. 3 bank. We wanted to be a No. 1 bank. So there was still a long way to go.

The CHAIRMAN. But a number three bank in reality and in truth is not all that bad.

Mr. COOK. At least it is not a four or a five. That is exactly right.

Mr. BARNARD. Mr. Chairman, I guess we cannot resolve until we talk to the Comptroller, how they moved from $5 million or $6 million in capital needs to $40 million in capital needs overnight.

Maybe Mr. Beller could answer that.

Mr. BELLER. No, sir, I can't. But based upon the anticipated chargeoffs that we had concluded in-house that our chargeoffs would run in the neighborhood of $3 million to $4 million, we had identified that many problems ourselves. The first indication I had that it would be more than that was when I was advised by the examiners that they looked like it was $6 million.

Mr. BARNARD. Now, you charged off $4 million at the end of 1981, at your direction, I believe.

Mr. BELLER. At my direction, after I came to work for the bank.

Mr. BARNARD. But those were other than energy loans? Those were real estate loans?

Mr. BELLER. Yes, other than energy, and those were loans that we charged them off ourselves.

Mr. BARNARD. Did you feel that you had cleaned up the loan portfolio at that time?

Mr. BELLER. Inasmuch as I had been able to find within those few short weeks. The examination continued and the examiners continued to come up with larger numbers of chargeoffs until they finally got to $12 million, $20 million, and I understand it ended up somewhere in the $40 millions. I have never seen the list of the chargeoffs yet.

Mr. BARNARD. Mr. Chairman, I would like to ask the board members, were you being lulled into the dream of this bank in the next 2 or 3 years becoming a billion dollar bank?

Mr. RANDOLPH. No. We were programming somewhere between 15 to 20 percent growth, which was in real terms probably 5 to 6 percent if you take account of inflation. We were basically basing our growth on the ability to fund the capital needs from the earnings of the bank rather than the need for new capital infusions.

Mr. WEBER. Mr. Chairman?

The CHAIRMAN. Mr. Weber.

Mr. WEBER. It seems to me the situation is becoming a little more clear. Based upon the testimony of the board of directors and also Mr. Beller's testimony that apparently—and also the earlier testimony that we had from Mr. Conover and buttressed by the testimony that we will be getting from the regional Comptroller's office later today, corrective actions apparently were in place or were being put into place that were satisfactory to the OCC as of the September 30, 1981 examination.

The question then is how were those corrective actions evaded so easily between October of 1981 and the period or the time of the next examination of the bank that the OCC made in I believe it was April of 1982, completed—the preliminary I think was completed in early May of 1982, arousing their alarm.

I think the question is, What were the corrective actions that were taken and how were they so easily evaded during that period of time? And I do not know that any of you can answer that, but I think that is really the question.

The OCC is saying that the bank had the corrective, was in the process of taking corrective actions and did not follow through, and I do not know who could answer that question. Apparently you were placing your reliance on a management that did not make good on the corrections that they had agreed, the corrective actions that they had agreed to make, and I do not know if that was the president, the chief executive officer, or the senior loan officer in the department of energy?

The CHAIRMAN. You are a little young to remember this, Mr. Weber, but when I was young, every Saturday you would go to the movies to see Tom Mix or one of those old cowboys, but you always had to go the next Saturday to see the next issue in the serial, you know, what happens next week.

So we are going to get as much as we can from these witnesses, and hopefully, as we get to the next episode, we might learn a little more.

Now, at the June 15, 1982, meeting, Mr. Patterson noted his participation in what appeared to be a partnership. "Mr. Randolph then inquired about possible conflict of interest. The chairman, Mr. Jennings, stated the ethics committee reviews officer participations as well as details of the borrowing."

Could anyone on this panel tell the committee what members of the board sat on the ethics committee?

Did any of you sit on the ethics committee?

Mr. ROSS. No.

The CHAIRMAN. Do you know who the members of the ethics committee were?

Ms. COE. No.

The CHAIRMAN. Does anyone know who was on the ethics committee?

Mr. RANDOLPH. No, sir.

Mr. SMELSER. It is the first time we've heard of it.

The CHAIRMAN. Was it kept a secret from you?

Mr. RICHARDSON. That's the first time we knew of it.

The CHAIRMAN. They answered your question, Mr. Randolph, about a conflict by saying the ethics committee would take it up.

I was going to ask you what the procedures of the committee, of the ethics committee were in reviewing potential conflicts of interest, but none of you know anything about the ethics committee at Penn Square Bank?

Mr. RANDOLPH. I don't know anything.

Mr. ROSS. No, sir.

The CHAIRMAN. Mr. Beller, were you on the ethics committee?

Mr. BELLER. There was not a formal ethics committee, to my knowledge. There was a standards and conduct directive. All officers had——

The CHAIRMAN. Directive?

Mr. BELLER. Yes, sir, an outline that we gave them that would, if they were placed in any type of relationship that would give a conflict of interest at any time, that that should be reported in writing to the chairman of the board and president of the bank. That is the nearest thing to an ethics committee that existed to my knowledge.

The CHAIRMAN. But you are not aware of any ethics committee that met in formal meetings?

Mr. BELLER. No, sir.

The CHAIRMAN. And people wonder why Penn Square had problems.

Ladies and gentlemen, we want to thank you very kindly for your assistance.

There might be some written questions we might submit to you and if you think of anything else that might be helpful to the committee, please feel free to contact us or our staffs.

But on behalf of each and every member of the committee, we want to thank you for your assistance, your openness, your frankness, your willingness to assist, and the help you have given us this morning and this afternoon.

The committee will be in recess for 5 minutes in order to allow our official reporter to retool and relubricate.

This fellow is fantastic. We have had him around the country with us. We have had him all over the place. He is just outstanding.

Mr. BARNARD. Is that going in the record, Mr. Chairman?

The CHAIRMAN. Of course. That goes in the official record. We asked for him to come with us because of the fact that he gets the testimony accurately.

Ray, you have 5 minutes.

We will be back.

Our next panel will consist of, so that they know, Mr. Frank Murphy and Mr. Cravens, Mr. Kenworthy, Mr. Kimberling, Dr. Margo, Mr. Mead Norton, and Bill Stubbs, and we have already had Gene Smelser.

[A brief recess was taken.]

The CHAIRMAN. The committee will come to order.

The Chair at this point in time would like to submit for the record other documents that have been referred to in the questioning of the witnesses, and this would be the minutes of the meeting of the board of directors of Penn Square Bank from April 14, 1981, through June 15, 1982, and without objection, these will be put into the record.

The CHAIRMAN. The Chair would also ask unanimous consent to place into the record a communication from the Comptroller of the Currency re Penn Square Bank from Mr. Conover, the Comptroller of the Currency, dated August 15, 1982, and this is a summary, a copy, rather, a formal agreement executed with the bank of September 1980, copies of the notice of charges of the order for cease-and-desist order June and July 1982, and a summary of each examination report from 1976 through 1982.

I would inform the press and everybody else not to get too excited because this is a summary of the examination reports with all kinds of names and I.D.'s deleted, and very frankly, I am afraid we are going to have to ask for much more than the summary.

[The material referred to, with an addendum, appears in the appendix section as appendix C.]

Mr. SPRADLING. I am Mr. Spradling, an attorney for Mr. Cravens.

With respect to the minutes first admitted, there is an error in the minutes of the Dallas meeting. Mr. Cravens was absent and Mr. Norton was present, and I think they have got it reversed.

The CHAIRMAN. They had it backwards.

Thank you.

At this time we have Mr. Frank Murphy, former president of Penn Square; J. C. Cravens, Mr. Kenworthy, Mr. Kimberling, Dr. Margo, H. Mead Norton, Mr. Stubbs, and Mr. Ron Burks.

If you gentlemen would be kind enough to rise with me.

[Witnesses sworn.]

The CHAIRMAN. The Chair would like to thank all of you again for your assistance and your appearance here, and the members of this particular panel have been with the institution since its inception, and it will be very helpful to get a real clear history of this.

And I think I would first like to ask Mr. Murphy, since he has been with the institution or connected with it for a long period of time, if you would be willing to tell us or give us a brief recap of the history of the bank from the time you joined I believe in the 1960's, a very brief one.

TESTIMONY OF FRANK MURPHY, FORMER PRESIDENT OF PENN SQUARE BANK; J. C. CRAVENS, KEN L. KENWORTHY, C. F. KIMBERLING, DR. MARVIN K. MARGO, H. MEAD NORTON, BILL STUBBS, AND RON BURKS

Mr. MURPHY. Yes, Mr. Chairman. I joined in January 1961 as assistant vice president. In September 1961 I went into commercial loans as vice president. In April 1964, the executive vice president; in January, I believe, 1965 until the present, then last year, as vice chairman.

The CHAIRMAN. Now, you became at any time between 1964 when Mr. Jennings left the bank and went to Fidelity and 1975 and 1976 when he regained control and returned, was the bank under any level of criticism from the Comptroller of the Currency's administrator, or from the Comptroller of the Currency?

Mr. MURPHY. No letter of administration, no, sir.

The CHAIRMAN. Any cease-and-desist orders?

Mr. MURPHY. No, sir.
The CHAIRMAN. In other words, the bank was functioning properly as far as the Comptroller's office was concerned? Your reports were relatively unexciting?
Mr. MURPHY. I would think operating above average, I would like to believe.
The CHAIRMAN. Now, could you tell the committee your impressions of what changes occurred at the bank subsequent to the return of Mr. Jennings and his assuming control?
Mr. MURPHY. The primary change was directing the bank into the energy field. That has been at the peak.
The CHAIRMAN. This was a rather substantial or dramatic change in direction, was it not?
Mr. MURPHY. Yes, it was.
The CHAIRMAN. Compared to what the bank had been doing previously.
Mr. MURPHY. Very much so.
The CHAIRMAN. What was your reaction to this right hand turn, so to speak, or 180 degree turn?
Mr. MURPHY. Well, I guess I am known as pretty conservative. I felt that with the proper direction and proper loans there would be nothing wrong with it, even though I am conservative.
The CHAIRMAN. When did you indeed leave the institution?
Mr. MURPHY. Sir?
The CHAIRMAN. When did you leave Penn Square?
Mr. MURPHY. When the FDIC—I was advised I was no longer on the payroll.
The CHAIRMAN. The minutes reflect considerable discussion of a former officer, Mr. Thomas Orr, and the problems he had caused prior to his resignation in 1981.
Could you tell us what was his function at Penn Square?
Mr. MURPHY. Mr. Orr was an executive vice president over commercial loans, excluding energy.
The CHAIRMAN. And do you know who brought him into Penn Square?
Mr. MURPHY. Yes, sir, Mr. Jennings.
The CHAIRMAN. We have heard references this morning to horse loans.
Was Mr. Orr involved in what is known, in these horse loans?
Mr. MURPHY. Well, we didn't think so, but apparently it has turned out that way, yes.
The CHAIRMAN. And were other members of the board or officers of the institution involved in these horse loans?
Mr. MURPHY. Not to my knowledge, sir.
The CHAIRMAN. Now, again, he seems to have had problems.
Is he the gentleman about whom letters went to the Comptroller in complaint?
Mr. MURPHY. Yes, sir.
The CHAIRMAN. Do you know what the sum and substance of those complaints were?
Mr. MURPHY. The sum and substance, no, sir, I do not.
The CHAIRMAN. You do not know what the allegations were?
Mr. MURPHY. Allegations, direct knowledge, I do not. Hearsay, yes, but direct knowledge I do not.

The CHAIRMAN. Maybe we can get that from the Comptroller's office.

Tell me, Mr. Murphy, would you be good enough to inform us as to how long you had been acquainted with Mrs. Evelyn Wood who I believe served as an assistant to Mr. Jennings?

Mr. MURPHY. I have been acquainted with her from the time she became a secretary originally to Mr. Jennings.

The CHAIRMAN. And when would that have been?

Mr. MURPHY. Four or five years ago maybe. Maybe longer.

The CHAIRMAN. Subsequent to his return to Penn Square in 1975?

Mr. MURPHY. Yes, sir.

The CHAIRMAN. And to the best of your knowledge she came on board and worked for Mr. Jennings throughout?

Mr. MURPHY. Yes, sir.

The CHAIRMAN. That period of time?

Mr. MURPHY. Yes, sir.

The CHAIRMAN. If the committee members will allow, I am just getting this in handwriting myself. I will go through with some of these members their involvement and then open up for the other members, and then that way maybe we will have a better handle.

Now, Mr. Stubbs, you have been a director since 1964?

Mr. STUBBS. Yes, sir.

The CHAIRMAN. And you, therefore, were with the bank since 1964 and 1974 prior to the change of direction?

Mr. STUBBS. Yes, sir.

The CHAIRMAN. And then you were on from 1975 until the demise, so to speak, on July 5 and 6?

Mr. STUBBS. Yes, sir.

The CHAIRMAN. Could you give us your impression of the direction the bank took, the difference between the manner in which it functioned prior to 1974 and subsequent to 1975—a very capsulized version?

Mr. STUBBS. I was on the board from 1964 to 1974. The bank was basically a real estate bank and I am in the real estate business, and that is the reason I was on the board. I offered to resign when Mr. Jennings and his group bought the bank and he requested that I stay on, and I did.

And it did take a complete change and go into the energy business, which was very foreign to me. And what I could see from sitting on the board, it seemed like it was a very profitable venture for the bank.

The CHAIRMAN. Let me ask you this, Mr. Stubbs. Were you present at the Dallas meeting in 1981?

Mr. STUBBS. Yes, sir.

The CHAIRMAN. With the Comptroller?

Mr. STUBBS. Yes, sir.

The CHAIRMAN. Did any of the directors at any time say to the Comptroller of the Currency—the people at that meeting—what is our authority as far as the control of management is concerned and do we have the power to remove management if we feel it is in the best interest of the institution?

Mr. STUBBS. Yes, sir. I think that was reflected in such minutes with Mr. Smelser, asking him, and he told us that if we did not feel—I am sorry; I have got laryngitis——

The CHAIRMAN. See if you can get a little closer.

Mr. STUBBS. That if he did not feel that we could move the people that we could resign from the board.

The CHAIRMAN. This is what the Comptroller told you?

Mr. STUBBS. I am afraid he said that, yes.

The CHAIRMAN. The Comptroller, when asked——

Mr. STUBBS. In the minutes.

The CHAIRMAN. In other words, when asked how you could reprove management if you felt that in some instances management was poor, the answer was well, one way would be to resign from the board?

Mr. STUBBS. Yes, sir. He said that.

The CHAIRMAN. That is a most unique way of solving the problem.

Now, Mr. Cravens and Mr. Norton, you were the two that we had a little dispute about. We again want to thank you for your appearance here. You two have been with the bank for a long period of time.

Let me ask, because you were there both before and after the original tenure of Mr. Jennings and then his return.

Mr. NORTON. Yes.

The CHAIRMAN. In your opinion, was the board of directors kept sufficiently informed about the affairs of the bank by management subsequent to 1975?

Mr. NORTON. You will have to talk a little bit louder. I am hard of hearing.

The CHAIRMAN. Do you feel as though you were sufficiently informed about the manner in which Penn Square Bank was being operated after 1975, when Mr. Jennings returned, until July of this year?

Mr. NORTON. Well, before Mr. Jennings came there it was pretty open, but after he got there, why it was not so open. In other words, he did not explain a lot of things to us.

The CHAIRMAN. Mr. Cravens?

Mr. CRAVENS. Well, I am one of the original directors of the bank and I am speaking more or less for Mead Norton and myself. We are just advisory directors. I have been a nonvoting director since inception, except I was a director until we sold out our interest in 1974, I believe it was, when we sold the majority interest to Jennings' group.

To my knowledge, and I guess I believe that of Mr. Norton, our greatest knowledge was of the early years of the bank, we do not know much about it after it became out of our control. I concur generally with General Randolph and Mr. Cook's comments. I will be happy to answer any questions that the committee may have to the best of my knowledge.

The CHAIRMAN. Dr. Margo, you have been on the board since 1965, is that correct?

Dr. MARGO. Yes, sir.

The CHAIRMAN. I tell you I must compliment you because prior to coming to Congress I did a lot of work with workman's comp with orthopedic surgeons and I have to have orthopedic men because of a back condition and I know how busy you are and the fact that you were able to spend time on the board of this bank I compliment you.

Tell me, do you feel as though the documents and the information provided to you by management of the bank subsequent to 1975 allowed you or gave you sufficient knowledge so that you could in an intelligent and responsible manner carry out your duties as a member of the board of directors of that institution?

Dr. MARGO. Well, at the time I thought I was getting enough information, but all of the information we received was at the board meetings only. It was always recommended to us at the end of the meetings that we not take home any of this information and keep it there in our board manuals, and that seemed reasonable.

And so we very seldom, if ever, had any material to take home and peruse and study.

The CHAIRMAN. For instance, let me ask you this. Did you ever see the management letter from Peat Marwick and Mitchell that cited the fact that a great number of steps should be taken to further improve the institution that was in oh, perhaps mid-1982?

Dr. MARGO. I believe that was in the June meeting and I do not remember having that, no, sir.

The CHAIRMAN. The previous panel told us that it was mentioned in passing, that a synopsis or a summary——

Dr. MARGO. Yes.

The CHAIRMAN. But you never saw the actual letter?

Dr. MARGO. I don't remember seeing it, no, sir.

The CHAIRMAN. The recommendation of the Comptroller's office, you signed the letter of agreement in Dallas, correct?

Dr. MARGO. Yes.

The CHAIRMAN. Did you get a copy of that letter to take home with you—that agreement?

Dr. MARGO. No, sir.

The CHAIRMAN. Did you ask for a copy?

Dr. MARGO. No, sir.

The CHAIRMAN. Would it have been helpful to you to have a copy?

Dr. MARGO. Well, in hindsight it would have been.

The CHAIRMAN. Well, you tell me you never asked for a copy. Tell me why did you not ask for a copy? It is a rather lengthy agreement. Frankly, I have read it a few times and I have a good memory, but a half an hour after I read it I do not remember each and every point in that letter.

Dr. MARGO. I assumed again that it was something that we should not be taking out. It was not public information. Therefore, they did not want it to get out into the public hands.

The CHAIRMAN. Yet you remember the board, you have, you are looked upon as a responsible individual since you are elected to that board. Don't you feel as though you were trustworthy enough to take that material home, and particularly you as a doctor? Just think of the responsibility you have under your Hippocratic oath, right?

Dr. MARGO. Yes, sir. There was only one copy that I know of and to my knowledge none of the members got a copy.

The CHAIRMAN. That is most unfortunate.

Mr. Kimberling, you came on the board in 1981?

Mr. KIMBERLING. In 1963.

The CHAIRMAN. And at that time you were treasurer of the CMI Corp?

Mr. KENWORTHY. That is me.

The CHAIRMAN. Mr. Kenworthy. I am sorry.

So you came on board in August of 1981?

Mr. KENWORTHY. I came on board in September. I was elected in August.

The CHAIRMAN. Your first meeting was September?

Mr. KENWORTHY. That is correct.

The CHAIRMAN. And that was immediately after the July 1981 meeting at the Comptroller in Dallas. Were you told about the bank's problems prior to joining the board?

Mr. KENWORTHY. Yes. I was told that the bank was under a letter agreement and had 10 points and were making progress toward those.

The CHAIRMAN. Who gave you that information?

Mr. KENWORTHY. Eldon Beller.

The CHAIRMAN. By the way, who asked or who was it that invited you to join the board?

Mr. KENWORTHY. Eldon Beller.

The CHAIRMAN. But I have here information that during the board meeting August 11 when Mr. Jennings was recommending your election as director, the minutes state the following: "Jennings repeated Mr. Kenworthy's background. Mr. Beller noted Mr. Kenworthy's knowledge of financial matters would be of special benefit to the board and from the asset and liability side." So you had both of them recommending you, so to speak. You could not miss.

Now you, I think, except for two instances, attended every board meeting from there on, right?

Mr. KENWORTHY. To my knowledge, yes.

The CHAIRMAN. And there were extensive discussions about pass-through loans and overdrafts in those meetings?

Mr. KENWORTHY. Yes, there was.

The CHAIRMAN. The June board meeting—that is the next-to-the-last one before the bank was shut down—you raised questions about the sudden changes and increases in loan loss reserves.

Mr. KENWORTHY. Yes, sir.

The CHAIRMAN. Is that correct?

Mr. KENWORTHY. Yes.

The CHAIRMAN. Would you share with the committee your impressions of the board meetings and the adequacy of the information you received at these meetings?

Mr. KENWORTHY. They were—from the moment I began until the last June meeting the information increased. The directors appeared to discuss the information in greater depth at each board meeting. It was an improving information, to my knowledge.

The CHAIRMAN. You heard me ask Dr. Margo about whether or not that letter of agreement that had been signed—incidentally, it had been entered into even before you went on the board—but when you were told about it.

Mr. KENWORTHY. Yes, it was.

The CHAIRMAN. Did you ever see a copy of that actual letter?

Mr. KENWORTHY. No, sir.

The CHAIRMAN. Did you ever ask to see a copy?

Mr. KENWORTHY. No, sir.

The CHAIRMAN. Would it have been helpful to you to see a copy, or to have a copy, so that you knew which direction the institution was taking, whether they were complying with the requirements of the Comptroller?

Mr. KENWORTHY. It was my understanding that that was the blueprint for Mr. Beller to work against in the bank. It was also my understanding that they were making progress against that letter.

The CHAIRMAN. The minutes reflected both you and your company, CMI, were borrowers at the bank. Could you tell us the status of your loans? Were any of them participated out or did they stay with Penn Square?

Mr. KENWORTHY. Personal loans or CMI?

The CHAIRMAN. The CMI loans.

Mr. KENWORTHY. The CMI loans, they are both—both in the bank and participated out.

The CHAIRMAN. What committees of the board did you serve on?

Mr. KENWORTHY. I was elected to the audit committee this year in March.

The CHAIRMAN. How about the ethics committee? Were you ever on the ethics committee?

Mr. KENWORTHY. No, sir.

The CHAIRMAN. Was anybody on this panel ever on the ethics committee?

Mr. KENWORTHY. No, sir.

The CHAIRMAN. Did anybody on this panel—were they ever aware of the existence of an ethics committee?

Mr. KENWORTHY. Only as it was mentioned.

The CHAIRMAN. As it was mentioned earlier this morning?

Mr. KENWORTHY. Yes, sir.

The CHAIRMAN. Mr. Kimberling, you have been a director since 1963?

Mr. KIMBERLING. Yes.

The CHAIRMAN. And do you have stock holdings in either Penn Square Bank or the holding company, the parent holding company, First Penn?

Mr. KIMBERLING. Yes.

The CHAIRMAN. And would you describe those for us?

Mr. KIMBERLING. I have 450 shares of stock, I believe, in the holding company.

The CHAIRMAN. And in the bank itself?

Mr. KIMBERLING. None.

The CHAIRMAN. Are you involved in the partnership that is still in the Penn Bank Tower?

Mr. KIMBERLING. No, sir.

The CHAIRMAN. Do you have any relationship with Kimberling's Inc., a supermarket concern?

Mr. KIMBERLING. My son is the operator of those and I have some interest in them.

The CHAIRMAN. Do you have any personal loan from Penn Square Bank?

Mr. KIMBERLING. No, sir.

The CHAIRMAN. Do you know if Kimberling's Inc., the supermarket chain, does?

Mr. KIMBERLING. Yes. They have one loan.

The CHAIRMAN. Are there any loans to any partnerships that you are a part of or have an interest in with Penn Square Bank?

Mr. KIMBERLING. Only the supermarket loan.

The CHAIRMAN. Do you know what the status of that loan is?

Mr. KIMBERLING. It is current.

The CHAIRMAN. You have faith in your son?

Mr. KIMBERLING. Yes, sir.

The CHAIRMAN. OK. On June 15, 1982, meeting, however, the minutes state that you were not at this meeting. Mr. Murphy commented on Kimberling's loan, 15-0055, noting he expects its overdraft to be cleared in a week or 10 days. Do you have any familiarity with that?

Mr. KIMBERLING. Yes, sir. The reason it was an overdraft, we were in the process of selling a supermarket and it did not go as soon as we thought. And so we made some—paid some bills to shake the deal.

The CHAIRMAN. Selling anything at this point in our economy is difficult.

Lastly, Mr. Kimberling, did you or any company you are involved in make any large withdrawals in the last few weeks prior to the demise of this institution?

Mr. KIMBERLING. No, sir.

The CHAIRMAN. And lastly, Mr. Burks, would you be good enough to tell the committee a little bit about your background and business background?

Mr. BURKS. I went to Stanford University and graduated from Harvard Business School and have spent the major portion of my business career in real estate activities, primarily in regard to the financial aspects of the real estate practice.

The CHAIRMAN. Now when did you become a director of Penn Square?

Mr. BURKS. In February 1980.

The CHAIRMAN. February 1980?

Mr. BURKS. Yes.

The CHAIRMAN. And do you have any interest in any of the corporations or partnerships involved in the construction of the building that was to be named Penn Bank Tower?

Mr. BURKS. Yes, I did.

The CHAIRMAN. Could you describe that for us?

Mr. BURKS. I would be happy to. I am the general partner of a limited partnership which is entitled "Penn Bank Tower Investors." This partnership contributed some $4.6 million toward the equity of the construction of the Penn Bank Tower Building.

The basic structure of the transaction was based on the $4.6 million equity contributed by the limited partner and the general partners and some $32 million of construction financing provided by Seattle First National Bank. The composition of the limited partnership was such that to the extent that a tenant in the building would occupy space in the building then he would have a right to participate to the extent of having to come up with his percentage of the equity required, his percentage of the loan guarantee that Seattle First and, of course, his lease in the building.

The CHAIRMAN. This is somewhat almost akin to a condo-type?

Mr. BURKS. It really is. That really was the kind of concept. For instance, if—I have precise numbers for you which I could give you, but just in terms of round numbers for simplification, one floor of the building approximated approximately 5 percent of the space of the building. The building was 22 stories, 300,000 square feet.

So that if an individual signed a lease for one floor, for 12,000 square feet, they would have had to come up with approximately 5 percent of the $4.6 million in equity, which would have been approximately a quarter of a million dollars. They would have to have personally guaranteed 150 percent of their pro rata share of the construction loan.

So, let's say, here is this hypothetical tenant that is leasing a floor which approximates 5 percent of the building and he would have had to have guaranteed 7½ percent or 150 percent of his pro rata share. He would have had to have guaranteed 7½ percent of the $32 million construction loan personally.

In addition, he would have had to have personally guaranteed the lease, which was a 10-year lease. All the leases in the building were the same, with the exception of the bank's. The bank's space was—the bank's lease was 20 years, and all other tenants were 10. So that individual who was signing the lease was on the hook for essentially— if a floor, using round numbers again, if a floor leased for $20 a square foot and it comprised 12,000 square feet, that would a quarter of a million dollars a year in lease payments, and it was a 10-year lease with the rent escalating 5 percent a year.

But even if it did not, the individual would be responsible for some, in excess of $2.5 million in lease payments over the term.

The CHAIRMAN. Let me ask you this and see if I understand this correctly. Who is the general partner?

Mr. BURKS. If I could, I am the general partner.

The CHAIRMAN. That means that no matter what happens with the Penn Square Bank, you are still on the line as the general partner.

Mr. BURKS. That is correct.

The CHAIRMAN. As I think most of us here understand what a general partner is and limited partners and the liabilities that accrue to the general as opposed to some of the limited partners, so that the failure of Penn Square Bank does not inure to or enhance your position as a general partner. In fact, I do not think I envy you very much.

Mr. BURKS. Well, I think on the basis of the number of telephone calls that I have received from people who want to buy the building, they seem to infer that I am in somewhat precarious position.

The CHAIRMAN. Well, I hope you get your price. [Laughter.]

Let me ask you this. You attended quite a few of the meetings.

Mr. BURKS. Yes.

The CHAIRMAN. And as a matter of fact you did attend the 1981 and 1982 meetings at the Comptroller's Office in Dallas.

Mr. BURKS. Yes, sir.

The CHAIRMAN. How about giving us, as a fellow New England student—I did not get to Harvard, but I got to Boston University.

Mr. BURKS. I understood you were in the neighborhood.

The CHAIRMAN. As a neighborhood boy who has done well, you, Mr. Burks, what is your impression? Do you feel you were getting adequate information from the Comptroller's Office and that you were kept fully informed by management of what was occurring at Penn Square Bank?

Mr. BURKS. That is two questions. Let me try and answer the first one. Let me start out by saying that prior to 1980 I had never served on a board of directors of a bank and so had no real standard of comparision with what kinds of information a person should get and should not get.

And I was obviously coming on the board in February 1980 and going down to Dallas that summer. Things were already in motion. To be honest, I never questioned the fact of the amount of information that the Comptroller should be providing the bank directors.

I did feel, frankly, that the summer meeting with the Comptroller, I reviewed my notes of that meeting. I took fairly specific notes at that meeting and time and again Mr. Poole reiterated that the real problem with Penn Square Bank was the growth of the bank and the capital and that in fact if it were not for the issue of adequate capital within the bank that the bank would not have been placed in the special projects area. And, as a matter of fact, my notes indicate Mr. Poole mentioned that three different times during the course of that meeting.

So I left the meeting very concerned about the direction of the bank and the situation in which we found ourselves and the high growth rate. Very frankly, the energy industry in Oklahoma and the economy in Oklahoma up until very recently has been going at a fairly rapid rate compared to other areas of the country and so while we were concerned about the level of growth, we felt like it was somewhat symptomatic of the economy in which we were operating.

And in the summer meeting of 1981 I would say really the only thing that I would disagree with in terms of any of the outside directors that made any comments prior to, in the group prior to us, was just one slight remark that was made as to the summer of 1981 meeting being very harsh. I understand that the minutes reflect that Mr. Poole was very harsh with the board.

But I came away from that meeting with a very good attitude and feeling about their confidence and knowledge of Mr. Beller and Mr. Preston, who they had known for some time. So I had a high degree of confidence.

In regard to the amount of management information that we received as directors, once again I really was not aware of what a bank director should be receiving. As several people have pointed out, I was—I really did not like the situation of not being able to—of always keeping the bank information at the bank. It is very difficult to have information presented to you and then taken away and you never see it again.

But I feel like and felt like that the reports that management provided, especially after Mr. Beller came, that there was a high degree of confidence on the part of the board of directors that we relied on Mr. Beller's background and experience. We relied on his commitment to be tough and to be strong and to bring areas that had been uncontrolled to bring them under control. And there was a high degree of comfort.

The CHAIRMAN. Now were you aware of the fact that Mr. Beller was doing his utmost but that he had his hands tied behind his back? I do not know if you were here earlier today, were you, when he cited——

Mr. BURKS. That comment of Mr. Beller's came as great a shock to me as it did to the previous outside directors that were on this panel and, I would imagine, as it did to the people that sit at this table right now.

The CHAIRMAN. As a matter of fact, would it not be rather difficult to really do things in that institution when you are hamstrung in that manner and a major portion of that portfolio you are not allowed to touch, so to speak?

Mr. BURKS. It would be very difficult.

The CHAIRMAN. Very difficult.

Incidentally, I would point out to you that there is a booklet, and there are quite a few of them out there, an official booklet, some put out by the Federal Reserve Board, some by the regulatory agencies, this by a former Chairman of the FDIC, Mr. Robert Barnett—"Responsibilities and Liabilities of Bank Directors." It is a very tiny book, $8.50. I will admit it is expensive. It was published in 1980 and I do not get a profit out of it. I am not trying to sell it.

But there are publications available from the regulatory agencies as well that perhaps you might get for nothing, but they do outline the responsibilities and liabilities of bank directors, and I think it would be very helpful and I wish that more—how many of you here are aware of the fact that these are available to you?

[A show of hands.]

The CHAIRMAN. All right, you are all aware of it? Swell. I am really not trying to sell this, really and truly.

Mr. Burks, are you involved in various other enterprises other than Penn Square or in partnerships or in companies in which you are a stockholder or director, where other officers of Penn Square or directors of Penn Square are also involved?

Mr. BURKS. I am involved in four different partnerships, of which the Penn Bank Towers is one partnership. There are three other partnerships of which I am the general partner and in which there are limited partners, of which there are Penn Square Bank directors and officers involved as limited partners.

The CHAIRMAN. Is Mr. Jennings involved in some of these?

Mr. BURKS. Yes, he is.

The CHAIRMAN. What type of businesses are those? You are talking about three other partnerships?

Mr. BURKS. Those businesses are three hotels with one partnership, also owning real estate and previously owned an office building that we sold a couple of years ago.

The CHAIRMAN. Mr. Leach.

Mr. LEACH. Thank you, Mr. Chairman.

Mr. Murphy, when you were president of the bank, did you also have authority as either chief executive officer or chief administrative officer? Would you describe your functions the same way as Mr. Beller described his, or were they very different?

Mr. MURPHY. During which period, sir—the 1964 to 1965 or after 1975?

Mr. LEACH. Please begin with the first period.

Mr. MURPHY. I was the chief executive officer and chief administrative officer from, say, 1965 to 1975. After 1975 Mr. Jennings was chief executive officer. I was chief administrative officer. I saw that on a call report one day. I did not know I had been appointed that.

Mr. LEACH. Were you as surprised as the rest of the directors at the reading of the various duties of the president as compared to the head of the petroleum division and the chairman of the board?

Mr. MURPHY. I certainly was, yes.

Mr. LEACH. Have you ever known of a bank structured that way, where the president had such a limited role?

Mr. MURPHY. Well, I operated that way for a while, yes. I must says in other banks I do not know, sir.

Mr. LEACH. Mr. Burks, you stated that the chief problem of the bank was lack of capital and too much growth, but Mr. Conover, head of the Comptroller's Office, testified before us in Washington several weeks ago, that the bank was repeatedly warned of illegal banking activities. Was this board ever informed of the fact that illegal practices—by illegal I mean violations of the banking law—were occurring?

Mr. BURKS. We were informed that there were some violations of the law at the summer of 1980 meeting, and I was extremely shocked that a bank upon which I was a member of the board of directors had violated any law.

Mr. LEACH. It is one thing to say abstractly we are dealing with a problem of a lot of growth and not quite enough capital. Many good companies as well as good banks in America deal with that problem all the time. In fact, I cannot think of a company that says it has too much capital. But there is a distinction between a problem that is abstract, that is dealt with in the Harvard Business School case study method all the time and a corporation in which the U.S. Government tells the board of directors that violations of law are occurring. I am just wondering how seriously the board of directors took those descriptions.

Mr. BURKS. I took that comment very seriously and it disturbed me a great deal and I did not mean to minimize the violations of the law that Mr. Poole cited that day. I merely meant to indicate, which my notes reflect, that Mr. Poole said that the Penn Square Bank would not be under the administrative letter if it were not for the single issue of capital.

Mr. LEACH. I appreciate that and I do not want to stress it too much. Frankly, I think that in terms of the outside directors we are perhaps spending more time than we need to, Mr. Chairman. It is the inside directors who I think will provide the most interesting insights into this problem. I suspect many of you outside directors are going to be embarrassed as to your pocketbooks and some perhaps as to your judgment, but I doubt very much if many of you will suffer any embarrassment to your reputation.

I think it should be stressed that when something goes wrong, a lot of very good and very decent and very reasonable people get tainted. In this case, it appears that the vast majority of people should suffer no damage to their reputations in a situation which frankly, has upset the Nation's whole banking system. While there is some suggestion of less than perfect ethical behavior on the part of some insiders, that certainly does not apply to the vast majority of those associated with this bank.

The CHAIRMAN. Mr. Annunzio?

Mr. ANNUNZIO. Thank you, Mr. Chairman.

I do not have any questions. I do not want to go over the same ground that we have been over. I look at the witness list and we are only about halfway, but just one comment.

I take it that after listening to the panel, the last group of directors—outside directors—and this panel, I just get this feeling that some of you or most of you think that the closing of the Penn Square Bank was a mistake by the Comptroller of the Currency, that things were really not as bad as the Comptroller pictured them to be, and that this is similar to an "Alice in Wonderland" story, despite the fact that millions and millions of dollars were lost and the Comptroller warned about the $41 million and a couple of directors here that lost a couple of million dollars and hundreds of thousands of dollars and bad loans all around the country.

How many of you feel that the Comptroller made a mistake when he closed the bank?

Mr. MURPHY. Sir, with the information I had on July 1—I was out of town that week and was called back in—at the meeting on July 1, when the cease-and-desist order was issued, the requirement of $30 million in capital given until July 9, the loan losses as shown at that time, which in my opinion some of them are not losses—that is a personal opinion—I, from that, what happened after that, I do not know. I left town again and came back in and heard it on the news—the 10 o'clock news July 5.

I was shocked, of course.

Mr. ANNUNZIO. That is why I detect this, Mr. Murphy. That is the reason I detect this feeling all morning that nobody knew what was going on.

Mr. MURPHY. Unless there is a lot of changes between the first and when the decision was made, which I am not aware of, it should not have been closed. The shareholders should have been given the opportunity to raise the capital and change management if they wanted to—fire Frank Murphy or some of the others. That would be fine.

But I do not think—to save the bank I do not think an effort was made to try to save it. That is my personal opinion, sir.

Mr. ANNUNZIO. Were there any other comments? Let's get this thing out in the open.

Mr. STUBBS. I think we definitely needed to have an effort to save the bank and I think there were commitments already made to cover the—cover $40 million instead of $30 million. I lost $800,000 in that bank myself and I had all the faith that we could keep it going.

Mr. ANNUNZIO. How much worse would it have been, Mr. Stubbs, if you got rid of Mr. Patterson and Mr. Jennings and the bank had remained open? The Comptroller, after all, could have recommended that both of these gentlemen get out. How much worse could it have been?

Mr. STUBBS. It could not have been this bad. [Laughter.] [Applause.]

Mr. ANNUNZIO. Anybody else? Mr. Burks?

Mr. BURKS. One of the things that I still cannot understand is the reason why.

Mr. ANNUNZIO. Let's get it out. That is right.

Mr. BURKS. Why the Comptroller did not make some of the information available to management. I do not understand why the Comptroller did not have some conversations with the Federal Reserve before this took place.

I read in the testimony before your committee that it came as a surprise during the last week or so. Just 2 or 3 days before the bank was closed the Comptroller found out that there were 150 credit unions that had $250 million in Penn Square Bank. I think the ramifications of the decision that the Comptroller of the Currency made, I think it would be very interesting to have those exposed to the light of day.

Mr. ANNUNZIO. You know, Mr. Burks, when he appeared before the committee I asked him if he knew of any banks that were going to close on the weekend, and our hearings were on, I think it was on a Thursday. So the weekend was coming. I said can you give me some advance information? Are you going to close any banks? And he did not know of any. But a few days later I read in the Wall Street Journal—that is how I got my information, and I am a senior member of the House Banking, Finance and Urban Affairs Committee—that he closed a bank in Abilene.

Mr. BARNARD. That was an aberration. [Laughter.]

Mr. ANNUNZIO. Right. But the point I wanted to make here was they pumped in a lot of money at Abilene and kept it open.

Mr. BURKS. We were prepared to do that here in Oklahoma City as well.

Mr. STUBBS. We were going to do it with private capital. They got the FDIC loan. We were going to do it with private capital.

Mr. ANNUNZIO. Thank you.

The CHAIRMAN. Mr. Weber.

Mr. WEBER. To the best of your recollection, was there ever an occurrence where the chairman or anyone else on the management team suggested that the board would voluntarily declare the bank insolvent?

Dr. MARGO. No.

Mr. KIMBERLING. No.

Mr. WEBER. There was never any discussion about that possibility?

Mr. KIMBERLING. No.

Dr. MARGO. No.

Mr. MURPHY. No.

Mr. BURKS. My memory escapes me exactly, but on the afternoon of the 4th, Mr. Jennings made a statement to the board that based on certain events that had taken place he had thought that the bank was technically—and I am not sure what the definition of "technically solvent" or "technically insolvent" is—but said that the law was such that it was his responsibility to notify the Comptroller of the Currency at such time that he thought that the bank was insolvent.

He advised certain people—and it was in a board room and some of the board had come and gone; it was not like the board was in session all day long. I happened to be at the bank that entire day and certain people had come and gone, but he came in and said it is my belief, based upon the information that we have because of all of the publicity in the newspapers and in the media, that there was a run, that there was in fact a run on the bank and that it was his opinion that the bank was probably technically insolvent and that it was his responsibility to notify the Comptroller.

Now I am just telling you what I heard. Mr. Jennings was gone for 30 or 45 minutes meeting with a representative of the Comptroller's office, and to the best of my knowledge came back to the room and said the Comptroller does not accept our position, that the bank is insolvent. It is the Comptroller's position that the bank is solvent and that the Federal Reserve is willing to lend up to $27 million to protect a run on the bank, and that the bank will be open for business on Tuesday.

Mr. WEBER. What day was that? Do you have any idea?

Mr. BURKS. That was Friday.

Mr. WEBER. Which would have been July 2?

Mr. BURKS. Yes, sir.

Mr. WEBER. And was that an official meeting of the board of directors?

Mr. BURKS. I can't really tell you. There were certain of the directors that were around the bank. The meeting started at 8 in the morning, as I recall, and certain people came and left. As I recall, that was midafternoon or so.

I had a subsequent conversation later that afternoon with a gentleman who, I believe, was the chief lending officer of the Federal Reserve, who advised me that the Federal Reserve was in fact going to support Penn Square Bank and I walked him to his car as he was racing to the airport, and we shook hands and he said he would see me next week. And I said I look forward to seeing you, with the thought that Penn Square would open on Tuesday morning.

Mr. WEBER. I believe that the chronology is that on that same day the OCC sent a letter to the FDIC formally requesting assessment of the prospect for an FDIC-assisted transaction and merger or something of that kind. And then it was on July 5, 1982, that the Federal Reserve Bank of Kansas City indicated that it was not prepared to extend further credit, and that was the day that the insolvency was declared.

Mr. BURKS. I am not sure I understand the disagreement in fact.

Mr. WEBER. I am not saying I disagree with anything you are saying at all. I do not want to recount the statement that I made to the earlier panel, but it does seem to me that we have got a failure, a problem of trust, I guess—who trusts whom.

You are being charged as a board of directors with the failure to exercise your powers as directors who control the operations of this bank. You were relying upon the officers to get that job done. I believe probably the officers were a major part of the problem. You signed an agreement—and I guess most of you were signatories to the formal agreement dated September 9, 1980. Are there any that were not on the board at that time?

Mr. KENWORTHY. I was not.

Mr. WEBER. Mr. Kenworthy, you were not a signatory, but were aware of it when you came on the board later.

One of the provisions of that agreement was not to grant additional loans unless current and satisfactory credit information was available and the loans were supported by appropriate collateral documentation.

One of the other points of that agreement was to revise the lending policy and establish procedures to monitor and enforce adherence and, very frankly, in October of 1981 the Comptroller of the Currency, as a result of its examinations, thought the bank was on the right road to correcting or to putting corrective procedures into practice. After having given the board great warnings—at two of the directors' meetings at least—they felt that you were on the right road.

I think the board felt it was on the right road to correcting the situation. You were relying on the officers, Mr. Beller and Mr. Jennings and Mr. Patterson. Mr. Beller tells us in effect this morning that he was relying upon Mr. Jennings and Mr. Patterson.

And I think that what needed to be done was to put into place some procedure for an independent review of the actions of the officers by a committee of the board of directors or agents that reported to the board of directors and had the power to review and control the actions of the officers specifically and could override the officers' actions in that way.

Apparently there was no such procedure. Am I correct that you had no independent group that was overriding the decisions of the officers? I guess I do not have any further questions.

The CHAIRMAN. Thank you.

Mr. Burks, since you were asked to bring certain documents with you today, are the documents that we requested available?

Mr. BURKS. Yes, sir, they are.

The CHAIRMAN. Would you be good enough to provide them to the committee at the conclusion of your testimony? Well, we will take them now. Thank you for your cooperation.

Prior to going to my colleagues, one question. The previous panel, we went back and forth on this. Now I am informed and I would like to ask this panel—I am informed that when a copy of the examiner's report was sent to the bank there is a signature sheet attached and it is the duty of each director to review the examination report and to sign the sheet attesting to his or her review. The examiners then check that signature sheet at the next exam.

Mr. Stubbs, have you signed the signature sheet on the examiner's report?

Mr. STUBBS. I think, if I recall correctly, that the examination would be reviewed at the board and passed around and everybody sign it.

The CHAIRMAN. And then everybody would sign the signature sheet to the effect that they had either reviewed or had reviewed for them?

Mr. STUBBS. It was reviewed for us.

97-830 O - 82 - 15

The CHAIRMAN. By management?

Mr. STUBBS. By management and then passed around and we signed it.

The CHAIRMAN. In other words, management told you what they wanted you to know about the examiner's report? Let's be honest now, Mr. Stubbs.

Mr. STUBBS. I never ever read the report.

The CHAIRMAN. You were told what they wanted to tell you about it, right? I mean, you are a $700,000 or $800,000 loser in this situation.

Mr. STUBBS. More than that.

The CHAIRMAN. Do you think maybe you should have read those reports rather than have them just summarized for you?

Mr. STUBBS. Maybe I am easier to con than Continental is. I do not know. [Laughter.]

The CHAIRMAN. You have got some sense of humor, taking the bath that you took, if you can still laugh about it.

Mr. STUBBS. I would rather laugh than cry.

Mr. ANNUNZIO. You know, in Congress we have a procedure known as the signing of a conference report that is passed around for all the members of the conference; and 80 percent do not know what is in that conference report.

Mr. BARNARD. Frank, don't tell it all. [Laughter.]

Mr. ANNUNZIO. Don't feel so bad.

Mr. STUBBS. Thank you, sir.

The CHAIRMAN. I assure you that there are very few Members of Congress who have lost the kind of money you have lost for not reading a conference report.

Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. Cravens, you and Mr. Norton are indicated as advisory board members. Why is that so?

Mr. CRAVENS. Well, it is automatic when you are 70. That is in the bylaws.

Mr. BARNARD. You do not have the same function and responsibilities as the other directors?

Mr. CRAVENS. We have no vote, no.

The CHAIRMAN. They do not get paid, either.

Mr. BARNARD. I would doubt that, Mr. Chairman.

Mr. Cravens, I know you are speaking somewhat for Mr. Norton. Your membership on the board dates back to what date?

Mr. CRAVENS. I was one of the original organizers of the bank.

Mr. BARNARD. One of the original organizers. Then I think that you and Mr. Norton and Mr. Murphy, your membership is dated back to the early 1960's, right?

Mr. MURPHY. I joined the bank in January 1961, sir, and became a board member in 1964, I believe it was.

Mr. BARNARD. Mr. Stubbs, I believe you were an early member of the board.

Mr. STUBBS. Frank came on in 1963 and I came on in 1964.

Mr. BARNARD. Did it disturb you gentlemen that after the change in organization in 1975 there was a change in modus operandi of the bank?

Mr. CRAVENS. Well, I thought there was a very enthusiastic bunch in trying to do something.
Mr. BARNARD. You did not question at all the thrust of the new enthusiastic bunch?
Mr. CRAVENS. Well, I kind of figured I was a little old fashioned.
Mr. BARNARD. Do you still feel that way about it?
Mr. CRAVENS. That I was not keeping up with the modern times.
Mr. BARNARD. But you felt that it was worth a go, right?
Mr. CRAVENS. Well, I do not know. I lost about a half a million in it too.
Mr. BARNARD. That is hindsight, isn't it. What about you, Mr. Murphy? Did you express any dissent about the new thrust of the management?
Mr. MURPHY. I say dissent? No; I cannot say I dissented, sir. Previously I was more conservative.
Mr. BARNARD. Well, hadn't this modus operandi been considerably different than the previous operation of the bank?
Mr. MURPHY. More aggressive, yes, sir.
Mr. BARNARD. Well, did you consider the concentration of loans that was developed? Did you think that was healthy for the bank?
Mr. MURPHY. Concentration with proper loans I felt would be healthy.
Mr. BARNARD. What about the lack of diversity?
Mr. MURPHY. It depends upon which area you are in. When real estate is up, you should be in real estate, and I am not saying 100 percent.
Mr. BARNARD. Do you remember the experience that some great banks had in the country during the era of REIT's?
Mr. MURPHY. Yes, sir, I sure do.
Mr. BARNARD. Wasn't that a problem of concentration and not being aware of the marketplace?
Mr. MURPHY. Yes, it was.
Mr. BARNARD. Would you go so far as to say that it is an example of poor bank management to concentrate in one particular area of loans?
Mr. MURPHY. Well, I personally would not dwell on that. I never did. But I did accept the philosophy—Mr. Jennings being from Oil Patch and all—and I had confidence that he knew what he was doing, sir.
Mr. BARNARD. Mr. Stubbs, you and Mr. Kimberling, how did you feel about this change in direction of the bank?
Mr. STUBBS. I was not adverse to oil. I was strictly real estate and I did not feel qualified to express myself on it. The profits looked great and the interest rates were high and nobody could afford to pay the interest rates but the oilers anyhow. I thought we were dropping a little too much real estate myself.
Mr. BARNARD. Let me ask Mr. Burks, was the board brought up to date from time to time as to how active brokers were in finding deposits for the institution?
Mr. CRAVENS. No, sir.
Mr. BURKS. I was never aware that the bank utilized brokers.
Mr. CRAVENS. We never heard that.
Mr. BARNARD. And yet they were paying brokers 100 or 200 basis points for deposits brought into the bank. From time to time were

you able to see the makeup of deposits such as the concentration of credit union deposits in the bank?

Mr. BURKS. Absolutely not.

Mr. BARNARD. Did any of you on the board except Mr. Murphy—I presume you knew about the brokers' activities.

Mr. MURPHY. I knew that. Yes, sir.

Mr. BARNARD. Did any of the other members of the board understand how broker deposits functioned?

Mr. STUBBS. No.

Mr. BARNARD. They are very expensive, you know—very expensive deposits to bring in.

Mr. Chairman, I have no further questions.

The CHAIRMAN. Mr. Wortley.

Mr. WORTLEY. Thank you, Mr. Chairman.

Mr. Murphy, just for the record, what is the fee for a director's meeting?

Mr. MURPHY. $400 a meeting if you attend.

Mr. WORTLEY. $400 a meeting.

Mr. MURPHY. Yes, sir.

Mr. WORTLEY. That is about the same fee which prevails all over Oklahoma City area in other banks?

Mr. MURPHY. I have no idea, sir.

Mr. WORTLEY. Mr. Burks, I wonder if you could straighten me out on some information I have here. According to some annual reports you had a number of interests with Bill Jennings and Carl Swan—for instance, First Penn Corp. You owned about 5.9 percent and Jennings owned 26.7 percent and Swan 7.6 percent.

Peachtree Hospitalities—you seem to be equal partners, the three of you—Jennings, Swan, and yourself had one-third interest. The Chi-Chi property in Atlanta, at least at one time you owned about 11 percent and Mr. Jennings around 25 percent and Mr. Swan 21 percent.

What is this Skirvin Plaza Investors? You had a 1 percent interest and Mr. Jennings had about 16 percent; and Copeland Energy you owned about 5 percent and Mr. Swan about 23 percent; and Northwest Investors you owned around 23 percent-plus and Mr. Jennings about 15 percent.

Would these be reasonably close figures as to common endeavors that you shared with these other gentlemen?

Mr. BURKS. Yes, sir. Those are reasonably close percentages.

Mr. WORTLEY. I would imagine that those various business endeavors did some of their banking at least with Penn Square. Would it be safe to say?

Mr. BURKS. To the best of my knowledge, Mr. Wortley, the amount of business that was done with Penn Square was very, very minor and I would be happy to go down with you, if you would like, the list of each one of those entities and describe the financial relationships, if you would like.

But from the time I went on the board of directors it was a personal policy of mine to limit the amount of business that I did with Penn Square Bank to the absolute minimum and my major bank is another bank here in Oklahoma City.

The CHAIRMAN. Would the gentleman yield on that?

Mr. WORTLEY. Yes.

The CHAIRMAN. By investment are you talking about shares of stock in the bank or the holding company?

Mr. BURKS. Yes, sir.

The CHAIRMAN. Did you also have deposits in Penn Square at the time?

Mr. BURKS. Yes, sir.

The CHAIRMAN. How did you do?

Mr. BURKS. Well, I don't know whether it is good or bad, but I was not in the position to have lost the amount of money that some people did, but we had two different accounts which exceeded $100,000.

The CHAIRMAN. All of those records are available to us. Did you or any of your—do you mind, George?

Mr. WORTLEY. Go right ahead, Mr. Chairman.

The CHAIRMAN. Did you or any of your businesses have any deposits in Penn Square that were removed within the last 4 or 5 days?

Mr. BURKS. No, sir.

The CHAIRMAN. You were not one of those lucky ones who had the benefit of the unnamed financial consultant?

Mr. BURKS. I personally deposited $80,000 in Penn Square Bank on Wednesday or Thursday of the week before it closed.

The CHAIRMAN. Was that a brand new account?

Mr. BURKS. No, it was an account that I had maintained. While it was an account that—it was one of my company accounts—I did maintain a number of business accounts at Penn Square Bank. But, as I said, my borrowings at the bank were very, very modest.

The CHAIRMAN. But the point is that you lost too.

Mr. BURKS. A great deal.

The CHAIRMAN. That does not help the others who lost.

Mr. BURKS. Misery loves company, I guess.

Mr. WORTLEY. Thank you, Mr. Burks, for your very forthright answers.

Mr. BURKS. You are welcome.

Mr. ANNUNZIO. Mr. Chairman, could I ask each of the witnesses one question with a yes or no answer?

Mr. Stubbs, could the bank have been saved, yes or no?

Mr. STUBBS. Yes.

Mr. ANNUNZIO. Mr. Kimberling?

Mr. KIMBERLING. I believe so, yes.

Mr. ANNUNZIO. Dr. Margo?

Dr. MARGO. I am not sure. I was not there at the last two meetings.

Mr. ANNUNZIO. Mr. Murphy?

Mr. MURPHY. From the information I had, yes.

Mr. ANNUNZIO. Mr. Burks?

Mr. BURKS. I have no knowledge of the information that the Comptroller had at his fingertips in making the determination that the loan losses were $50 million. I do know that that figure, as late as 2 or 3 days before the bank closed, was as low as $22 and the number was bouncing around like a ping-pong ball.

Mr. ANNUNZIO. Mr. Kenworthy?

Mr. KENWORTHY. I have no knowledge.

Mr. ANNUNZIO. Just your opinion.

The CHAIRMAN. Is what you are saying that once you went on the board that rather than borrow from Penn Square, either yourself or the partnerships in which you are involved, you went to other institutions? You were better off avoiding any conflicts?

Mr. BURKS. Yes, sir.

The CHAIRMAN. Is it safe to assume that your involvement—because I had the same questions—that as far as borrowing from Penn Square are concerned they were de minimus? You provided us with volumes of documentation.

Mr. BURKS. I would be more than happy to provide you with detailed information, but it certainly is my position that my borrowings with Penn Square were very negligible.

Mr. WORTLEY. Your personal borrowings or the borrowings of these institutions I just recited?

Mr. BURKS. Both.

Mr. WORTLEY. In other words, are you also saying that those institutions never borrowed any money from Penn Square Bank?

Mr. BURKS. As I said before, I would be delighted to give you a detailed description. I would not want to say never, but I can tell you that it is very minimal and I will be happy to provide as detailed an information as this committee would like.

Mr. WORTLEY. Maybe just a bottom line item, if I could ask you. At the time Penn Square was closed, did any of these organizations I just mentioned owe any money to Penn Square Bank?

Mr. BURKS. One company, called Copeland Energy, of which I was a very small investor, I am not sure even what their borrowings were with the Penn Square Bank, so I would hate to make any—I do know that they borrowed from a correspondent. Northwest Investors had no borrowings, had their borrowings from Liberty National Bank. Skirvin Plaza Hotel had $110,000 laundry lease with the Penn Square Bank, which was at a market rate and which I was asked to give— I have got $10 million of financing on the Skirvin Plaza Hotel and $110,000 at Penn Square Bank.

I have got $10 million of financing at Northwest Investors and virtually none at Penn Square Bank.

So they are modest numbers.

Mr. WORTLEY. Do you think that business relationships that you may have enjoyed with Mr. Jennings and Mr. Swan in any way might have impaired your ability to exercise some independent judgment as an outside director of the Penn Square Bank?

Mr. BURKS. Well, let me speak to that question. You indicated two individuals and I would like to speak to the two individuals as opposed to just one question.

Mr. Swan has had a long relationship with Mr. Jennings and so anything that I was involved in with Mr. Swan was a result of his close and long-term friendship with Mr. Jennings, and any of my investments with Mr. Swan were extremely minor, as I think the information that I have provided you will show.

In regard to my ability to be an objective director of the Penn Square Bank, I think the record will show that I had more money invested in Penn Square Bank than Mr. Jennings had invested in any of my real estate projects of which he was a limited partner. I believe that I was able to indicate to him total objectivity.

Mr. KENWORTHY. I have no opinion.
Mr. ANNUNZIO. Mr. Cravens?
Mr. CRAVENS. I do not have an opinion.
Mr. ANNUNZIO. Mr. Norton?
Mr. NORTON. No opinion.
Mr. ANNUNZIO. Thank you, Mr. Chairman.

The CHAIRMAN. I want to thank all of you for assisting us here today. And for those who suffered such losses, it is not easy, and unfortunately it is part of the process. And your presence here and your assistance has been deeply appreciated. Thank you.

Now we will ask Jim Blanton, the managing partner, and Dean York, engagement partner of Peat Marwick and Mitchell, to please join us.

[Witnesses sworn.]

TESTIMONY OF JIM BLANTON, MANAGING PARTNER, AND DEAN YORK, ENGAGEMENT PARTNER, PEAT, MARWICK, MITCHELL & CO., OKLAHOMA CITY, OKLA.

The CHAIRMAN. Mr. Blanton and Mr. York, we want to thank you for your appearance here today. We would like to inform the committee or remind them of the fact that a friendly subpena was issued to these gentlemen to appear. They have, however, indeed been most cooperative. They have submitted a statement that I would like to place in the record at this point. If there is no objection, we will put your entire statement in the record at this point.

[The statement submitted for the record follows:]

Statement by James D. Blanton, Managing Partner, Peat, Marwick, Mitchell & Co., Oklahoma City, Okla., August 16, 1982

Mr. Chairman and Members of the Committee:

I am James Blanton, managing partner of the Oklahoma City office of Peat, Marwick, Mitchell & Co. I served as our firm's partner in overall charge of our relationship with First Penn Corporation and its subsidiaries, principal of which was Penn Square Bank. With me today is one of our partners, Dean York, who was in charge of our 1981 audit of First Penn Corporation and Penn Square.

With banks as with all clients, the code of ethics governing our profession dictates that we not discuss publicly confidential client matters. We are able, however, to discuss Penn Square with you today because we appear pursuant to your subpoena.

Your staff asked that we provide a chronology of our relationship with the Bank, a relationship which began ten months ago. This statement reviews that chronology in brief.

Penn Square Retention of Peat Marwick

During the Spring of 1981, the Bank hired several new senior executives. We were later to learn that recruitment of new management talent was a part of the Bank's response to the critical findings of the Office of the Comptroller of the Currency during prior examinations of the Bank.

Certain of the new senior officers who joined in 1981 -- including Mr. Eldon Beller, as President and Chief Administrative Officer -- came to Penn Square as experienced bank executives from other banks in the area which are clients of Peat Marwick. We knew Mr. Beller and many of his colleagues to be respected, professional bankers. They in turn knew our firm, our services, our people and our reputation. As you may know, Peat Marwick serves clients of all sizes in all industries around the world. We are particularly known, however, as a leader among accounting firms providing services to the banking industry.

In November 1981, Mr. Beller contacted us to discuss the possibility that Peat Marwick consider serving as independent auditors for the parent company and the Bank. Important aspects of the discussions included three matters:

(1) The Bank's Response to the Agreement Between the Board of Directors and the Comptroller

Mr. Beller advised us that the Bank was operating under an Administrative Agreement with the Comptroller requiring changes in various areas noted by the Comptroller's prior examinations. His mission, as he explained it, was to do what was necessary and appropriate to satisfy the regulators' concerns. Additionally, he wished to improve the Bank's policies, procedures and practices to sustain its continued growth and profitability consistent with sound banking practice. He indicated that the Bank's independent accounting firm would perform the annual audit and also be asked to provide professional services needed to assist management in establishing improved accounting procedures, controls, and information systems to better manage the Bank's growth.

(2) The Prior Auditors, Arthur Young & Company

During these discussions we obtained the prior audit reports and noted that while the 1979 report was unqualified, the 1980 report reflected a qualified opinion by Arthur Young. The Arthur Young report indicated that they were unable to satisfy themselves as to the adequacy of the reserve for possible loan losses at December 31, 1980 "due to the lack of supporting documentation of collateral values of certain loans."

As is customary, we contacted Arthur Young to discuss their relationship with the parent company and the Bank and to inquire of any disagreements or problems they might have had in serving this client. They indicated they had served this client for several years with a good professional relationship, free of significant problems. They cited the qualification in their 1980 report to be certain we were aware of it. They also indicated that in accordance with usual practices there would be no problem in our reviewing their working papers whenever we desired.

We have seen reports in the media which imply that Arthur Young was "fired" because they gave a qualified opinion in 1980. We have never had that impression. Based on everything we were told by that firm, and by Penn Square, they were not "fired" because of their qualified opinion. We believe we were engaged at a time when the new president and the new management team were doing their utmost to bring to bear all necessary resources, both within and outside the Bank, to remedy the past problems.

During our discussions, we advised Penn Square that if the conditions Arthur Young encountered had not been corrected, we would also qualify our report for 1981.

(3) Peat Marwick Independence

The requirements of our firm and profession specify that we must be independent of our clients before serving as auditors. In terms of client banks, this means, among other things, that our partners should not have unsecured loans with a client bank in excess of ten percent of individual net worth.

Since our office serves a number of banking clients, Penn Square was, until late 1981, one of the banks where our partners could borrow money with no independence concern. Hence, several of our partners had loans at Penn Square.

As is our usual practice, we asked our Executive Office in New York for advice on the steps to take to ensure our independence. After consultation with our Executive Office, we advised the Bank that the loans must be sold by the Bank to non-client banks to ensure that Penn Square would not be at risk of loss.

The Bank sold the partners' loans to non-client banks. During the audit, we satisfied ourselves that such loans were out of the Bank.

After thorough discussions of these and other matters we agreed to accept appointment as the independent auditors.

The 1981 Audit

Our audit of the financial statements was as of and for the year ended December 31, 1981. On the other hand, the Arthur Young audit was as of and for the year ended December 31, 1980. At no time did we have any quarrel with the qualified opinion on their 1980 audit and our report disclosed the existence of their 1980 opinion with its qualification.

Our audit of the 1981 financial statements was conducted in accordance with generally accepted auditing standards as promulgated by the American Institute of Certified Public Accountants. In accordance with these standards and based on our evaluation of internal controls, our audit procedures were principally substantive in nature. That is to say that we focused on account balances at or near year end and performed procedures, on a test basis, designed to verify such year-end balances. So, for example, we obtained written confirmations directly from selected borrowers and depositors as to their account balances.

As I am sure you know, Penn Square had sold many loans, without recourse, to other banks. Once sold, these loans were no longer assets of Penn Square but were assets of the purchasing bank. Accordingly, these loans were no longer in the financial statements of Penn Square. We did, however, check the accuracy of Penn Square memorandum records on loans sold to other banks by obtaining written confirmations from the purchasing banks of the amount of the loans they had purchased from Penn Square.

As part of the 1981 audit, we spent considerable time reviewing the adequacy of the Bank's "allowance for possible loan losses". We noted the Bank had established a loan review function as a part of the Credit Review Department. This Department was established in September 1981 to review all significant loans in the Bank. Its objective was to identify and evaluate all problem loans and use such information to assist management in correcting the problems where possible and to establish the "allowance for possible loan losses" at the proper level. This ongoing process was the basis of the Bank's "allowance" recorded as of December 31, 1981.

In our audit, we reviewed information, including financial and other data, on selected borrowers, principally those loans which were past due or had other indications of problems, to assess the risk of loss in the loan portfolio. Much like the Comptroller's examiners, we categorized such loans by our evaluation as to risk of loss. After summarizing this information, we satisfied ourselves that the "allowance for possible loan losses" at December 31, 1981 was a reasonable estimate by management of possible loan losses in the loan portfolio at that time.

From our review of the Arthur Young workpapers we ascertained that the "certain loans" which were the subject of their qualification in 1980 and to which they referred as lacking supporting documentation of collateral value aggregated approximately $14,700,000 or about 7% of the total loans of the Bank at December 31, 1980.

Our audit work in 1981 disclosed that subsequently 12 of these loans totalling approximately $3,000,000 were completely or substantially paid-off. Of these loans, $800,000 were charged-off in 1981. Other of these loans had little, if any, documentation problems in 1981 due to follow-up by management to correct deficiencies. Those loans that still had documentation problems were considered in assessing the overall adequacy of the allowance for possible loan losses at December 31, 1981.

As part of its ongoing monitoring process, the Comptroller's office in October 1981 conducted an examination to follow up on progress made in correcting deficiencies noted by them in prior examinations. Their report indicated that although significant problems remained, improvement was reflected in all areas and commended the Directors for their efforts in recent months.

During the course of our audit, we also noted the improving picture with respect to the Bank's operations, procedures, policies, credit review, and loan administration. While a definite improvement had occurred, the Bank still had problems with much still to be done. Areas which we believed needed attention and further improvement were covered in our extensive 22 page management letter to the Bank's Board of Directors -- a document separate from the audited statements.

This management letter contained our specific recommendations with respect to the many problems of the Bank, including:

- o loan administration, and specifically loan review and documentation;
- o organization structure;
- o written policies and procedures and related employee training;
- o internal monitoring and reporting to the Board of Directors; and
- o increased internal auditor effectiveness.

While these were important areas to the Bank, they did not, in our view, significantly impact the Bank's financial statements at December 31, 1981 or our opinion that such statements were fairly presented.

The independent auditor's function is to determine whether the financial statements including the notes thereto, as prepared by management, fairly present the financial position and results of operations in accordance with generally accepted accounting principles for the reporting period. The facts disclosed in the Bank's 1981 financial statements include:

- o the provision for possible loan losses in 1981 was $6,343,000 as compared with $1,407,830 in 1980.
- o loans charged off in 1981 were $4,835,557 as compared with $617,401 in 1980.
- o the allowance for possible loan losses at December 31, 1981 was

$4,141,447 as compared with $2,004,587 at December 31, 1980.

After the audit work on the financial condition as of December 31, 1981, was completed in March 1982, 50 copies of the audit report were delivered to First Penn Corporation and the Bank, and our 22 page management letter to the Board was subsequently delivered.

The Bank, as you may know, produced and distributed an annual report for 1981. This report contained limited financial data but did not contain the full set of financial statements or our accountant's report or that of Arthur Young for 1980. As the Bank is not publicly held, it is not required to present this information in its printed annual report.

After the Audit

We had involvement with the Bank management following delivery of the report, principally on financial systems consulting and tax matters. Our contact with the Comptroller's examiners before they closed the Bank was limited and we have had no communication with them since then as to the problems they found.

We did have one meeting on July 1, 1982, with management of the Bank who informed us that one of our partner's loans, which had been sold to another bank, apparently had been repurchased by Penn Square Bank. This repurchase occurred without our knowledge and was completely contrary to our prior understanding with the Bank. Immediately after being made aware of this matter, our partner arranged to repay the Bank in full.

Neither the Comptroller nor the FDIC have indicated to us specifically why they concluded that the Bank had to be liquidated.

We appreciate this opportunity to provide a brief overview of our audit of Penn Square. I will be pleased to answer questions that you may have of us.

The CHAIRMAN. I think you are both aware of the fact that there are two primary areas that we would like to inquire into. And indeed, you have also been cooperative prior to today with staff in providing us information in these areas. And so I would at this point, with your statement in the record, just approach the loan relationship situation.

Mr. BLANTON. Mr. Chairman, may I read my statement into the record?

The CHAIRMAN. Well, it is in the record already. If you want to summarize it, I am just trying to get along with the situation. We have put the entire statement in as presented. It is one of our standard procedures. OK?

Mr. BLANTON. Yes, sir.

The CHAIRMAN. Now, you have provided us with memorandum relating to loans to Penn Square Bank with various individuals with Peat, Marwick, Mitchell & Co.; correct?

Mr. BLANTON. That is correct.

The CHAIRMAN. What were the origination dates on the loans discussed in your memos? By "memos" I mean the memo from Peat, Marwick, Mitchell & Co. in New York to you here in Oklahoma City, dated December 30, 1981.

Mr. BLANTON. There were, to my recollection, approximately six different loans. There were three loans to one partner in our firm. There was one loan to another partner in our firm. I don't know the exact dates, but I believe they were in 1979 and 1980. There were two additional loans that were made to a group of partners. One loan was a line of credit that I believe was in place about the latter part of August. The first draw was in September.

The CHAIRMAN. Of?

Mr. BLANTON. 1981.

The CHAIRMAN. Would that be Doral Associates?

Mr. BLANTON. Yes. Both of those are Doral Associates.

The second loan was committed to, I believe, in about September of 1981. It was a permanent financing loan, if you will, a mortgage on a project. And it was funded and closed in January of 1982.

The CHAIRMAN. Were these loans subsequently sold, the Doral loans?

Mr. BLANTON. Yes, they were.

The CHAIRMAN. Do you know when that occurred, the date of the sale?

Mr. BLANTON. I don't know the exact dates. I believe they were both sold. It is my understanding that the permanent loan, the mortgage, was actually sold when it was closed, that presumably it was never on the books of the bank. The first loan, the equity loan, was sold, I believe, in January.

The CHAIRMAN. Do you know to which institutions these were sold?

Mr. BLANTON. It is my understanding that—and both of those were Doral loans—that they were sold to Utica Bank, the Bank of New England, I believe, and Citizens Bank in Muskogee.

The CHAIRMAN. And were these loans sold in their entirety? And does Penn Square have any remaining interest?

Mr. BLANTON. Penn Square has no interest.

The CHAIRMAN. Were they nonrecourse sales?

Mr. BLANTON. Yes.

The CHAIRMAN. Has Penn Square Bank ever bought back any of these loans or taken back any of these loans whether they be the Doral loans or the other loans referred to in the memorandum?

Mr. BLANTON. It is my understanding that one of the loans that belonged to one of our partners did get returned to Penn Square for collection or renewal and was not reparticipated.

The CHAIRMAN. Do you know which one that was?

Mr. BLANTON. It was approximately, I believe, a $300,000 loan.

The CHAIRMAN. And to whom was that one? I see $50,000 to Dick Turner; $600,000 to Marshall Snipes

Mr. BLANTON. It was one of the loans to Mr. Snipes.

The CHAIRMAN. And that was repurchased by Penn Square?

Mr. BLANTON. It was returned to Penn Square.

The CHAIRMAN. And where does it stand now?

Mr. BLANTON. It has been paid.

The CHAIRMAN. So there is no loan outstanding from Penn Square to any of the Peat, Marwick, Mitchell & Co. people?

Mr. BLANTON. That is correct.

The CHAIRMAN. The memo from your New York office dates December 30, 1981. And that memo describes what has to be done to assure independence. Do you know when your New York office was asked to provide the advice concerning this issue?

Mr. BLANTON. From my memory, I don't know the exact date. It was late November.

The CHAIRMAN. Then it would have been about the time that Arthur Young was terminated, November 20, 1981?

Mr. BLANTON. Yes. My recollection of the facts was that it was, in fact, before Arthur Young was terminated.

The CHAIRMAN. But as a matter of fact, the independence issue was resolved subsequent to Peat, Marwick, Mitchell & Co. having been retained by Penn Square? By that I mean the memorandum of independence.

Mr. BLANTON. The memorandum that you have there was dated after we were retained.

The CHAIRMAN. December 30, 1981?

Mr. BLANTON. Yes. But the independence issue, we believe, was resolved prior to our engagement as auditors.

The CHAIRMAN. Do you have your material? I think there is a typo here. We have a memorandum, and I would like to put these in the record, but before I do, I would like to correct this. There is the December 31, 1981, memo from Mr. Guinan to Mr. Blanton.

Mr. BLANTON. Correct.

The CHAIRMAN. And then there is a March 4, it says, 1981, but I think it should be 1982 memo to the file from C. D. York, the engaging partner.

Mr. BLANTON. If that is dated in 1981, you are correct.

The CHAIRMAN. That is a mistake, is that not correct, because it indeed tells us what you have just been telling us about the loans have been participated out, Doral to Utica, and to Idaho First National Bank of Boise?

Mr. BLANTON. Yes, that is correct.

The CHAIRMAN. And another one, a line of credit to Citizens National in Muskogee, Okla.

Mr. BLANTON. Yes.

The CHAIRMAN. So the record will show that there is a typo in that. And at this point I would ask unanimous consent that both those memoranda be put into the record.

[The material referred to follows:]

97-830 O - 82 - 16

Peat, Marwick, Mitchell & Co.

To: J. D. Blanton
Office: Oklahoma City

From: J. M. Guinan
Office: Executive

Date: December 30, 1981
Steno: as

Enc:
cc: C. E. Graese - Executive
L. E. Levy - Executive
Independence Files

Subject: Independence - Borrowings from Financial Institutions

Personal

This memorandum summarizes our discussions regarding certain loan arrangements that partners in your office have with Penn Square Bank, a new audit client. The loan arrangements have been grouped into three separate categories below for ease of discussion. All of the loans described herein were negotiated with the Bank prior to it becoming a client.

In connection with a real estate venture, a group of partners have a $2.3 MM loan with the Bank. Eighty percent of the loan is secured by a first mortgage on the property; the remainder is guaranteed personally by the partners involved. The loan is material to the partners, but not to the Bank. Penn Square Bank currently has arranged to fully participate out the loans to nonclient financial institutions. It would service the loan for the nonclient. The Bank would bear no risk for default because the participation would be without recourse. The participation arrangement should be completed by December 31, 1981, the Bank's fiscal year-end. As we discussed, an independence problem would not arise if the above arrangement were completed as proposed.

A partner has a loan of approximately $50,000 for a partnership investment which is secured by those partnership assets and which he personally has guaranteed. Under AICPA and Firm independence rules, this type of unsecured loan would not create an independence problem if the loan were not to exceed ten percent of the partner's net worth. It is my understanding that the loan amount is below the ten percent threshhold; therefore, no independence problem exists with regard to the subject loan.

Another partner has three separate loans that total $600,000. The loans relate to various investments and are secured either by investment assets or by the partner's personal guarantee. The loans are material to the partner's net worth. None of the investments involves participation with prohibited companies or persons. The partner intends to pay off the loans within six months. As we discussed, the appearance of independence would not be impaired if the partner were to pay off the loans prior to the year-end of the Bank. In no event, however, should the pay off period extend beyond the date of our initial accountants' report. If the partner were unable to pay off the loans within that time period, he would have to obtain a letter of credit from a nonclient bank to support the loans. If the client were to fully participate out the loans similar to the participation arrangement discussed above, the appearance of independence also would not be impaired.

JMGuinan

Peat, Marwick, Mitchell & Co.

CONFIDENTIAL

To: File
Office:

Date: March 4, 1981
Steno: jk

From: C. Dean York
Office: Engagement Partner

Enc:
cc:

Subject: Independence re: Penn Square Bank

In response to the instructions from John Guinan in his memo dated December 30, 1981, regarding the Firm's independence with Penn Square Bank, a new client, I am satisfied the following has occurred:

(1) The Doral Associates related loans in which the partners of the office equally participate amount to the following with the related actions taken by the Bank:

- o The interim first mortgage loan which approximates $1.6 million on a real estate project in Oklahoma City has been fully participated to Utica National Bank & Trust Co. in Tulsa. Plans are to make the permanent loan with the Idaho First National Bank in Boise, Idaho.

- o The line of credit of $1. million to Doral Associates has been participated to Citizens National Bank of Muskogee.

(2) A $50,000 loan made by Dick Turner for an oil and gas personal investment is not considered to be material to Mr. Turner's net worth.

(3) The loans to Marshall Snipes, which approximates $600,000 to his interest, to the extent material to his net worth, have been participated out of the bank on a nonrecourse to non-client banks.

All of the above was reviewed with Mr. Rick Dunn, Executive Vice President, on this date. I am satisfied the above arrangements conform to the spirit of Mr. Guinan's memo and that the Firm is independent of Penn Square Bank and its related entities.

C. Dean York

The CHAIRMAN. Mr. Leach.

Mr. LEACH. With reference to the Arthur Young audit statement, which they qualified, how unusual is it to have a qualified statement on a bank audit?

Mr. BLANTON. My reaction is that it probably would not be that unusual.

Dean, would you feel differently?

Mr. YORK. Well, I would only say that a qualified opinion, while it is unusual, it certainly does occur.

Mr. LEACH. When I look at the Arthur Young contract dated January 6, 1981, it makes specific mention that they would be looking at the possibility that illegal acts might have occurred. When you audited the bank, did you find that any illegal acts had occurred?

Mr. BLANTON. No, we did not.

Mr. LEACH. Were you aware that the Comptroller's Office had repeatedly warned the bank about violations of the banking laws of the United States?

Mr. BLANTON. Yes.

Mr. LEACH. Would you call a violation of the law an illegal act?

Mr. BLANTON. I think the way that we would interpret that—and let me say that we were, as we said, aware that those were technical violations as opposed to someone knowingly or willingly violating the law.

Mr. LEACH. The Comptroller of the United States has talked about repeated violations of the banking laws of the United States. As a banking committee, we write legislation in the banking area, and we have a high respect for what we do. Repeated violations of law are something that one raises one's eyebrows about. And I think that this would be particularly the case from an auditor's perspective.

None of us knows how this situation is going to unfold, but certainly there are widespread rumors that activities have occurred here that go beyond the realm of bad judgment into the realm of conflict of interest and, very possibly, if not probably, violation of the law. Did you find any indication of this at any time during your audit?

Mr. BLANTON. No, we did not.

Mr. LEACH. When you prepared a second audit that explained your major audit, it indicated some negative things at the bank. Did you consider including part of this in the public audit?

Mr. BLANTON. We only conducted one audit and rendered our opinion on the financial statements. The management letter, which I presume you are referring to, was a byproduct of that one audit.

Mr. LEACH. You probably heard mentioned by a number of public directors of the bank that they had a good deal of confidence in how the bank was doing based upon your audit of the bank. Do you think they had reason, based upon your discussions with them, to be concerned otherwise? In particular, one director asked at a board meeting whether there was anything that should be brought to the attention of the board of directors, and he indicates that you said no. Do you recall that question being asked, and do you recall your response?

Mr. BLANTON. I don't specifically recall that question being asked. Obviously, there were many things in our management letter that were of importance to the board and areas that they needed to direct their attention to. But I think it would be fair for the board to say that when we met with them to briefly discuss the results of the audit, that we gave them the impression of an improving picture. And I presume that maybe that is what he is referring to.

Mr. LEACH. But you do not think that any member of the board has the right to feel somewhat misled by a failure on the part of the auditors to stipulate that things were not perhaps as good as they might have been?

Mr. BLANTON. I believe that we—well, as I said, we advised the board of an improving situation which is what we believed.

Mr. LEACH. Sometimes improving situations mask troubles. One can say that some parts of the situation were improving and new people were brought in to handle certain things. But in terms of bank assets being leveraged, in terms of loans being made with perhaps less than adequate documentation, one might argue that the problem was not improving but worsening. Even if it were improving, things could still have been very, very bad.

Mr. BLANTON. Yes, that is correct. Let me clarify what I mean by "an improving situation." Not that the bank's financial condition was improving, because we looked at it only at one date, but that they were addressing those areas that the Comptroller had criticized bank management for and that they were making improvement.

Mr. LEACH. Perhaps I am confusing roles here. You are responsible for the figures, and the Comptroller is responsible for the structural things like whether or not there are enough people in place. Are you saying that there was no improvement in the figures but that with respect to what the Comptroller was concerned about there might have been improvement in some areas?

Mr. BLANTON. I am not quite certain how to answer that. Let me try. The context of the Comptroller's report, as I recall it, was that the bank had numerous administrative problems. It is also my recollection of that report that although the Comptroller did have classified loans, that they were not of such a magnitude that we were concerned. Our own evaluation of the loans on December 31, and the Comptroller, his review was either September 30 or October 31, was that we had classified loans in excess of what the Comptroller had.

Mr. LEACH. How many banks does your office audit?

Mr. BLANTON. We provide auditing, tax, and consulting services to approximately 50 banks.

Mr. LEACH. Of the 50 banks, how many have loans with inadequate documentation in the same proportion as Penn Square? Would you say that Penn Square was average in terms of its documentation problems, or substantially worse than average?

Mr. BLANTON. Worse than average.

Mr. LEACH. Out of the 50 banks, would you place it 20th from the bottom or at the bottom?

Mr. BLANTON. I am not sure that I know the answer to that. Certainly, it was worse than average.

Mr. LEACH. Just barely worse than average?

Mr. BLANTON. It was substantially worse than average.

Mr. LEACH. Do you know of any bank that is worse?

Mr. BLANTON. I don't have the basis for knowing the details of the other banks. I personally do not audit the banking clients.

Mr. LEACH. Have you ever personally audited a worse bank in terms of documentation?

Mr. BLANTON. I personally have never audited any bank, including Penn Square.

Mr. LEACH. Why are you before us?

Mr. BLANTON. Well, I was hoping to read my statement, or at least portions of it, to somewhat explain my role. I am managing partner of the office.

Mr. LEACH. Has your office ever audited a bank with worse documentation?

Mr. BLANTON. I don't know the answer to that, but I suspect we have audited, perhaps not banks, but companies whose records were as bad or worse.

Mr. LEACH. But no bank? You cannot think of a bank?

Mr. York, can you?

Mr. YORK. I can say, yes, that I have.

Mr. LEACH. How many? How many have you audited?

Mr. YORK. Because I am speaking from personal knowledge, I can think of one.

Mr. LEACH. Out of 5 or out of 50?

Mr. YORK. Out of the client base that is in our office.

Mr. LEACH. Do you compete with other auditing firms to get clients?

Mr. BLANTON. Yes, we do.

Mr. LEACH. When you take on a firm that has had a qualified audit report and you give an unqualified audit report, you bear an extra burden of responsibility, particularly when you take over for one of the reputable firms—and yours is one of the reputable firms—in America. Do you agree that you bear an extra burden?

Mr. BLANTON. No, sir, I think that our responsibility lies with our opinion. In other words, we have responsibility for our opinion regardless of what the previous auditors did.

Mr. LEACH. Was there any in-house dissent? Did anyone in your firm say that this ought to be a qualified audit or that there might be something going on beneath the surface that appeared to be a violation of the law?

Mr. BLANTON. No, sir.

Mr. LEACH. There was no dissent? This was a unanimous opinion?

Mr. BLANTON. Yes, sir.

Mr. LEACH. I have no further questions.

The CHAIRMAN. No one on your examining team saw anything at Penn Square that they felt was a violation of the regulations or the statutes that apply?

Mr. BLANTON. I did not. Are you asking about my answer to Mr. Leach's question? Was it the same question?

The CHAIRMAN. I changed the question slightly. Would you answer the question?

Mr. YORK. When you speak of violations of the law, one that is commonly referred to by the Comptroller is in the area of legal lending limit violations. And, yes, those did occur in the bank, we did observe them, and we did comment on them in our letter to the board.

The CHAIRMAN. Were you aware of the participations that were indeed supposedly nonrecourse and yet it now appears as though they were recourse participations?

Mr. YORK. Yes, we were aware of one of them.

The CHAIRMAN. You do not think that there is anything illegal about that to label them nonrecourse, whereas in reality they were recourse?

Mr. BLANTON. We were not aware of any participations with any understandings that they were not nonrecourse. It was our understanding that all participations were nonrecourse.

The CHAIRMAN. Did your people observe the fact that there were a number of nonrecourse loans that had been repurchased by Penn Square from the upstream banks?

Mr. YORK. I was not aware of a number of them. As I can recall, I can think of one loan that did come back to the bank that we reviewed.

The CHAIRMAN. Just one?

Mr. YORK. Just one that I can think of.

The CHAIRMAN. Mr. Annunzio.

Mr. ANNUNZIO. I have no questions, Mr. Chairman.

The CHAIRMAN. Mr. Weber.

Mr. WEBER. Thank you, Mr. Chairman.

Did you have any discussions of your yearend audit report with the Comptroller of the Currency's office, with the OCC?

Mr. BLANTON. No, we did not.

Mr. WEBER. Were you aware that they made an examination of this bank on March 1 of 1982 and that in their findings they report that the external audit was unacceptable to the examiner?

Mr. BLANTON. I am not aware of that. That is the first that I have heard that.

Mr. WEBER. You are not aware whether they were referring to the external audit of Peat Marwick or not?

Mr. BLANTON. I don't know what they're talking about. We have had virtually no communication with the Comptroller or the FDIC.

Mr. WEBER. You know, I was looking at, on May 4, 1982, a confidential report to the board of directors of the bank from Peat Marwick. It is quite a few pages long, 20 pages or so, giving recommendations on management procedures that should be improved and so forth.

And there is a statement on page 5 that it says, in summary, virtually every significant area of the bank has been reviewed and changes have either been made or in process.

And on page 20 of the report, the bank has made great strides in correcting or improving practically all of the areas addressed in this agreement of September or the administrative agreement that had been entered into between the board and the Comptroller of the Currency.

You know, it was at that very same time that the Comptroller of the Currency was engaged in another examination of a bank that was leading, in their own words, to uncovering serious problems with the bank.

What that says to me is that the board of directors was receiving very, very mixed signals here. On the one hand they were being told by people, their own officers and Peat Marwick, that everything was coming along just fine. And on the other hand there were these things going on with the Office of the Comptroller of the Currency that indicated things were quite different.

Specifically, did you know the president had no control over the lending functions of the department of energy or the energy department, the energy lending, and that was being carried out by Mr. Jennings and Mr. Patterson?

Mr. BLANTON. It may be necessary to ask Mr. Beller. But as I interpreted Mr. Beller's comments was that Mr. Jennings had the authority to override him on lending decisions. I did not interpret, nor was it our observation, that Mr. Beller did not have authority over the operations of the Energy Department.

Mr. WEBER. So you, in fact, did not know the differentiation of responsibilities between the president and the chairman?

Mr. BLANTON. Well, I think that it has been represented that 80 percent of the banks lending activity was devoted to energy and Mr. Beller had no involvement over that 80 percent. That was not our understanding or observation. That is not my understanding of his comment.

It was my understanding that if Mr. Jennings could override Mr. Beller on making an energy loan; that was my understanding of the comment. If he is here, perhaps we need to ask him.

The CHAIRMAN. Would the gentleman yield?

Mr. WEBER. Yes, I would.

The CHAIRMAN. I think the gentleman and I both heard Mr. Beller read his instructions from the CEO and the chairman of the board. Were you here when he read those?

Mr. BLANTON. Yes, I was.

Mr. WEBER. My recollection, Mr. Chairman, was very clearly that Mr. Patterson reported to Mr. Jennings and Mr. Beller reported to Mr. Jennings.

The CHAIRMAN. And Mr. Beller was told that as far as energy loans are concerned, don't you worry about them, we are taking care of them.

Mr. WEBER. I want to get back to the differences between the Arthur Young report on the 1980 audit and your findings. In the 1981 audit, Arthur Young qualified their report on the basis that it was the adequacy of the reserves for possible loan losses due to the lack of submitting documentation and collateral values of certain loans. That was the reason why they qualified their report.

You have, in turn, in your report found, I quote, "that the bank formed a loan review function and adopted a formalized approach to the evaluation and documentation of credit risks within the loan portfolio," and went on to say that this satisfied your judgment.

That was not satisfactory to the Office of the Comptroller of the Currency. But can you explain what improvement there had been in the evaluation of the loan reserves as the result of what you call the formalization of that systematic analysis and so forth? How did that actually work to the benefit of the bank, or did it work at all?

Mr. YORK. In our judgment, it was in place and working, acknowledging the fact that the people who came to the bank to establish that review function came basically in September of 1981.

They had in place people with the background in credit review and evaluation. They had established their own internal procedures as to how they would classify loans internally, how they would relate those classifications to the reserve for loan losses, and help management and the board establish the necessary reserves.

We certainly noted that. And very frankly, Arthur Young, the previous auditors, did not have that to review.

Mr. WEBER. I would yield back, Mr. Chairman.

The CHAIRMAN. Mr. Barnard.

Mr. BARNARD. Thank you, Mr. Chairman.

Mr. York, I presume you had the largest part to play in the report to the board after your initial examination. Is that true?

Mr. YORK. Yes. I signed the firm's reports.

Mr. BARNARD. Have you had any second thoughts about that since this time? Do you think that you should have probably been stronger in your recommendations of some of the things that you found in the examination of the bank?

Mr. YORK. Well, certainly, when you read the newspapers now, you might surmise that. The problem that I am still dealing with, and I think a lot of people are dealing with, is factually why the bank was closed. We understand that the Comptroller classified $40 million or whatever the number is in loans, which caused the bank to become insolvent.

Mr. BARNARD. Well, at the time of that examination, you did know, of course, about the administrative agreement?

Mr. YORK. Absolutely.

Mr. BARNARD. What is the general approach of Peat Marwick and Mitchell when writing an audit report about revealing administrative agreements?

Mr. YORK. To my knowledge, there are banks that are under other administrative agreements. It is my understanding generally. I have never seen those disclosures made, for some good reasons. If you make those kind of disclosures in financial statements, since public confidence is such that that type of disclosure, in essence, could trigger some kind of run on the bank.

Mr. BARNARD. Well, would you kindly interpret this to me? As I understand it, this is a footnote that is on the audit reports. It is in the work papers.

Mr. YORK. This was a memorandum written by the manager on engagement regarding the letter of agreement. Since that agreement did exist and we were aware of it, in one of my review notes, as I recall, I felt like that it needed to be addressed as a matter of import as far as the audit goes, but not from the standpoint that the administrative agreement would require disclosure.

In footnotes to financial statements, that is not a typical disclosure.

Mr. BARNARD. But what you wrote—and I would like for you to read it into the record—it seems to be pretty substantial to me as far as your opinion of the operation of this bank. Could you read it into the record for us, please?

Mr. YORK. I will try. This copy is not real clear. I believe it says something to the effect—may I take just a moment and look at this to make sure I am reading the same thing?

The directorate of the bank signed an administrative agreement with the Comptroller. Until Mr. Beller became president of the bank in 1981, the bank remained in total noncompliance with the agreement. Presently, the bank is in substantial compliance with the agreement and expects to be released from it during the next ongoing examination.

Due to the fact that the new management has worked so vigorously towards correcting the situation that led to the issuance of the agreement and the fact that they expect to be released from it shortly, it is not necessary to disclose the agreement in the footnotes to our report.

Reading on:

In order to ensure that substantial compliance existed, PMM examined all areas of agreement either through review and observation or inquiry of personnel. All areas appear to be satisfactory with the exception of occasional lending limit violations and a substantial number of loan document exceptions which the bank is working on vigorously to correct.

Mr. BARNARD. Mr. York, in the fourth line of that, is it not true that the word "total" was originally in that, and it was struck out and the word "substantial" written over it?

Mr. YORK. That is correct.

Mr. BARNARD. In other words, originally it read "Until Mr. Beller became president of the bank in May of 1981, the bank remained in total noncompliance with your agreement. At present, the bank is in total," and then that "total" was scratched out and "substantial compliance" with the agreement? Right?

Mr. YORK. That is correct.

Mr. BARNARD. But the question I asked you originally was, you did not feel that this was important enough to be in the report itself?

Mr. YORK. No. And I am not sure it would ever normally be, merely because of the existence of an administrative agreement.

Mr. BARNARD. Well, what happened to these poor institutions that put money in there, relying upon your report? You think that they would have had the same attitude about this bank if they had seen that the auditors had said that they were in even substantial noncompliance?

Mr. YORK. I don't how they might interpret that.

The CHAIRMAN. Would the gentleman yield?

Mr. BARNARD. Yes.

The CHAIRMAN. Does Peat Marwick and Mitchell audit any credit unions?

Mr. BLANTON. We do not audit any credit unions in Oklahoma City out of the Oklahoma City office.

The CHAIRMAN. I mean in the United States of America.

Mr. BLANTON. I am very sure we do.

The CHAIRMAN. Do you audit any savings and loans?

Mr. BLANTON. Yes, we do.

The CHAIRMAN. Do you think it is possible that some of those you audit, that your firm audits, may have had funds in excess of $100,000 at Penn Square Bank?

Mr. BLANTON. It's possible.

The CHAIRMAN. I thank the gentleman for yielding. I would not be too happy if I were they.

Mr. BARNARD. Mr. York, another question I would like to ask you about your report. On page 8 of the management letter it says, "after reviewing the new organizational chart which is currently in the process of implementation" and I emphasize this "there is only one recommendation that we wish to make" and I will read on very hurriedly:

The oil and gas division is quite large and has several key personnel reporting to the senior vice president in charge of the department. Because of the relatively large span of control which now exists and the variety of tasks performed within the department and particular talents of the department head, we recommend that the organization of this key department continue to be reviewed.

The review should be made from the standpoint of continuing to improve the administration of the day-to-day activities of the department and yet capitalize on the strengths of the department head and his relationship with key loan customers and upstream correspondents. For him to maintain these relationships and effectively administer the department may be unrealistic as the bank continues to grow.

Do you think possibly on reflection you might want to make that a little bit stronger? I presume we are talking about Mr. Patterson in that statement; is that correct?

Mr. YORK. That is correct.

Mr. BARNARD. Would you care to answer that?

Mr. YORK. Well, I feel like our recommendation is still good today because of the span of control that he did have and all of the things that Mr. Patterson was doing.

Mr. BARNARD. On another subject, let us talk about the adequacy of loan loss reserves. In a memo written during March, Mr. York, I believe that you discussed the adequacy of Penn Square's loan loss reserves. The memo states that:

In connection with our review of the loan charge-offs for 1981 and our review made to determine the adequacy of the reserve for 1981 there was nothing specifically noted that would indicate the 1980 reserve was materially inadequate at that point in time.

One could surmise because of the large charge-offs which occurred in 1981 that perhaps the 1980 reserve was inadequate at that point in time. However, on review of what happened during 1981, this would not necessarily be the conclusion that one would draw.

So I ask the question, was it your opinion today that the 1980 reserve was understated, according to Peat, Marwick, Mitchell & Co.'s formula?

[The memorandum referred to follows:]

Client: First Penn Corporation and Penn
Square Bank, N.A.

From : C.D. York, Engagement Partner

Subject: 1981 Accountants' Report

Because 1981 was our first year to audit the Company and its related entities, principally, Penn Square Bank, it was necessary for us to refer to the prior auditor's report which was qualified. Arthur Young's qualification was quite unusual due to the fact they qualified their opinion on the basis of a scope restriction because they were unable to satisfy themselves as to the adequacy of the reserve for loan losses due to certain collateral information being insuffficent for their purposes. Naturally it was necessary on our part to consider their qualification in relation to our opinion on the 1981 financial statements.

After much review of the professional literature regarding auditors reports and qualified opinions, I was unable to find an example of the particular problem that we have. In considering our opinion for 1981, first I determined that we are satisfied that the 1981 balance sheet is fairly stated. I am satisfied we will give a clean opinion on the 1981 financial position without any problem. The next question is, due to Arthur Young's qualification, should it have any impact on our opinion on the 1981 results of operations. In analyzing this particular problem the following was considered:

1. AY's qualification did not indicate they were satisfied or dissatisfied with the reserve for loan losses. Their qualification only indicated they could not make a determination as to the adequacy or inadequacy and accordingly resulted in their "except for" opinion.

2. Management of the Company and the Bank maintain that, in their opinion, the 1980 reserve for loan losses was sufficient. This is borne out by a number of statements made by management in their offering document for the sale of stock in November 1981.

3. In connection with our review of the loan chargeoffs for 1981 and our review made to determine the adequacy of the reserve for 1981, there was nothing specifically noted that would indicate the 1980 reserve was materially inadequate at that point in time. One could surmise, because of the large chargeoffs which occured in 1981, that perhaps the 1980 reserve was inadequate; however, on review of what happened during 1981, this would not necessarily be the conclusion that one would draw. Several things were noted in our review of 1981 such as:

    o The Bank's senior management changed considerably with the addition of a new president, a new executive vice president in charge of credit and collection and a new executive vice president in charge of finance.

- o The establishment of a loan review department.
- o A formalization of their approach as to how the reserve for loan losses should be reviewed and adjusted periodically.

Also, in reviewing what happened in 1981, we noted that the federal examiners' report had a number of classified loans in their examination of early 1981. However, such classifications, insofar as losses and doubtful loans, was not in excess of the reserve which was established at the end of 1980. It was also noted that when Mr. Beller, the new bank president, came on board he took a very conservative view of the loans they had reviewed internally. If loans were determined to be anywhere near doubtful in collection, he placed them on a nonaccrual status and gave them a very conservative classification which in turn caused an upward adjustment in the reserve for loan losses. Also, if in their view, a loan could not be recovered in the very near term, the loan was charged-off and litigation was immediately instituted against the borrower; even though they knew, and subsequently, it has occurred there were significant recoveries to be had on such loans. In reviewing the prospectus that the Bank prepared as of September 30, 1981, it was noted that the reserve for loan losses was about $2,600,000. Subsequently, due to a softening in the local economy, and particularly the energy industry, the Bank believed it was necessary to increase the reserve for potential problems that appear to exist in the loan portfolio.

So, in reviewing what happened in 1981 with respect to the reserve for loan losses, it appears to me that the Bank's new management is taking a much stronger stance in it's estimation of the reserve and has adjusted the reserve upward to recognize potential losses in the loan portfolio which are more visible due to the change in the economy in the latter part of 1981 as compared to what the picture was at the end of 1980.

Consequently, my conclusion is that the change in the reserve is just a natural progression of the estimating process which management must continually undertake. Although, I do recognize that the attitude of senior mangement now is probably different than it was in 1980; however, this is still a part of the estimating process.

In summary, it is my opinion that what we have is a situation where management has certainly improved its documentation of their rationale for maintaining the reserve for loan losses at a certain level. It was also obvious to me and our staff, during the course of the audit, that the Bank's system of loan review and documentation of credit and collateral has certainly improved over the prior year. In the course of our review and evaluation of the loans, we were able to have at our disposal documentation and and information with which to make a review of the individual loans. Management also uses such information to help determine the necessary adjustments to the reserve on a quarterly basis.

In view of the foregoing, it's my opinion that the 1981 adjustments made to the reserve for loan losses are part of the normal estimating process. Management's opinion as to the adequacy of the reserve at the end of 1980 further confirms that whatever happened in 1981 is again reflective of the estimating process and the actual occurances during 1981. As a result of our review and tests of the reserve including the above information, I believe that we can give an opinion on the 1981 results of operations.

In order to help bridge the gap between AY's qualified opinion for 1980 and our clean opinion for 1981, I felt that it was necessary to have language in our opinion drawing the reader's attention to footnote 4 of the financial statements which discusses improvements made in 1981 in the formalization of their approach to evaluating the reserve and related documentation. Such language was added immediately following our reference to AY's qualified opinion. The location of the reference, I believe, should be there as opposed to a middle paragraph in order to immediately draw the reader's attention to the fact that something has changed in 1981 as compared to 1980. While professional literature speaks to middle paragraphs where an emphasis of a matter is concerned, I believe, in this case, the notation of that reference is best shown immediately following our reference to AY's qualification as opposed to a middle paragraph.

Due to the unusual nature of these reporting problems, I consulted with various of my audit partners as to what they thought about the problems encountered and my recommendations as to how to handle them. I spoke with Hugh Hyde, bank partner in the Houston office, Mr. Jack Noftsger, our audit PIC and Mr. Jim Blanton, the managing partner. After discussing the various points mentioned herein with them, they all indicated that my assessment of these problems and the resulting resolutions were acceptable.

Mr. YORK. Do I believe that the 1980 reserve was understated?
Mr. BARNARD. Right.
Mr. YORK. Not necessarily, no.
Mr. BARNARD. What about the 1981 reserve?
Mr. YORK. I am aware of no information to this date as to why that reserve would be inadequate.
Mr. BARNARD. According to the information that we have, Penn Square in each instance, did not reserve nearly the percentage that most banks did against its substandard loans or the next classification, doubtful loans. It did reserve 100 percent of its loss loans. But the percentages of substandard and doubtful were far less than what the normal average was.
Do you know any reason why that was done?
Mr. YORK. No, I don't. The whole area of loan review, as you can appreciate, is a highly judgmental area, and there are different rules of thumb that are used.
Mr. BARNARD. Mr. Chairman, I have no further questions.
The CHAIRMAN. Mr. Wortley.
Mr. WORTLEY. Thank you, Mr. Chairman.
In the scope of your audit of a client, what portion of the loan portfolio do you verify?
Mr. BLANTON. We took the total loan portfolio of the Penn Square Bank. We performed tests of that portfolio in total, but they were only tests. In other words, we did not verify every loan. The total population was the portfolio of Penn Square Bank.
Mr. WORTLEY. How much of the loan, how much of the Energy Department, since that was about 80 percent of the portfolio?
Mr. BLANTON. It was in the total population, so the entire energy portfolio had an opportunity to be tested.
Mr. WORTLEY. And you did not find any deficiencies in it, and you were satisfied with what you saw that these loans were in good shape that were on the books and were verified?
Mr. BLANTON. Our review of those loans was to form an opinion on the financial statements as a whole, which we did; not to discribe the energy portfolio in particular, some of the energy loans were classified in our examination.
Mr. WORTLEY. In view of the fact that the Comptroller of the Currency was critical of the Penn Square Bank, do you feel that the internal controls of Penn Square were adequate?
Mr. BLANTON. No, sir. We don't believe that they were adequate.
Mr. WORTLEY. Well, did you criticize them in the public statement?
Mr. BLANTON. No, sir.
Mr. WORTLEY. You only criticized them in the management letter?
Mr. BLANTON. That is correct.
Mr. WORTLEY. Do you think that is fair to the public? And is t[illegible] a custom of the profession?
Mr. BLANTON. I am not sure that I can determine what is fair [illegible] unfair to the public. I can say that it is a normal procedure to issu[illegible] a management letter, and that we do not address in the financia[illegible] statements or in footnotes all of the problems of a client.
Mr. WORTLEY. Well, do you not feel that you have a responsibility to someone other than your client, in this case Penn Square? Is

the whole purpose of an audit not to make certain that things are verified and the public is adequately informed of it, and shareholders and investors and depositors?

Mr. BLANTON. Penn Square Bank was a privately held bank. We were engaged by and to report to the board of directors. We did not report to depositors. We did not report to the public. We reported only to the directors of Penn Square Bank.

Mr. WORTLEY. But was not your audit report, in turn, passed on to depositors?

Mr. BLANTON. To my knowledge, our audit report was not passed on to depositors.

Mr. WORTLEY. What was the distribution of the report then? Who would get it?

Mr. BLANTON. We delivered 50 copies of our report to the board of directors. We would assume that that report was for the use of the directors, and we would presume that the report would probably be requested by the upstream banks. The bank itself, as far as putting information to whomever, they produced their own slick, if you will, annual report, with pictures. It did not include a complete set of financial statements. It did not include our opinion, nor did it include Arthur Young's opinion.

[The documents referred to will be found in the appendix section as follows: Appendix D, Penn Square Bank, N.A., Annual Report, 1981; appendix E, Penn Square Bank, N.A., Annual Report, 1982; appendix F, filings of First Penn Corp. with the Federal Reserve Bank, received in Records Section, June 4, 1982, which includes amendments to organizational documents, First Penn Corp. minutes of special shareholders' meeting, Tuesday, June 14, 1981, and consolidated and parent holding company financial statements with Peat, Marwick, Mitchell & Co. report thereon.]

Mr. WORTLEY. It did not include your statement at all?

Mr. BLANTON. That is correct.

Mr. WORTLEY. Is that the custom for most banks?

Mr. BLANTON. If a bank is publicly held, then it is required to produce an annual report in accordance with the rules of the SEC. Penn Square, not being publicly held, was not required to do that. In other words, a publicly held bank would include a complete set of financial statements, the auditor's report, and other management information that are required to discuss the operations of the bank. And those are SEC rules. Where you have a private company or bank, they generally don't publish anything. But in an instance like this, I can't recall any specific examples, but, yes, this is done. It is not that unusual.

Mr. WORTLEY. Well, in other words, your audit is only for their personal gratification? It went nowhere else?

...TON. Our audit was for the board of directors, and that ...reported to. If I might distinguish, we were not a part of ...ing document. So from our viewpoint, well, if we were ...an offering document, then we would, in fact, know that in...s were going to rely on it. That was not the case here.

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

The CHAIRMAN. If it were indeed going to be part of an offering document, what would you have put in there that you did not put in?

Mr. BLANTON. If it were——

The CHAIRMAN. Say, you were auditing Chase Manhattan, and that is publicly held; right?

Mr. BLANTON. If it were an offering document, it would have financial statements in it, as we have reported. But it would also contain other disclosures by management.

The CHAIRMAN. I am talking about Peat, Marwick, Mitchell & Co.

Mr. BLANTON. If it were an offering document?

The CHAIRMAN. If your report was going to be part of an offering document, tell me what you would have done.

Mr. BLANTON. If our report were going to be part of an offering document, it would be the same set of financial statements, assuming that it met regulatory requirements. From time to time there are differences. For example, the SEC wants certain information, or perhaps the Federal home loan bank wants certain information.

Basically, our product, or our opinion on the financial statements would be the same, with one exception, and that is that they would require our consent to the use of our opinion. To obtain our consent for the use of our opinion, we would presumably have insisted that other disclosures be placed in there by management, something so that an investor would be aware of all events up to the date of his investment.

The CHAIRMAN. Would that include the letter of agreement with the Comptroller of the Currency?

Mr. BLANTON. I don't know.

Mr. LEACH. Would the gentleman yield?

The CHAIRMAN. I would yield to the gentleman.

Mr. LEACH. The chairman asked a question earlier as to whether you audited any credit unions that might be involved. Are you responsible for auditing any activity of Seattle First, of Chase Manhattan, or of Continental Illinois?

Mr. BLANTON. Our firm is the auditor for Chase Manhattan.

Mr. LEACH. In this instance, did you have any contact with your firm regarding the audit of Chase Manhattan, and would you have given any information to Chase Manhattan that might have been relevant to them?

Mr. BLANTON. To my knowledge, we gave no information to our firm regarding that.

Mr. LEACH. If you knew what we presume is new knowledge in comparison with 6 months ago, what are your obligations as an auditor? Would that information be immediately given to your firm in New York as relevant to Chase Manhattan's audit?

Mr. BLANTON. My response would be no, that we would not give information. I have never encountered that. So in a real-life situation——

The CHAIRMAN. You have never encountered it. You encountered it right here. You have it right here. Are you wearing blinders?

Mr. BLANTON. While we were doing the audit of the Penn Square Bank, we didn't share anything.

The CHAIRMAN. You were not aware of the fact that there were numerous classified energy loans in Penn Square Bank?

Mr. BLANTON. Are you asking did we notify our New York office after conducting our examination?

The CHAIRMAN. Excuse me. I am asking you if you were aware of the fact that there were numerous classified energy loans at Penn Square Bank.

Mr. BLANTON. As of what date?

The CHAIRMAN. During your audit.

Mr. BLANTON. I don't believe that there were numerous classified energy loans as of the date of our audit.

The CHAIRMAN. Were you aware of the fact that Penn Square was paying the interest on behalf of borrowers on participation loans that had been sold upstream to Chase Manhattan and to Continental?

Mr. BLANTON. Yes, we were aware of that. We discussed it in our management letter.

The CHAIRMAN. You were aware of that?

Mr. BLANTON. Yes, we were.

The CHAIRMAN. You do not and did not feel an obligation, therefore, as an auditing firm to inform Chase Manhattan of the fact that this bank in Oklahoma City was pulling the wool over their eyes on some of those participation loans that they purchased from Penn Square?

Mr. BLANTON. I don't believe that you can conclude that if they were advancing interest on these participations that they were pulling the wool over anyone's eyes without knowing why the advance was made.

The CHAIRMAN. Mr. Blanton, Mr. Blanton, please, please. This is one of the problem areas. Mr. Beller stated earlier that as a result of the December 8 memorandum that has been placed in the record that there was over $2 million of interest that was paid to upstream banks on loans that were nonperforming loans, and some of these moneys were going to your other client, Chase Manhattan.

And there is only one reason to do something like that, and that is so Mr. Patterson and his colleagues could continue selling participations to upstream banks. Otherwise, if too many of the loans were found to be nonperforming, they could not continue their sales around the Nation, could they?

So to say that that was not improper, that they were not pulling the wool over Chase Manhattan's eyes, you are maybe hoping they were not. But I think perhaps you should think twice about that one.

You have two clients, and I think maybe you think you did not have an obligation to the borrowers or rather to the depositors who put sums in excess of $100,000 into Penn Square. But it seems to me that since your firm was collecting fees from both Chase and Penn Square, that you might have had some kind of obligation there.

[Witnesses conferred.]

Mr. BLANTON. I think Mr. York can add to that. Some of those advances were investigated, the information available to us indicated the practice was decreasing and there were some reasons for those instances where it was continuing.

Mr. YORK. Yes. We also read the memo that you had presented this morning to you. We looked at that area as well. We inquired and reviewed what management was doing, and still felt that it was the type of thing that should still be a subject matter in our management letter, which we covered.

The CHAIRMAN. What do you mean, a subject matter? What is that? Absolution? I mean you say you are forgiven for your sin, we will make it a subject matter rather than a sin?

Mr. YORK. No.

The CHAIRMAN. Well, what do you mean by "a subject matter"? I mean something is either right or it is wrong.

Mr. YORK. And it was wrong from a viewpoint of good business practice.

The CHAIRMAN. OK. Well, why call it a subject matter? Why not just say it is wrong? I mean this obfuscation and semantics and all of that, let us talk English that the people in Oklahoma and the people in Rhode Island and Georgia and Iowa can understand rather than some gobblydegook?

Now, Mr. Blanton, you know those 50 copies you say you delivered to the board of directors because it is a privately held bank; is that correct?

Mr. BLANTON. Yes, sir.

The CHAIRMAN. You are not aware of the fact that the people at Penn Square dealing with brokers gave your reports as well as those of Arthur Young of those money brokers who, in turn, cited those, your reports, to people, credit unions, S&L's around this Nation who put enormous sums of money into this institution based on your audit reports, since that was all that was available to them?

Do you mean to tell me you are not aware of the fact that your reports are used by brokers for that purpose and by the people at Penn Square Bank who were attempting to get large deposits into that institution?

Mr. BLANTON. I have read newspaper reports that money brokers had copies of our financial statements.

The CHAIRMAN. And this is the first time it ever occurred to you in your career with Peat Marwick and Mitchell that your reports of Peat, Marwick, Mitchell & Co. were used in this manner by financial institutions, whether it be Penn Square or any other institution that you do auditing for? Did this come as a complete and total surprise to you, like the fact that when you get to be 10 years old you find out there is no Santa Claus?

Mr. BLANTON. Because there were two sets of financial statements that we discussed, I do not know whether the credit unions had the financial statements that we issued or the financial statements that the bank issued. Obviously, I do not know what the bank did with those financial statements.

The CHAIRMAN. You have heard of Xerox machines?

Mr. BLANTON. Yes, sir.

The CHAIRMAN. I have a letter here that was handed to me.

Mr. LEACH. Will the gentleman yield to me?

The CHAIRMAN. Yes.

Mr. LEACH. At any time, whether directly after the audit or up through late June, did you talk to your office in New York with an understanding that they might talk to Chase Manhattan about difficulties at this bank?

Mr. BLANTON. To my knowledge, we never initiated any calls to our New York office concerning Penn Square Bank.

Mr. LEACH. How about vice versa?

Mr. BLANTON. It is my understanding that our New York office did call us and ask that we perform certain procedures with respect to their participations that were being serviced by Penn Square.

Mr. LEACH. At what time was this?

Mr. BLANTON. In March.

Mr. LEACH. In other words, by virtue of the fact that Peat, Marwick worked as an auditor for both banks, Chase came to have earlier knowledge of this particular bank's situation?

Mr. BLANTON. Not to my knowledge. To my knowledge, no one in our office involved with Penn Square Bank ever initiated any calls to Chase or to New York.

Mr. LEACH. But you indicated a moment ago that your office in New York initiated a call to your office here.

Mr. BLANTON. They asked us to perform certain procedures.

The CHAIRMAN. I feel as though now we are in General Hospital.

[Laughter.]

The CHAIRMAN. What do you mean by a certain procedure—I mean, is this a blood transfusion or a transplant or a bypass? Could you be more specific?

Mr. BLANTON. When we audited Penn Square Bank we were looking at Penn Square's portfolio, not the participations. They asked us to perform similar types of procedures with respect to participations.

The CHAIRMAN. Your New York office, on behalf of Chase Manhattan?

Mr. BLANTON. That is correct.

Mr. LEACH. Earlier you indicated that if you came upon problems, you would not feel it your obligation to inform Peat, Marwick in New York and to inform Chase. Is that your position? Do you think that intra-company obligation is something that the auditing community is going to have to look at very carefully in terms of its future procedures?

Mr. BLANTON. Mr. Leach, as the chairman pointed out, yes, that did happen in this instance where Penn Square was closed, but we had no advance notice to give our New York office that it was coming.

All I am saying is that that never became an issue, and to my knowledge, I don't ever recall that being an issue on any client. So I guess what I am saying—my response would be I think that we probably would not notify, but I have never encountered it.

Mr. LEACH. I understand exactly what you are saying. I suspect that this might become a problem in your intracompany discussions. It poses a very serious philosophical dilemma for the company as well as for the auditing profession.

Mr. WEBER. Would the gentleman yield?

Mr. LEACH. I would be happy to.

Mr. WEBER. It seems to me you could do us a favor if you would restate, as best you understand it, what are the rules of ethical conduct that pertain to the accounting profession so far as the confidentiality of client information is concerned.

I assume that you keep all confidences of the client just that, confidential, between you and the client only. Is that correct?

Mr. BLANTON. That is correct.

Mr. WEBER. And the thing that clouds the issue here is that we may be dealing in an area of civil fraud or actual illegality, and the question is at that point, do you maintain the confidentiality of those potential violations of law from other people who may be affected by that information, I assume. Is that the way you read that question also, or that problem?

[Pause.]

Mr. WEBER. Can you answer?

Mr. BLANTON. I am thinking. I really do not know the answer to that question. It obviously has been the subject of much debate among accountants.

Mr. WEBER. You are in a situation of a conflict of interest. You are representing two clients who have conflicting interests. The interest of the one client is to keep the information totally confidential. The interest of the other client, of course, is to be informed.

Mr. BLANTON. I think that I can safely say that it is our firm policy that we do not ever discuss the condition of one client with another client. And I do not think that that was the question being asked.

The CHAIRMAN. Let me rephrase the question for you. No. 1, I do not think that accountants are in the stead of attorneys or doctors.

Mr. BLANTON. That is correct.

The CHAIRMAN. You do perhaps have a code of conduct within a profession.

Mr. BLANTON. That is correct.

The CHAIRMAN. But you do not have an immunity, say, where if you were brought into a courtroom.

Mr. BLANTON. That is correct.

The CHAIRMAN. Don't you really face the dilemma, in this instance, when indeed, that which is happening at Penn Square has a very direct relationship, as we found out, on Chase Manhattan? Both of whom are your clients. I would suspect that the fee for auditing Penn Square doesn't begin to compare with the fee Peat, Marwick, Mitchell & Co. gets for auditing Chase Manhattan.

Now, it is not as though Chase Manhattan says, We want to know about the internal workings of this competitor institution. What you are faced with here is a situation where they are dealing with each other; there is an interaction, a business relationship, and the health of one affects the health of the other.

Don't you really have a compounding of your dilemma because gee, if the people at Chase Manhattan say to themselves, Why didn't that Oklahoma City group of Peat, Marwick, Mitchell & Co. let us know what was happening or what was going on at Penn Square, when they knew that this would affect our losses at Chase Manhattan, also being audited by Peat, Marwick.

Mr. BLANTON. Mr. Chairman, you are assuming that we knew what was going on at Penn Square.

The CHAIRMAN. I think that is because I am told you are an excellent firm.

Mr. BLANTON. You are assuming that we have knowledge of what the Comptroller found during his examination.

The CHAIRMAN. Mr. York said he was aware of the memo of December 8 about what was happening on those participations. That is not an assumption. I am not assuming, sir.

Mr. BARNARD. Mr. Chairman, would you yield for a minute?

The CHAIRMAN. I would be happy to.

Mr. BARNARD. Mr. Blanton, what was the substance of the inquiry from the Chase Manhattan Bank? Was it about a specific participation, or was it about general participation policy? Can you tell us what that inquiry was?

Mr. BLANTON. Mr. Barnard, I would like to decline to answer your question, only because we are getting now out of the discussion of Penn Square and into a discussion of Chase Manhattan. And I am not free to discuss Chase Manhattan.

Mr. BARNARD. Well, may I just differ slightly in saying that we are really talking about what information is privy to Chase Manhattan and not privy to other people who also stand to lose.

The CHAIRMAN. And excuse me, we are talking—the question is directed to the situation at Penn Square, not Chase Manhattan. What was that procedure?

Mr. BARNARD. In other words, we were talking here about an inquiry that the Peat, Marwick, & Mitchell Co., office in New York made to the Oklahoma City office as a result of a Chase Manhattan inquiry. Was that about a specific participation loan or was it about a general participation policy? You don't think you could tell us that?

Mr. BLANTON. I do not believe I could tell you that.

Mr. LEACH. If you would yield, Mr. Barnard.

Mr. BARNARD. Yes.

Mr. LEACH. Was this request based upon a standard audit of Chase Manhattan, or was it a request based upon some concerns reflected by Peat, Marwick, Mitchell & Co.?

Mr. BLANTON. I do not know the answer. If I did know the answer, I do not think I could say.

The CHAIRMAN. Do you want to state that question again for me, Jim?

Mr. LEACH. The question was whether this was a standard operating procedure stemming from a normal audit of Chase, or whether it was a special request growing out of a nonstandard audit procedure.

The CHAIRMAN. If the gentleman would yield, I would like to rephrase his question. Actually, the question was propounded by Mr. Barnard, and the question was, you were asked as you stated, "to perform a procedure" at Penn Square relative to participation loans. Is that not correct?

Mr. BLANTON. That is correct.

The CHAIRMAN. I think I am quoting you. Is that correct?

Mr. BLANTON. That is correct.

The CHAIRMAN. We are now asking you to tell us whether that procedure had to do with participations in general, whether it related to the December 8 memo about prepayment of interest, whether it was on a particular participation. You now tell us you don't feel you can answer, but the Chair at this point would state to you, sir, that this committee is investigating the failure of Penn Square Bank, a matter of which we have jurisdiction and, indeed, the responsibility to look into to see if any changes in legislation or bank regulatory procedures or processes are necessary.

Your answer to the question would help this committee, and would be invaluable to this committee and necessary to this committee to carry out its duties. The Chair rules that the question is pertinent and directed to the situation at hand. I would respectfully request on behalf of this committee that you, indeed, answer the question.

[Witness conferring with counsel.]

Mr. BLANTON. Mr. Chairman, my counsel has advised me that we would be pleased to discuss any information concerning Chase only if we can obtain Chase's permission first.

Mr. BARNARD. Mr. Chairman, I don't believe we are asking anything about Chase.

The CHAIRMAN. Excuse me. Let me ask you this question. The inquiry to perform a procedure, did it come from Chase Manhattan or from Peat, Marwick, Mitchell & Co. in New York?

Mr. BLANTON. I do not know the answer.

The CHAIRMAN. Mr. York? I assume Mr. York is the gentleman who performed the procedure.

Mr. YORK. It is my understanding that the request came from Chase.

The CHAIRMAN. Directly or through Peat, Marwick, Mitchell & Co.?

Mr. YORK. Through Peat, Marwick, Mitchell & Co.

Mr. LEACH. Mr. Chairman?

The CHAIRMAN. Mr. Leach.

Mr. LEACH. This is a very interesting area of concern and of philosophical import. Since we are going to be holding additional hearings, however, and given the position of the gentlemen present and their counsel's advice, I would suggest that we postpone further consideration of this issue. To press the point at this time could be unnecessarily embarrassing both to the witnesses and their company, which is one of the great American auditing firms. With the understanding that this matter will be pursued further, I recommend that we not pursue it at this time.

The CHAIRMAN. Well, if we don't pursue it, Mr. Leach, I think that by the same token, it leaves unanswered from this moment forward the fact that Chase Manhattan asked that certain procedures be performed in March of this past year.

We were told by the Comptroller in a briefing by the Comptroller and the FDIC that they informed—the Comptroller didn't inform their office; that they, in turn, informed Continental Illinois and Chase Manhattan and the others until 6 or 7 days before July 5, the date the D-Day here.

We are finding out that it appears as though Chase Manhattan, through some ESP—which in this instance I don't criticize; I think it is great of Chase Manhattan—that they had some inklings about the fact that maybe procedures ought to be performed here at Penn Square to try to learn a little more about these participations.

It appears that Chase Manhattan may have been privy to something through the Peat, Marwick, Mitchell & Co. route back in March of this year. If we want to leave that hanging—and certainly I want to assure Mr. Blanton and Mr. York that we will not leave it hanging for ad infinitum, because this committee does pursue these things. If you want to leave it hanging and you make a conscious decision that you are better off letting it hang out there unanswered than to face up to it now, perhaps then we will allow you to leave it hanging.

[Witness conferring with counsel.]

Mr. BLANTON. Mr. Chairman, let me just make this statement. To the best of my knowledge, no one in Peat, Marwick, Mitchell & Co. in Oklahoma City had any conversations with any individual from Chase Manhattan specifically concerning Penn Square. To my knowledge, no one in Peat, Marwick, Mitchell & Co. in Oklahoma City initiated any discussions with anyone in our New York office to discuss specifically Penn Square Bank.

I would be pleased to——

The CHAIRMAN. But you are leaving one—let's go this way. To your knowledge, did anyone at Peat, Marwick, Mitchell & Co. in New York City initiate any discussions with personnel in Peat, Marwick, Mitchell & Co. in Oklahoma City relative to performing a procedure in Oklahoma City? That is one you did not include.

Mr. BLANTON. As I stated earlier, we would be pleased to discuss that matter, but we feel that we need the consent of Chase Manhattan.

Mr. LEACH. Mr. Chairman?

The CHAIRMAN. Just let me get an answer to this. He told me to his knowledge, no one from Chase contacted Peat, Marwick, Mitchell & Co. in Oklahoma; no one from Oklahoma contacted either Peat, Marwick, Mitchell & Co. or Chase. Now I am saying did anyone from Peat, Marwick, Mitchell & Co. New York contact somebody at Peat, Marwick, Oklahoma City relative to performing a procedure at Penn Square on participations?

Mr. BLANTON. I have already answered that question, that yes, we were contacted by New York.

Mr. LEACH. Mr. Chairman?

The CHAIRMAN. Yes?

Mr. LEACH. I certainly understand the dilemma you gentlemen face in wanting to discuss this with your client. It would be my suggestion at this point, given the potential for contempt citations, that the representatives of Peat, Marwick, Mitchell & Co. relating to Chase Manhattan be invited to testify at a future hearing to resolve all of this.

The CHAIRMAN. May the Chair just state that I wanted to get it clear on the record, because of his last reply, that there was communication. I didn't want to leave it hanging that there was not. I am satisfied that we will have—certainly, there are going to be further hearings on this, and not only for the benefit of Peat, Marwick, Mitchell & Co., but for many others who are happy to testify, or who were unhappy to testify today or didn't want to testify today.

I want to make it very clear that we are going to be chatting with them in the months ahead, and maybe the years ahead. There is too much of this case that has to be cleared up that we are not going to forget about it.

Mr. Barnard, do you have any further questions?

Mr. BARNARD. No, Mr. Chairman.

The CHAIRMAN. Does anyone else have any questions of these witnesses?

[No response.]

Let me ask you this, Mr. Blanton and Mr. York. You have heard the panel preceding who testified that in their opinion, Penn Square should not have been shut down on July 5. You were here, weren't you?

Mr. BLANTON. Yes.

Mr. YORK. Yes.

The CHAIRMAN. Now, you are the auditing firm. Do you agree or disagree with that panel? Do you feel that Penn Square should have been shut down and this unusual procedure entered into by establishing the special deposit insurance bank? Or should that have been triggered, or do you think other means should have been taken?

Mr. BLANTON. Because we do not have the facts that caused the Comptroller to reach his decision as of that date, let me say this. If the Comptroller had closed Penn Square Bank on December 31, 1981, then I believe that would have been done in error.

The CHAIRMAN. Thank you, gentlemen. At this time, I would ask unanimous consent to have placed in the record the two documents from Peat, Marwick, Mitchell & Co; one dated June 14, 1982, addressed to Mr. James Gunter, executive vice president, Penn Square Bank; and the other dated May 4, 1982, board of directors, Penn Square Bank in Oklahoma. Without objection, so ordered.

[The documents referred to follow:]

Peat, Marwick, Mitchell & Co.

Certified Public Accountants

First Oklahoma Tower
Oklahoma City, Oklahoma 73102

June 14, 1982

CONFIDENTIAL

Mr. James J. Gunter, Executive Vice-President
Penn Square Bank, N.A.
Oklahoma City, Oklahoma

Dear Mr. Gunter:

In connection with our examination of the financial statements of Penn Square Bank, N.A. as of December 31, 1981, we noted certain matters relating to the Bank's system of internal accounting control and accounting procedures that we wish to call to your attention. In your consideration of the items mentioned in the following paragraphs, please understand that our recommendations are intended to assist you in the presentation of and accountability for the Bank's assets, liabilities, income and expense accounts. An effective system of internal accounting control and operating procedures should help guard against any irregularities that our test work may not disclose. The efficiency and effectiveness of Bank personnel are determined by adequate managerial policies and periodic reviews of such policies and employee performance.

As you read this letter, please bear in mind that its purpose is to supplement our letter which was issued to the Bank's Board of Directors on May 4, 1982. Also, please consider that we have not reviewed the Bank's internal accounting controls since March 19, 1982, the date of completion of our fieldwork in the Bank, and therefore, we may not be aware of changes subsequent to that date.

GENERAL

As noted in our previous letter, the Bank's growth rate over the last few years has been phenominal. This type of rapid expansion normally increases processing requirements and tends to stretch existing personnel. This in turn increases the opportunity for errors to occur, processing short cuts and the circumventing of existing internal controls. The remainder of this letter will speak to individual areas of the Bank which we believe merit your attention; however, we urge you to continually be aware of and make improvements in other areas of the Bank where controls may have been weakened during this period of rapid growth.

OPERATIONS

Efficient workflows are essential to any organization to ensure and maintain excellent customer satisfaction. The following items are intended to enhance the Bank's ability to process items orderly and efficiently.

- Require all departments to release work immediately to the Proof Department. This will assist the department in meeting important deadlines and reduce the late afternoon volume;
- Clean checks of all staples, rubber bands, paper clips and other fasteners prior to delivery to the Proof Department to avoid rehandling the items and to reduce the number of rejected items;
- Encode account numbers on unencoded deposit and withdrawal tickets at the funds receiving areas to assist in assuring that the encoded number is correct and to encourage the use of pre-encoded customer deposit slips;

- Establish procedures in all funds receiving areas to prepare items for MICR encoding by arranging items in proper sequence before sending them to Proof;

- Prepare a notice of missing documents for inclusion with the customer's monthly statement when an item or items are missing from the statement. The notice should explain that an item is missing but to prevent delay, the statement is being mailed. The notice should continue with a statement indicating that should the customer need a copy for tax purposes, to circle the needed item, return the statement to the Bank and a copy will be forwarded as soon as possible. This procedure will reduce the amount of time necessary for research and filmwork;

- Review the types of manually prepared reports to the reports produced by the data processing system. When the same or similar information is available from the system, the manual reports should be deleted;

- Close select departments to outside calls (bookkeeping, proof, tellers, etc.) except during posted operating hours. This allows individual departments to prepare and process the bulk of their work without disruptions;

- Encourage customers to properly endorse all checks with name and account number. This procedure reduces bookkeeping research time for deposited items returned;

- Request a program change in order to automatically assess insufficient check charges through the data processing system. This method decreases the amount of time required to manually handle the items and decreases the number of paper items in the system. In addition, it requires positive officer response to waive insufficient charges, improving controls over excess waivers;

- Revise the overall Bank policy regarding NSF items. We realize that the Bank will not collect 100% of the income generated and that special arrangements have been made for zero balance type accounts or customers who maintain substantial balances in other accounts;

- Establish a cut-off time in which loans may be brought to the note area for same day processing. This will assist the note departments in forwarding their work to proof in a timely manner;

- o Discontinue manually posting payment activity on the reverse side of commercial notes. This is time consuming and unnecessary. Department personnel indicated that an account history can be requested from the processor's automated system and received the following day; and

- o Relocate operational departments (bookkeeping, proof, transit, data processing, etc.) within close proximity of each other. At the present time, these departments are located in separate sections of the Bank, creating disruptions in the efficient flow of work. This recommendation is currently being reviewed by the senior operations officer.

CASH MANAGEMENT

The realization of any bank's earning potential is dependent upon the effective management of its earning assets. An overall goal for employing Bank assets effectively is to maintain an average of 90% of total assets in an earning capacity.

- o Due From Bank Accounts - The Bank continually monitors the activity of its primary correspondent banks in order to maintain balances to compensate for services performed. At the same time, it was indicated that "due from" accounts with little or no activity were reviewed periodically. We recommend the Bank review these relationships and eliminate or reduce balances where possible;

- o Clearinghouse Cash Letter - At the present time the Bank does not make a cash letter send to the 10:00 A.M. clearinghouse exchange. The Bank's check volumes may be significant enough, due to holdovers and early morning mail, to indicate an opportunity may exist to reduce float by making an additional send to the clearinghouse exchange. We understand this option is currently being evaluated;

- o Large Item Procedures - The Bank should ensure that large item procedures are clearly defined and understood for all funds receiving areas, by documenting the procedures and reviewing them periodically with the staff who processes these items. Additionally, the money manager should monitor areas where large items are normally received to ensure that all large items are identified, pulled and processed in time to meet key deadlines.

LOANS

The following represent opportunities for possible improvements in the area of loans (commercial and installment):

- As of December 31, 1981, the Bank was approximately two months behind on preparing its daily commercial loan reconciliations. We recommend that the loans and their related interest be reconciled on a daily basis without exception and that an officer scrutinize and approve each reconciliation. Subsequent to year end, the Bank corrected, in varying degrees, many of the problems that plagued this process; however, we urge the Bank to devote a great deal of attention to this area until the reconciliation process is operating smoothly.

- A formalized daily reconciliation of installment loans (principal and interest) is not being consistently prepared. Personnel within the department should be required to prepare daily a formalized reconciliation on a standardized form. Once this reconciliation is complete, a subsequent review and approval by a supervisor in the department should be performed.

- On certain participated loans, we noted that the Bank had maturity dates on certain of the notes and corresponding participation certificates which did not correspond. The Bank should consider improving procedures in this area to ensure such dates are the same on future participated loans.

DEPOSITOR ACCOUNTS

During our examination, we noted the following with respect to depositor accounts:

- There was no supervisory review and approval of the demand and savings accounts reconciliations. Such a review would encourage a more timely recognition of errors or unusual reconciling items.

- Although all depositor account reconciliations are being performed timely, they only reconcile dollar amounts. The Bank should consider instituting a requirement in the reconciliation process that a reconciliation of the <u>number</u> of accounts be performed in addition to reconciliations of <u>dollar</u> amounts. This procedure will ensure that accounts are not inadvertently or purposely dropped from the system and the dollars transferred to another account.

OTHER

The following represent other areas of the Bank where improvements can occur:

- The Bank sometimes releases loan collateral without requiring proper authorization and documentation of the released items.
- The Bank does not always prepare reconciliations of all "due from bank" accounts on a timely basis. Procedures should be implemented to require that such accounts be reconciled on a current basis.
- The control logs for travelers checks in both the main bank and drive-in bank were not posted up-to-date on the day of our surprise count. Also, it was noted the log had only a grand total with no denominational break down. We recommend a review of policies in this area for possible improvement.

* * * * * * * * *

Jim, we trust these operational comments will be of benefit as you continue to improve the Bank's financial controls and procedures.

Very truly yours,

C. Dean York

C. Dean York, Partner

cc. Mr. Bill Jennings

Mr. Eldon Beller

Board of Directors

Peat, Marwick, Mitchell & Co.

Certified Public Accountants

First Oklahoma Tower
Oklahoma City, Oklahoma 73102
(405) 239-6411

May 4, 1982

CONFIDENTIAL

The Board of Directors
Penn Square Bank, N.A.
Oklahoma City, Oklahoma

Gentlemen:

Recently, we completed our examination of Penn Square Bank, N.A.'s financial statements for the year ended December 31, 1981 along with the consolidated financial statements of First Penn Corporation (collectively referred to herein as the Bank).

Because this was the first year for us to be associated with the Bank, we spent considerable time reviewing such areas as the Bank's organization, policies, procedures, information systems, internal reporting, income tax strategies, data processing, internal accounting controls, etc. The topics as outlined herein are the result of such review.

Our recommendations are designed to address the broader issues which confront management that have been brought about by the Bank's phenomenal growth over the past five years. These recommendations, if adopted, will enhance the Bank's security over its assets and depositor accounts and increase overall profitability and control of the organization as a whole. Matters which relate directly to accounting procedures and internal controls of an operational nature are covered in a separate letter to Mr. James J. Gunter, Executive Vice President of Finance. A copy of such letter will be made available to you.

After reviewing the letter, we recommend that you ask Bank management to respond to the various recommendations and indicate in writing which recommendations will be implemented and the reasons for those which are rejected, if any. Also, a time frame should be established for implementation of the recommended procedures. Periodic progress reports should be made to the Board and/or Audit Committee as to the progress the Bank is making with its implementation schedule. However, as new controls and procedures are considered, please bear in mind that organizational changes and effective systems of internal control evolve over a period of time and the cost-benefit of such changes must be evaluated by management and the Board prior to implementation.

Gentlemen, you have the overall responsibility for the financial health of the Bank and protection of its assets. We trust the recommendations herein and our involvement with your organization will be beneficial as each of you fulfill your duties as directors.

OVERVIEW

Presently the Bank is the fourth largest bank in Oklahoma City with assets in excess of $400 million. Three years ago, assets were only $100 million which indicates the Bank's remarkable growth in such a short time.

Typically when an institution experiences rapid growth of this magnitude, tremendous stress is placed on virtually every aspect of the Bank to keep pace, but in particular, it is difficult on personnel and support systems. Penn Square has been no different in feeling the stress of its rapid growth.

97-830 O - 82 - 18

The positive results of growth are generally obvious and occur almost immediately with accelerating growth in assets, deposits and increased profits. However, there are usually negative aspects to growth if the growth is not carefully controlled. Such negative aspects are not so obvious and take longer to surface. The negative aspects to the Bank's virtually uncontrolled growth culminated in 1980 and early 1981 with a qualified audit report for 1980 and a critical bank examiners' report from the Comptroller's office in early 1981.

The more significant problem areas within the Bank which caused these reports were:

- Inadequate asset, liability management;
- Poor liquidity;
- No monitoring of credit and collection;
- Large number of loan collateral documentation deficiencies and technical violations;
- Rising loan losses;
- Inadequate financial management information;
- Support systems in the commercial and energy lending area could not keep pace with the loan volume. As a result, the details of commercial loans along with accrued interest were very difficult to reconcile to the general ledger control accounts;
- Numerous extensions of loans for both principal and interest were made with no cash payments required of the customer;
- Many of the Bank's best loans were participated upstream to large correspondent banks which often left the lesser quality loans on the Bank's books. The Bank's loan volume at year end was between $1.5 billion and $2 billion, most of which had been participated with other banks;

- Inadequate information with respect to customer balances, profitability and his total relationship with the Bank;
- Numerous lending limit violations;
- Large overdrafts on which fees were often waived;
- Insufficient level of equity capital to support the Bank's growth; and
- Inadequate internal monitoring through committees of the Board and management to set policy, follow-up and measure results.

These and other problems were only symptoms of the larger problem. Due to the Bank's unparalleled growth, there were insufficient numbers of personnel to cope with the growth and a corresponding lack of experienced senior management to direct the efforts of departmental personnel.

During the second quarter of 1981, the Bank's senior management responded to these problems by making a commitment to do whatever was necessary to correct the problems and bring the Bank's growth under control. Some of the steps taken which have been quite visible to us were:

- Hiring of a new president who had experience in a large bank.
- Hiring of additional senior management all with large bank experience to support the president in the areas of:
  - Loan administration, credit and collection
  - Finance
  - General legal counsel
- Hiring of additional supervisory personnel and staff to support the new senior management as well as additional personnel to adequately support existing departments within the bank. This meant the hiring of personnel ranging from senior loan officers to file clerks.

- The Bank's number of personnel more than doubled in a nine month period from a level of approximately 160 to a level of almost 325 by December 31, 1981.

- Internal committees of the Board and senior management have been formed to set policy and monitor performance.

- Some of the Bank's policies have been formalized in writing while others are in the process of being formalized.

- Procedures manuals are in the process of being written.

- A credit department has been established to review and evaluate loan collection and documentation.

- Controls have been placed on the making of new loans and the extension of existing loans.

- A process has been established for determining the necessary level of the loan loss reserve and the related monthly provision.

- Controls over letters of credit have been established.

- Criteria has been established for the charge off of loans and the placement of loans on a noninterest accrual status.

- An asset, liability program has been established with the related review of liquidity.

- Financial controls have been improved and the accounting department significantly strengthened.

- The Bank's current and long-term financial management information needs are currently being reviewed with an action plan to make the necessary charges in a cost-effective orderly fashion.

- The Bank's entire organization structure has been reviewed from top to bottom with consequent changes made which are in the process of being implemented.

In summary, virtually every significant area of the Bank has been reviewed and changes have either been made or are in process.

During the course of our audit of the Bank for 1981, we had an opportunity to work with virtually all of the Bank's new senior management and many of the new supervisory personnel. Without exception we have been highly impressed with their professional banking knowledge and ability to bring about change in their area of responsibility. It appears to us that the Bank has put together, in a very short time, an outstanding management team which has the skills to bring the Bank's growth under control. But more importantly, they have the talent to take advantage of the growth the Bank has achieved to date by strengthening the existing asset base and use it to develop a long-term program of controlled growth and profits. The positive changes which have occurred in less than one year have been truly remarkable and impressive.

As mentioned in the first part of this letter our remaining comments and recommendations are designed to help the Bank bring about further change and/or to encourage the changes which are already underway. Such comments and recommendations should also help the Bank further formalize and structure its program for changes and improvement in the Bank's operations and performance.

These comments have been reviewed with senior management to ensure that factual content is correct. In the process of such review, it was gratifying to note there were few comments which we had that management had not previously considered or was in the process of reviewing. In short, there were no surprises of significance.

PLANNING FOR CONTROLLED GROWTH AND PROFITS

Goal Setting and Long Range Planning

One of the characteristics of a high performance bank is having clearly defined goals and objectives for growth and profits with the necessary short and long range plans for achievement of such goals.

As the Bank considers a variety of changes throughout the organization, we recommend that the Board of Directors and senior management consider the need to formalize the Bank's goals and objectives with the related short and long range plans for achievement. Also, in conjunction with such strategies, the Bank should consider establishing budgetary controls over all general ledger accounts and cost centers for certain departments of the Bank.

Establishment of a formal planning process and budgetary controls will provide the Bank with multiple benefits and allow the following to occur:

- Penetrating questions are asked by both members of the Board and senior management as to what the organization is now and where would they like for it to be in the future.
- Careful analysis is made of the organization's strengths and weaknesses.
- Realistic and measurable goals and objectives are set with a plan for periodic monitoring and reporting to the Board on the Bank's progress.
- Management develops a short and long range strategy for the achievement of its goals.
- Reward systems are reviewed and often revised to encourage the achievement of established individual and departmental goals.

There is no question that organizations perform better when they have a clear understanding as to where they are going and a well developed plan to get there as opposed to organizations which just operate from day-to-day and let the future take its course.

While we recognize the Bank has begun to address the area of long range planning and budgetary control, we urge you to continue the progress on perhaps a more formalized basis. By doing so, we believe it will be easier to treat longer range organizational problems on an overall basis rather than by the traditional piecemeal approach.

Organizational Structure

Recently, the Bank's organizational structure was revised for the effect of new additions of senior and intermediate levels of management personnel which was mentioned earlier. As a result, new positions and even new departments have been created.

While the organizational changes are still in an evolutionary state, we urge that senior management and the Board continue to review the organizational structure and personnel positions and ask yourselves "is it right now and for the future, or does it need revision?"

After reviewing the new organization chart which is currently in the process of implementation, there is only one recommendation we wish to make.

The Oil and Gas Division is quite large and has several key personnel reporting to the Senior Executive Vice President in charge of the department. Because of the relatively large span of control which now exists, the variety of tasks performed within the department and the particular talents of the department head, we recommend that the organization of this key department continue to be reviewed. The review should be made from the standpoint of continuing to improve the administration of the day-to-day activities of the department and yet capitalize on the strengths of the department head and his relationships with key loan customers and upstream correspondents. For him to maintain these relationships and effectively administer the department may be unrealisitic as the Bank continues to grow.

Policies and Procedures

Guidelines for the operation of a bank or any organization are generally set through policies established by the board of directors and senior management. Specific procedures are then designed by management and staff to implement the various policies. In some organizations, policies and procedures are informal and most often communicated orally or through internal memos. However, as an organization grows in terms of volume of business and number of personnel, such informal means of communicating important operational matters becomes less and less efficient and effective.

The above described method has been the way in which the Bank has operated with respect to the setting of policies and implementation of related procedures. However, with the Bank's rapid growth, principally in the past three years, it is becoming more necessary to formalize old policies and establish new ones along with the necessary procedures to carry out the various policies.

At the present time, the Bank has under its employment a systems group which is responsible for reducing to writing all policies and procedures which govern operations in various areas of the Bank. This is, indeed, a positive effort, for approximately a year ago the Bank had practically no manuals in any areas. As the Bank continues to complete the various manuals for each area of the Bank, we urge you to consider the following:

- As the systems personnel go into an area to formalize the policies and procedures in writing, an officer from that area should be assigned to work closely with this group. This will allow individual areas of the Bank to lend valuable input to the systems group during the formulation of that area's policies and procedures.

- When the policies and procedures have been written in a certain area, management should consider having the internal audit department perform a detailed review of the policies and procedures of that area before presentation to the Board for their approval. This will help ensure that the policies and procedures provide for proper controls in each area.

- As procedures are being developed, management should strive to design them to be functionally oriented rather than written for an individual's duties. This approach will provide more flexibility as the Bank continues to grow.

Completion of the policies and procedures manuals in each area of the Bank and required compliance with them by all bank personnel will allow the Bank's operations to flow more smoothly and provide the Bank with stronger controls in each

Profitability

In the past, the Bank has not established formalized performance goals such as:

- o return on average assets,
- o return on equity capital,
- o ratio of capital to assets,
- o earning assets as a percentage of total assets,
- o ratio of loans to deposits,
- o interest spread,
- o liquidity ratio,
- o etc.

With today's volatile interest rates and inflationary pressures which the Bank must operate within, the establishment of such measurable performance goals becomes a necessity in order to monitor and control the Bank's growth.

When establishing these goals, management must recognize that profitability levels of the Bank should be higher than most banks of similar asset size primarily due to the large loan portfolio which the Bank is currently servicing for correspondent banks and the related fee income generated therefrom.

Although the Bank has performed work in some of these areas, we encourage further development of matters such as the following:

- o Review the pricing of all products and services.
- o Determine the actual profitability of the Bank's large customer relationships.
- o Consider revising Bank policy with respect to service charges for overdrafts and NSF items. It appears to us that some customers have taken advantage of the Bank in this area.

- o Determine the direction of the Bank's trust department. Our limited analysis indicates that it will continue to be a loss center for some time.
- o Establish an overall goal of maintaining an average of a percentage of total assets (say 90%) in earning assets. This is especially important since the realization of the Bank's earning potential is dependent upon the effective management of its assets.
- o As the Bank considers improved operational efficiencies throughout the Bank, there are a number of ways in which improved workflow and controls can be achieved in the processing of items. Specific suggestions have been made in our letter to Mr. Gunter.

REPORTING AND MONITORING SYSTEMS

Internal Monitoring Reports

As described in the diagram at Appendix A, the "control environment" of the Bank in its simplest form consists of the Board and senior management setting policies, goals and objectives for the organization with the related monitoring and reporting systems established to monitor adherence to policies and measurement of performance.

Naturally, for proper monitoring to occur, the Bank must have a good information system to meet the needs of the various levels of management and a well organized and managed internal audit department to review and test adherence to policies and procedures and report exceptions noted to the Board and senior management.

At the present time the Bank, aided by the consulting division of our firm, is determining whether it is receiving the necessary reports to adequately monitor the operations of the Bank. This is a vital question facing the Bank, which should receive a high priority until the management information needs of the Bank have been determined and an action plan agreed upon as to how such needs will be met.

Completion of this project will allow the Bank to determine the following:

- o Determine what information is necessary which will allow management to properly monitor bank operations.
- o Once this is determined and cost estimates are developed, the Bank can decide whether it needs to establish a data processing function within the Bank, leave it at Fidelity Bank as a service bureau operation or a combination of the two.
- o The Bank will then be able to formulate alternatives and ultimately establish the necessary system along with related data processing equipment which will benefit the Bank in the short and long run on a cost-effective basis.

Reports to the Board of Directors

Although you as Board members are receiving various financial reports at the monthly meetings, we believe that the presentation of additional financial information would be beneficial. We recommend the following as improvements in this area:

- o The Board has been seeing financial information for only the Bank. We recommend that the Board also receive consolidated financial statements of First Penn Corporation. Such information represents the true financial picture of your financial institution as a whole and presents the only meaningful financial results from a stockholder point of view.

- A presentation of asset yield and cost of money trends over a period of time should be presented to help you monitor the actual "spread". made by the Bank on its interest margin. A proper management of this spread has a direct impact on the Bank's profit objectives.

- After management establishes a budgetary system, they will be able to present to you a comparison of actual financial results compared with the corresponding budgeted data on a monthly basis. Such a report should also contain explanations of material variances between budgeted and actual information.

- The loan administration area of the Bank presently prepares an excellent "problem loan list" and a related calculation of the necessary loan loss reserve. We believe this information will be an excellent addition to your board reports and should be presented to you on at least a quarterly basis. Because the level of the Bank's reserve for loan losses has a direct impact on earnings, you should be familiar with the rationale as to how the level of the reserve is determined at any point in time.

- Many times the presentation of financial information in the form of illustrated graphs is beneficial to the readers of such information. This provides the preparer of information an opportunity to provide the reader a view of asset, income and expense, yields and cost of money trends over an extended period of time in a clearer but much less detailed presentation. Virtually all the measurement goals which the Board establishes can be reported effectively through the use of various types of charts and graphs. We encourage the use of such presentation due to the trends which are highlighted and the time savings achieved when having to present and read a large variety of financial data.

Increasing Internal Audit Effectiveness

The Internal Audit Department is an important and integral part of the monitoring process. They serve as your "eyes and ears" to determine how well the rest of the Bank is following established policies and procedures.

For any internal audit function to be effective, it must have direct and visible support from the Board in order for them to have the proper stature within the organization. Their reports to the Board should receive due consideration and significant exceptions reported should be appropriately dealt with in a decisive and timely manner. The audit department also requires input and direction of the Board with respect to their annual audit program, areas which require emphasis or special projects in areas where the Board requires more information. At the same time, the audit department should be accountable to the Board for their budget of time and money to operate the department versus amounts actually spent.

The Bank has an active internal audit department of six persons. To improve their effectiveness, we recommend the following:

- The development of a complete internal audit program which spans the entire year and is approved annually by the Board's audit committee. Such a program should relate audit risk to time spent and be comprehensive enough to cover all significant areas of the Bank. Presently, we are making arrangements with personnel of this department to assist in the development of such a program.

- The stature and authority of the department within the Bank is unclear among some of the Bank's officers and staff. The Board should consider instructing its senior management to convey to all personnel the importance of the internal audit function within the Bank and the cooperation they are expected to receive.

- Development of an adequate working knowledge of EDP functions, especially if processing is established "in house", could prove to be extremely beneficial to the department. The use of audit software programs will allow the auditors to be more efficient and effective in the work they perform.

LOAN ADMINISTRATION

Loan Review Function

In 1981, the Bank established a much needed loan review function which consists of a grading system for all loans to be used to determine the necessary reserve for loan losses at the end of each quarter. A controlled expansion of this function will allow the Bank to challenge its reserve for adequacy on a regular basis, which is an admirable trait of any bank. This is an extremely positive step for the Bank, and we urge you to take full advantage of your capable staff in this area.

Loan Documentation

As was pointed out in recent regulatory examinations of the Bank, documentation of loans and their related collateral has been less than adequate in the past. During the latter part of 1981, the Bank showed a marked improvement with respect to loan documentation and will apparently continue to improve due primarily to the perseverance of senior management to correct existing problems and reduce future errors through the hiring of an excellent staff to monitor this area. This is a critical area for any bank but especially your bank, due to the expanding nature of your loan operations. Therefore, we believe it merits your utmost attention until all problems are corrected.

Correspondent Banking

During 1981, the Bank was involved in certain practices with respect to loans participated upstream to other banks which we consider questionable. The most significant of these involves the practice of making periodic payments of both principal and interest to the correspondent banks without first receiving payments from the borrowers. The Bank is not required to do this according to the written participation agreements, but apparently the Correspondent Banking division has orally agreed to do this with some banks.

This practice is not desirable for the following reasons:

- It causes a continual increase in the Bank's accrued interest receivable (a non-earning asset) which reduces the potential earnings of the Bank.
- It also causes an unplanned strain on the Bank's liquidity since cash is paid out before cash is received from the borrowers.
- When these transactions occur, an extension of credit has been made to the borrower without official approval.

In our opinion, discontinuance of this practice is imperative to the Bank. If it remains necessary to continue on certain occasions, it should require documented approval by the credit policy committee or executive management.

Other

During our examination, we observed other practices in the area of loans which we believe merit your attention and possible improvement:

- As of December 31, 1981, the Bank was approximately two months behind on preparing its daily loan reconciliations. We recommend that the loans and their related interest be reconciled on a daily basis without exception and that an officer scrutinize and approve each reconciliation. Subsequent to year end, the Bank corrected, in varying degrees, many of the problems that plagued this process; however, we urge the Bank to devote a great deal of attention to this area until the reconciliation process is operating smoothly.

- We noted instances where loan officers have extended loans, some as many as 15 times, without requiring a principal reduction and many times without requiring the payment of the accrued interest. In addition, we noted several cases when interest is not paid, the accrued interest is not added to the principal of the new loan. As a result, interest income is being lost when these situations occur. Additionally, the effects of this practice resulted in a situation at December 31, 1981 where there was approximately five months of interest income for the year which had not been collected compared to three months at December 31, 1980. The effect on the Bank is a strain on cash flow and an increase in non-earning assets. We recommend the Bank establish a policy of requiring interest to be paid when due and exceptions to this policy only approved by the Bank's chairman, president or Board. If the interest payment is extended, it should be added to the principal of the note.

- Subsequent to December 31, 1981, we observed a continual increase in customer overdrafts. Some of the overdrafts resulted in the Bank violating its legal lending limit to certain of these customers. We believe the Bank should make concentrated efforts to not allow these violations to occur in the future. Also, management should consider working with customers in an effort to reduce the amounts involved in these overdrafts, especially since customers are often not charged for their overdrafts. To also ease the problem in the overdraft area, we recommend that the Bank's loan officers not make loans until funds are available for such loans.

- It came to our attention during our examination that loan officers occasionally instruct their secretaries to prepare and sign official documents such as official checks and loan instruments in their absence. In most cases, such persons have no authority to perform such a task. We recommend, if the loan officers are unable to be in the Bank, they should arrange for other officers to perform these tasks in their absence.

TRAINING

As discussed earlier herein, the Bank's number of personnel have more than doubled in the past year. Such an increase was necessary to adequately staff the Bank in order to handle its growth to date as well as future growth and changes which will occur. When the Bank assimilates such a large number of personnel in such a short time, little time is available to properly train new personnel in the Bank's policies, procedures, practices and philosophy of operation.

Presently, the Bank has slowed its hiring to a more normal pace. Now is a good time to review the Bank's need to establish a formal internal training program. Establishment of such a program will allow the following to happen:

- All personnel can be instructed in an orderly manner regarding recent changes which have taken place with respect to policies, procedures and organizational changes. An excellent training program can serve to communicate the Board's and senior management's views on a variety of matters.
- The Bank will have a vehicle whereby once an employee is hired, he can be taken through a new-employee orientation program and adequately trained to perform his job early in his employment, thereby helping to avoid unnecessary and costly errors.
- The Bank can also begin a program of cross-training for all positions in the Bank. This will provide adequate backup to ensure that during periods of vacation or illness, an employee's daily tasks and routines are adequately performed by another employee in the Bank.

OTHER MATTERS

Administrative Agreement

As you are well aware, the Bank has been operating under an administrative agreement with the Comptroller of the Currency throughout most of 1981. Primarily, during the later part of 1981, management of the Bank has made great strides in correcting or improving practically all of the areas addressed in this agreement. Management is to be commended for their efforts and progress to correct a serious situation in such a short period of time.

Centralized Purchasing

During this period of rapid growth, the Bank has lacked control over its purchasing function. It appears that several departments have purchased fixed assets, such as minicomputers, cars, artwork, etc. without approval of the purchasing officer.

Recently, controls in the purchasing area have been significantly strengthened. The Bank now requires that all purchasing be performed or approved by the purchasing department. These new controls are a must before previously mentioned budgetary controls can be effective.

IMPLEMENTATION OF RECOMMENDATIONS

As you consider the comments and recommendations made herein, please remember that responsibility for having effective internal controls and sound operating procedures within the Bank ultimately rests with each of you as Directors. In preparing to implement some or all of the recommendations, the following should be considered:

- Preparation of a formal response to this letter for the Board by management of the Bank;
- Preparation of a plan for implementation on a priority basis with definite timetables established;
- Identification of matters which can be performed by the Bank and those which will require outside assistance;
- Reporting periodically to the Board the progress made regarding the implementation schedule; and
- Consideration of the concept of cost versus benefit as decisions are made regarding controls and procedures to be installed.

* * * * * * * *

Our examination of the Bank's financial statements is based on tests of data supporting financial transactions and as such, you will appreciate that our examination will not necessarily disclose the existence of irregularities, if any. The ultimate assurance as to the safeguarding of assets and reliability of the financial records and information is dependent upon an effective system of internal controls, good management and the application of proper accounting principles and procedures. We trust that the recommendations made herein will serve to strengthen and enhance such controls in your efforts to meet your underlying managerial responsibilities.

Normally, the transition to a new accounting firm can be quite time consuming and sometimes rather frustrating for certain of the Bank's personnel. However, we trust that the benefits of our first audit will outweigh any of the negative aspects and that on the whole, you will find it to have been a worthwhile experience. We have certainly enjoyed this first year in working with you and Bank management and look forward to a lasting relationship in serving Penn Square Bank and its related entities.

Should you have any questions concerning the matters discussed in this letter, we shall be pleased to discuss them with you at your convenience.

Very truly yours,

Peat, Marwick, Mitchell & Co.

Peat, Marwick, Mitchell & Co.

Certified Public Accountants

345 Park Avenue
New York, New York 10154
(212) 758-9700

Office of General Counsel

October 8, 1982

The Hon. Fernand J. St Germain
Chairman
Committee on Banking, Finance and
Urban Affairs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Peat, Marwick, Mitchell & Co. ("PMM&Co.") submits this letter to clarify and to amplify its testimony during the hearing on Penn Square Bank, N.A. ("Penn Square") before your Committee on August 16. On behalf of the Firm, I request the permission of the Committee to supplement the record of that hearing.

During the hearing on August 16, PMM&Co.'s witnesses respectfully declined to discuss, on the grounds of client confidentiality, the services performed by PMM&Co.'s Oklahoma City office for The Chase Manhattan Bank, N.A. ("Chase") with respect to loan participations Chase purchased from Penn Square. The witnesses faced a dilemma. They had appeared pursuant to a subpoena which, in PMM&Co.'s view, extended to services performed for Penn Square, but not to services performed for any other client of the Firm. With respect to services performed independently for and at the request of another client, i.e., Chase, PMM&Co. was bound by a professional code of ethics not to disclose the services or the resulting communications.

PMM&Co.'s predicament, of course, could be resolved by Chase's consent. As Mr. Blanton then stated, PMM&Co. would be pleased to provide this information to the Committee under such circumstances. Subsequently PMM&Co. requested and received permission from Chase for PMM&Co. to set forth its views as to the request it received, the services performed and the resulting communications with Chase.

As you, Mr. Chairman, noted during the hearing, the assertion of client confidentiality could result, and did result, in false accusations and misinformation being circulated in the media. We believe the disclosure, with the client's permission, of the facts relating to the services performed for Chase amply demonstrates the propriety of PMM&Co.'s conduct.

PMM&Co.'s New York office, for many years, has served as Chase's independent certified public accountants. In late October, before Penn Square had approached PMM&Co. to accept the engagement as Penn Square's auditors, Chase requested advice from our New York office on procedures Chase might employ with respect to its loan participations from Penn Square. PMM&Co.'s New York office recommended that Chase engage Penn Square's auditors, with Penn Square's permission, to conduct the anticipated procedures. Arthur Young & Company had been, and was then assumed to be continuing as, Penn Square's auditors. Such a recommendation and course of action is not uncommon in the case of loan participations.

Later, when Chase determined to proceed, Penn Square had engaged PMM&Co.'s Oklahoma City office to conduct its audit examination as of and for the year ended December 31, 1981. Thus, in early February 1982, Chase's request was made to PMM&Co. personnel in New York who in turn discussed it with PMM&Co.'s Oklahoma City office. Attached as Exhibit A is a copy of a memorandum dated February 10, 1982 outlining Chase's request. As expressly set forth in the memorandum, Chase was to forward a letter of understanding to Penn Square once the scope of the assignment was determined.

PMM&Co. personnel in New York and Oklahoma City discussed the work to be undertaken and then PMM&Co. New York personnel reviewed the scope of the assignment with Chase. Once PMM&Co. and Chase agreed upon the specific procedures, Chase on April 8, 1982 wrote to Mr. Bill P. Jennings, Chairman and Chief Executive Officer of Penn Square, requesting Penn Square's approval. Following the approval of Penn Square senior management -- confirmed orally to PMM&Co. by Eldon Beller, President and Chief Administrative Officer and James Gunter, Chief Financial Officer -- PMM&Co. began its work.

By letter dated May 21, 1982, PMM&Co.'s Oklahoma City office forwarded a draft of the expected report, dated May 5, 1982, to PMM&Co.'s New York office. PMM&Co.'s New York office subsequently provided a draft to Chase for purposes of review and discussion, and determination as to whether further procedures were appropriate. The letter and draft report appear as Exhibit B hereto. With the press of other matters, the report was never completed nor any additional procedures performed.

As is evident, there was nothing improper in these procedures. It is not uncommon for one financial institution to approve the conduct of special procedures by its auditors for a second institution when the first is servicing loans for the other. Moreover, as the draft report indicates, these limited, special procedures did not disclose significant discrepancies or weaknesses. The proposed findings of the draft report were not inconsistent with the information available at the time of the PMM&Co. report on Penn Square's financial statements.

We believe this information will clarify the testimony presented on August 16 and will resolve the questions raised concerning the services Peat, Marwick, Mitchell & Co. performed for Chase with respect to the Penn Square loan participations.

Respectfully yours,

Edwin D. Scott

Edwin D. Scott
Assistant General Counsel

EDS:bw
Attachments

Peat, Marwick, Mitchell & Co.

To: Mr. C. D. York
Office: Oklahoma City

Date: February 10, 1982
Steno: rms

From: J. S. Zwaik
Office: New York

Enc:
cc:

Subject: Performance of Agreed-upon Procedures at Request of Chase Manhattan Bank

Pursuant to our telephone conversation of February 9, the purpose of this memorandum is to outline certain procedures which you are being asked to perform on behalf of The Chase Manhattan Bank. These procedures pertain to certain commercial loans (primarily production payment loans) in which Chase is participating with Penn Square (generally 90%-99% Chase share). These loans were originated by Penn Square, who continues to service them. Currently, Chase has approximately 150 such loans totaling approximately $230 million.

Based upon discussions I have held with Chase personnel, they are requesting the following procedures to be performed:

- review of Penn Square's credit granting policies and procedures

- review of Penn Square's credit monitoring (subsequent to credit extension) policies and procedures

- review of Penn Square's procedures for the servicing of loans (including, but not limited to, collection of payments from borrowers and forwarding appropriate amounts to Chase)

- confirmation of 25% of the number of loans Chase is participating with Penn Square (confirmation with both borrowers and any other participants). Selection to be on a random basis.

- review of credit files for all Chase participation loans over $5 million, plus 15 such loans under $5 million, randomly selected.

EXHIBIT A

Based upon the above, could you please prepare and forward to me the following:

- o proposed draft report
- o detail procedures to be performed
- o fee estimate

Based upon the procedures, etc., Chase personnel will prepare a letter of understanding to be sent to Penn Square.

In addition, as we discussed, since Chase says that they will pay for these procedures (Chase will address the question of passing the cost to Penn Square with them at a later date), you should charge your time and expenses to New York contract #176-07545-77.

I appreciate very much your cooperation in this matter. If you have any questions, please call me at (212) 552-2873 (or 2874).

Peat, Marwick, Mitchell & Co.

First Oklahoma Tower
Oklahoma City, Oklahoma 73102
(405) 239-6411

May 21, 1982

Joeseph Chu
Peat, Marwick, Mitchell & Co.
345 Park Avenue
New York, NY 10154

Dear Mr. Chu:

Enclosed is a draft of our special report performed for Chase Manhatten Bank on Penn Square Bank, N.A. Please note any changes you wish to make and provide me with the proper heading of our report and return to me as soon as possible.

Sincerely,

PEAT, MARWICK, MITCHELL & CO.

Kim W. Shoemake, Supervising Senior

KWS/dlh

EXHIBIT B

DRAFT FOR DISCUSSION PURPOSES ONLY

Robert L. Denner, Vice-President
Chase Manhattan Bank, N.A.
One Chase Manhattan Plaza
New York, New York 10015

Dear Mr. Denner:

As you requested, we have performed certain agreed procedures on behalf of Chase Manhattan Bank (Chase) on certain loans and records of Penn Square Bank, N.A. (Penn Square). These procedures are in accordance with our audit program (Exhibit B) which was attached to the authorization letter from Chase to Mr. Bill P. Jennings, Chairman of the Board, Penn Square Bank, N.A. Our resulting findings were as follows:

Credit Granting

We discussed credit granting policies with Mr. John Baldwin, Senior Vice President, who informed us at the present time any lending officer in the Bank has authority to make a loan, if such loan does not cause the borrower's total indebtedness to exceed $50,000. If such a loan does cause total indebtedness to exceed $50,000, the loan is then approved by either the Bank's credit policy committee, or the Bank's president or Chairman. We performed an inspection of the loan documents on a test basis to determine whether all new notes which caused total indebtedness to exceed $50,000 were so approved and discovered no discrepancies from this policy. The Bank has plans in the near future to establish individual lending limits for each officer rather than the $50,000 limit for all officers.

Credit Monitoring

During 1981 the Bank established a strong loan review function. It is presently a joint responsibility of the loan review department and each individual loan officer to monitor the financial condition of their customers. The loan review department performs this task by reviewing past due reports and overdraft lists, performing periodic collectibility reviews and maintaining a problem loan list. We performed various tests and reviews to ensure the completeness of this work and discovered no discrepancies. In addition, the loan review department reviews all new loans within 90 days of the issuance date to ensure performance as agreed on in the loan documents. The individual loan officers are responsible for maintaining contact with each customer in an effort to determine their business needs and possibly detect potential problems with a loan when they first occur.

Loan Servicing

We discussed with Bank officials the policies regarding servicing of the loans participated with Chase and learned there are two types of payments to Chase. The first type is simply when a customer makes a payment and Penn Square wires Chase its pro-rata share. The Bank has adequate controls over this function. The second type of payment to Chase occurs when Penn Square wires Chase money from its own funds to meet the requirements of the note even though the borrower has failed to meet these requirements. This procedure occurred quite frequently in 1981, due to the lack of a policy to govern it. In 1982 a new policy was established which requires the approval of Penn Square's credit policy committee and therefore, due to these stringent controls, this situation is occurring less frequently.

Confirmations

We randomly selected 25% of the total number of loans in which Chase is participating with Penn Square for direct confirmation with the borrower as of March 31, 1982. This resulted in 38 confirmations mailed and 36 being returned to us with no exceptions.. We performed alternative procedures to ensure validity of the notes on those borrowers not responding.

Loan Document Inspection and Payment History

We randomly selected 25 loans participated to Chase and inspected the loan files for the following required documentation:

- executed loan document
- signed note
- collateral properly perfected
- appraisals when appropriate
- engineering reports, including a documented revie by Penn Square's engineers, when appropriate
- insurance coverage with Penn Square named as loss payee, when appropriate
- current financial information
- properly executed extensions, when applicable

We discovered three minor exceptions which the Bank is in the process of correcting.

Also, on these 25 loans we performed a payment history test which consisted of:

- Determining whether loan payments are made when due.

- Determining whether a loan is current or past due and that such status is reflected in Penn Square's internal reports.

- Determining the number of times, if any, the loan has been extended.

- Determining the borrower is making his required payments or if Penn Square is making them on behalf of the borrower to Chase (see information under loan servicing).

We discovered no significant exceptions in this area.

Collectibility Review

We performed a credit file review for collectibility on all loans in which the portion Chase owned, equaled or exceeded $5,000,000. Also, we performed such a review on 15 additional loans selected at random in which Chase participated in an amount less than $5,000,000. See Exhibit A for a detail list of loans reviewed and their related classification.

* * * * * * * *

Because these procedures do not constitute an examination in accordance with generally accepted auditing standards, we express no opinion on the financial statements of Penn Square. In connection with the procedures referred to above, no significant discrepancies or weaknesses were discovered. Had we performed additional procedures or had we made an examination of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you. It is understood that this report is for the exclusive information of Chase Manhattan Bank and is not to be distributed to others for any purpose.

May 5, 1982

Exhibit A

NAMES OF INDIVIDUAL BORROWERS DELETED FROM THIS COPY.

Name of Borrower	Classification
	Good
	Good
	Good
	OLEM
	Good
	Good
	Good
	OLEM
	OLEM
	Good
	OLEM
	OLEM
	Substandard
	Substandard
	Good
	Doubtful
	Substandard
	OLEM
	Good
	OLEM
	OLEM
	Substandard

PW&CO.

Examination of Agreed on Procedures for Chase Manhattan Bank

Company Penn Square Bank, N.A. Period ended 3-31-82

Item No.	Auditing Procedure	Period and Extent	Done By
	Objectives:		
	The objective of the following audit tests is to determine whether or not that Penn Square Bank is following its own policies and those of prudent banking with respect to the loans they have participated to Chase Manhattan Bank of New York. A special report in accordance with SAS #14 will be prepared which covers our finding after applying the below agreed upon procedures.		
1.	Review existing policies and procedures regarding Penn Square Bank's credit granting policies. Discuss all pertinent data with appropriate personnel and prepare a memo documenting our findings.		
2.	Perform the same procedures as mentioned in #1 regarding credit monitoring.		
3.	Prepare a memo regarding the servicing of Penn Square Bank's loans which are participated to Chase Manhatten Bank.		
4.	Randomly select 25 loans participated to Chase and perform the following: (A) Review and analyze loan document file to determine if such documents are complete with data such as: o Executed loan document o Currently signed notes o Collateral properly perfected o Appraisals obtained where appropriate o Engineering reports obtained and reviewed by the Bank's engineers where appropriate o Insurance coverage obtained with the Bank named as loss payable payee where appropriate o Current financial statements o If loan extensions for principal and/or interest exist, determine they have been properly executed. (B) In reviewing the loan documentation, compliance test the Bank's adherence to the policies noted in steps 1, 2 and 3 above. (C) On the loans selected, perform a payment history test of the loan or credit line tracking such information as: o Are payments made when due for principal and interest? o Determine if loan is current or past due and that such status is reflected on the Bank's internal reports. o Determine number of times the loan has been extended for principal and/or interest. o Determine if customer is making the principal and interest payments or if the Bank is making them in the customer's behalf to Chase. (D) If significant exceptions are found in this test, call Jan Zwaik in New York for guidance as to how we should proceed.		

PMM&CO.

Examination of Agreed on Procedures for Chase Manhattan Bank

Company Penn Square Bank, N.A. Period ended 3-31-82

Item No.	Auditing Procedure	Period and Extent	Done By
5.	On a random basis as of a random date, select 25% of the total number of loans in which Chase is participating with Penn Square and confirm directly with borrowers via positive confirmations. Such loans were previously confirmed as of December 31, 1981 and all exceptions were cleared to our satisfaction. The loans selected in (4) above should be included in the test.		
6.	Send second requests as necessary.		
7.	Clear all exceptions to our satisfaction.		
8.	Review for collectibility all loans which Chase has a participation equal to or greater than $5,000,000 plus fifteen other loans less than $5,000,000 selected at random. Include all loans classified other than "good" in the report to Chase.		
9.	Draft the report noting all procedures performed and any errors or weaknesses noted during our work. Such report will be prepared in conformity with SAS #14.		

The CHAIRMAN. At this time, the Chair would call Mr. Harold Russell, managing partner of Arthur Young & Co.

Mr. BARNARD. Mr. Chairman, might I ask a procedural question? Because of the essence of time, might it not be possible to question some of the witnesses whose testimony would be a lot more pertinent today?

The CHAIRMAN. I assure the gentlemen we will complete the witness list today.

Mr. BARNARD. We are going to complete it today?

The CHAIRMAN. Yes, sir.

Mr. BARNARD. Thank you. You are not going to complete it today; you might complete it tonight or in the morning.

The CHAIRMAN. As the gentleman knows, we from Rhode Island feel that all hours are daytime hours. The way you enjoy life, it is a wonderful thing, and being in Oklahoma City is such a wonderful pleasure——

Mr. BARNARD. You are enjoying this? [Laughter.]

The CHAIRMAN. I enjoy being with these wonderful people and with you and Jim, and the rest. [Laughter.] [Witness sworn.]

TESTIMONY OF HAROLD RUSSELL, ARTHUR YOUNG & CO.

The CHAIRMAN. Mr. Russell, you are the gentleman with Arthur Young & Co. who was the predecessor firm to Peat, Marwick, Mitchell & Co., doing the auditing at Penn Square Bank?

Mr. RUSSELL. Yes, I am.

The CHAIRMAN. For how long a period of time were you auditing Penn Square?

Mr. RUSSELL. We began to audit the bank in 1976. We examined the balance sheets for 3 years, and then on the formation of the holding company in 1979. We reported on the holding company in 1979 and 1980.

The CHAIRMAN. In addition to the bank——

Mr. RUSSELL. We reported only on the holding company in 1979.

The CHAIRMAN. Would you be good enough to describe for us the reasons given to you by the people at Penn Square when they informed you that they had no further need for your services?

Mr. RUSSELL. We really weren't given a reason; we simply were sent a letter saying that—I think the term was executive management had decided to make a change.

The CHAIRMAN. Were you here this morning when the question was asked of Mr. Beller as to this change, and among the reasons were that he could not get any return phone calls from the people at Arthur Young & Co.?

Mr. RUSSELL. I think he said Mr. Gunter complained of that. Yes, I was here. There was a period for about a week when the individual who was responsible for the day-to-day work was ill, and there was some difficulty in getting a hold of him.

The CHAIRMAN. Were the people at Penn Square informed of the fact that that gentleman was ill?

Mr. RUSSELL. It was a woman, but yes, they were. And in fact, I think she called them from home.

The CHAIRMAN. Now, your 1980 audit, I think everybody is aware of the fact, at this point had a qualifying statement. Do you feel as though this necessarily placed doubt on the adequacy of the loan loss reserves?

Mr. RUSSELL. In the 1980 accounts?

The CHAIRMAN. Yes.

Mr. RUSSELL. Yes. With respect to 1980. Of course, that is exactly what we were qualifying for, and we said that we had a scope qualification which is a highly unusual thing, particularly in a financial institution. And particularly, when it goes to the reserve to loan losses, as ours does.

We simply indicated that the supporting documentation which was inadequate was so inadequate that we could not make the determination as to whether it was adequate or not adequate.

The CHAIRMAN. In 1979, you performed an extensive examination of the oil and gas loans of Penn Square.

Mr. RUSSELL. Yes.

The CHAIRMAN. And my information is that you found that they were in pretty good condition?

Mr. RUSSELL. In 1979, they were in excellent condition.

The CHAIRMAN. In 1980, you analyzed the loans that were criticized by the Comptroller's examiners. Did you find the Comptroller's people to be evenly balanced in their approach, or in your opinion, what was the attitude of the bank officials about those classifications?

Mr. RUSSELL. That is two questions. Yes, certainly in 1980, at the end of the year, the Comptroller really had what I would call their A team examining the bank.

The CHAIRMAN. Their best?

Mr. RUSSELL. Some of the best people that they had because they brought in people from the Dallas office, the Houston office and other offices. So I think in answer to that question, they had excellent people reviewing the accounts of the bank at the end of 1980. And I have forgotten your second question.

The CHAIRMAN. As you know, that team did, indeed, classify a number of those loans energy loans.

Mr. RUSSELL. Yes, they did.

The CHAIRMAN. Do you think that the people—that the A team was overly harsh in their classifications of those loans?

Mr. RUSSELL. Well, the bank suggested to officials that they were overly harsh. We reviewed those classifications and we agreed with the classifications of the Comptroller, or those examiners.

The CHAIRMAN. Mr. Leach?

Mr. LEACH. Let me say that in retrospect, it is quite clear that seldom has a caveat served an auditing company so well. [Laughter.]

Mr. RUSSELL. But it is not simply a caveat.

Mr. LEACH. I asked the gentleman from Peat, Marwick how common a practice it was to have a qualification in a bank audit, and he said it was not highly unusual. You have just stated that it is highly unusual to have a scope qualification. Could you elaborate on that?

Mr. RUSSELL. Well, I don't know how I could elaborate other than expressing my opinion that when you havira scope qualification that says there is inadequate documentation that goes to the reserve loan losses. I doubt very much if you will find very many of those kinds of qualifications in a bank or any financial institution.

Mr. LEACH. Out of 1,000 banks that are audited by principal auditing companies in America, how many will have scope of qualifications?

Mr. RUSSELL. That run to the loan loss reserve? I would guess—and these are hypothetical type questions—but I would guess, I would be surprised if it exceeded five.

Mr. LEACH. Five out of 1,000 would qualify as a highly unusual condition.

I was intrigued to read your letter of contract with the bank dated January 6, 1981, in which you stated, and I will just quote, "In conducting our examination, we became aware of the possibility that illegal acts may have occurred that may have a material effect on the financial statements." Is that standard contractual language?

Mr. RUSSELL. That is standard.

Mr. LEACH. That is not an unusual aspect?

Mr. RUSSELL. No.

Mr. LEACH. In your judgment, were there illegal acts that occurred?

Mr. RUSSELL. Almost in any bank situation there will be some violation, some technical violations, which would be characterized as illegal acts.

Mr. LEACH. Were you saying that your scope qualification indicated that the possibility of illegal acts was high or low?

Mr. RUSSELL. No. Our scope qualification goes to the inadequacy of the documentation of the loan loss ratios. We are saying that the loan files themselves were inadequate, the documentation, so we could not make a decision.

Mr. LEACH. I appreciate that and would yield briefly to the chairman.

The CHAIRMAN. I thank the gentleman for yielding. Now, you said that paragraph on illegal acts is standard, and in many institutions you will find some violations, and we are aware of that. But let's talk about Penn Square.

You just told us that in about 5 out of 1,000 cases you would have a scope qualification such as was contained in your report?

Mr. RUSSELL. Yes, I would be surprised.

The CHAIRMAN. As to illegal procedures at Penn Square, were they within the ordinary realm, or would you say that they were a little higher than ordinary?

Mr. RUSSELL. Well, I don't think I can make that comparison. There were a number of illegal acts which were identified both by the examiners and ourselves, and I really couldn't compare it to other banks. I don't think I could add anything to that.

The CHAIRMAN. Except for the fact that—well, you perhaps do not think you could add anything, but I think you could because I am told that you have written a few manuals on bank procedures and are very, very knowledgeable in the area, and this is why I asked my colleague to yield for a moment.

Mr. RUSSELL. Well, I was as far as writing technically when I was chairman of the Subcommittee for the American Institute which was writing the Bank Audit Guide for the Institute. That is my involvement with that.

With respect to Penn Square at the end of 1980, I would have to say that I think that the technical violations were probably, as far as number, more than you would normally incur or see in a bank. Yes. But I think they were well documented in the examiner's report.

I think—as I say, I really think they did a fine job, and they sent in excellent people to do that. So I think they did document that.

The CHAIRMAN. I thank the gentleman for yielding.

Mr. LEACH. In your judgment, do you feel the fact that you made a qualifying statement in your audit was a factor in your not being rehired to perform the audit the following year?

Mr. RUSSELL. I have no way of knowing. I have listened to the testimony that you have heard today, and I would have to assume that Mr. Beller would feel more comfortable with Peat, Marwick. But beyond that, I have no knowledge.

Mr. LEACH. Firms can only make money when they have clients. To make an audit finding that is less than perfect and will reflect poorly on that company takes a degree of courage. I would like to tip my hat both to you, sir, and to your firm. And I appreciate your willingness to appear before us today.

Mr. RUSSELL. Thank you. It is, indeed, an easy thing to do as a practical matter.

The CHAIRMAN. Mr. Barnard?

Mr. BARNARD. As far as procedure is concerned, when an auditing firm such as yours finds the need to make a qualifying disclosure, where is it normally found?

Mr. RUSSELL. Well, I think you are speaking about the specific situation.

Mr. BARNARD. Yes.

Mr. RUSSELL. Do you mean where the report is found or where the qualifying statement is?

Mr. BARNARD. Where the qualifying statement is found.

Mr. RUSSELL. The qualifying statement, when it goes to a scope qualification, is normally found in the auditor's opinion letter.

Mr. BARNARD. And in your particular statement, it was found in paragraph 2, I believe.

Mr. RUSSELL. That is right.

Mr. BARNARD. Paragraph 2 of your letter?

Mr. RUSSELL. That is correct. It is actually in paragraph 1, which refers you to paragraph 2. It is an "except for" letter.

Mr. BARNARD. Is that a generally accepted procedure among all creditable——

Mr. RUSSELL. As far as the way it is presented, yes, that would be the way; what we would call the statement of auditing standards were presented, yes, sir.

Mr. BARNARD. That is the general modus operandi?

Mr. RUSSELL. Yes.

Mr. BARNARD. The acceptable modus operandi?

Mr. RUSSELL. Yes, sir.

Mr. BARNARD. So in other words, if it was on the four last pages of a document that had at least 20 or 25 pages, you would find that that might be a little unusual, right?

Mr. RUSSELL. Well, that would be unusual because you would have to have a four-page opinion letter to do that. When you have a scope qualification it must be in the opinion letter. It cannot be in the financial statement.

Mr. BARNARD. Would you consider, then, a statement such as this as being a scope qualification:

It should be understood that future loan losses involved an exercise of judgment. It is the judgment of management that the allowance is adequate at both December 31, 1981 and 1980.

Is that an explanation?

Mr. RUSSELL. I think you must be reading from the Peat, Marwick report.

Mr. BARNARD. Yes, I am.

Mr. RUSSELL. No, that would normally—let me think about how I might answer you. Well, it would not be a scope qualification. It is more—it would be a representation of management in the financial statements. I think you would have to characterize it as a representation of management.

Mr. BARNARD. It is a representation of management?

Mr. RUSSELL. Yes.

Mr. BARNARD. But it is a statement from the auditors to whom? The board of directors?

Mr. RUSSELL. Well, the auditors, ourselves, or anyone else really only render an opinion letter. The financial statements themselves are supposed to be the representation of management. They have the primary responsibility for that. So the auditors would be responsible for their opinion letter.

Mr. BARNARD. I have no further questions.

The CHAIRMAN. Mr. Russell, when you prepared that report that had the qualification, were you aware of the fact that it would be reviewed not only by the board of directors of Penn Square or the parent holding, but by many, many people around the country who might be giving thought to investing funds in Penn Square?

Mr. RUSSELL. Well, the answer is that we were aware that it would become public information, but it would not necessarily become public information to the general public in that it was included in a filing with the Federal Reserve, which is required of a bank holding company, and in a document entitled FRY-6 report. So we were aware of that.

And obviously, we have been quite cognizant of the fact that our report would be the only public information available—even though it is on the holding company itself—for an investor who understood those reports to understand our qualification went to the subsidiary bank.

The CHAIRMAN. And so, a sophisticated money broker who was attempting to make a determination as to whether or not advise clients to invest funds in a particular institution would know enough to look at that report, would they not?

Mr. RUSSELL. Well, I don't know whether they would know or not. It would depend upon the broker.

The CHAIRMAN. Would it surprise you to be told that quite a few of the money brokers have told us that yes, indeed, they reviewed your report and that of Peat, Marwick, Mitchell & Co.?

Mr. RUSSELL. I would think that brokers were sophisticated would know where the information was, and would make sure they had access to it, yes, sir.

The CHAIRMAN. So it would not surprise you to learn that your report was being reviewed by those people?

Mr. RUSSELL. No, I would expect it to be.

The CHAIRMAN. Thank you. Mr. Weber?

Mr. WEBER. Thank you, Mr. Chairman. Mr. Russell, your 1980 financial statement is qualified for the reason that there was a lack of supporting documentation of collateral values of certain loans. Your 1979 report was not so qualified. Was there some change in documentation between 1979 and 1980 that caused you to qualify the 1980 report but not the 1979?

Mr. RUSSELL. Yes, there was. In 1979, the bank did a very good job in obtaining engineering reports from very reputable engineering firms like Keplinger and Lawson and others, and did that quite well and quite thoroughly, and they were very current.

In 1980, that deteriorated and there were not current engineering reports. In some cases, there were engineering reports which did not include an opinion of the engineer, or did not include the assumption that the engineer used or the nature of the reserves that he had estimated; volumetric versus historical data.

Mr. WEBER. Do you know any reason why that was permitted to deteriorate in that fashion?

Mr. RUSSELL. No, I do not.

Mr. WEBER. When did you first bring to management's attention the fact that you were giving consideration to qualifying the report in this fashion?

Mr. RUSSELL. Well, we would normally begin really doing our audit, the bulk of it, being able to look at loan reserves, after the end of the year. So it would have been sometime prior to the issuing of the report obviously, but sometime in latter February or the first part of March.

Mr. WEBER. I assume that you did discuss this with management; the fact that you would include this type of statement?

Mr. RUSSELL. Yes, we did.

Mr. WEBER. Who specifically did you speak to?

Mr. RUSSELL. Bill Jennings.

Mr. WEBER. What was his reaction?

Mr. RUSSELL. Obviously, he was not pleased with that, but the meeting concluded on, I think, you have to do what you think you have to do.

Mr. WEBER. Did he make any statement about future employment?

Mr. RUSSELL. No, he did not.

Mr. WEBER. Did he make any other threat or recommendation or pleading or arm twisting of any kind?

Mr. RUSSELL. No other threat.

Mr. WEBER. Did you perform any further services after March 13, 1981, for the bank?

Mr. RUSSELL. Yes, we did some various little, what we would call management services activities. One was to help them look for a new financial vice president. There was another, dealing with some review of or actually just helping establish and supervising or helping direct internal auditors in a study of commitment fees. And one was to look at some of the financial accounting and tax ramifications of some of the fringe benefits of the package.

Mr. WEBER. Did you give them any assistance in instituting procedures to remedy your qualification?

Mr. RUSSELL. They did not request that.

Mr. WEBER. Are you familiar at all with the procedures which were instituted?

Mr. RUSSELL. Only as they have been. I, of course, knew that Beller had been hired, or Mr. Beller had been hired, and that some others had been hired, but nothing beyond that.

Mr. WEBER. Do you have sufficient knowledge of those new procedures to have an opinion as to whether or not they would have satisfied you, had you been the ones to prepare the 1980 or 81 statement?

Mr. RUSSELL. No, I wouldn't have an opinion.

Mr. WEBER. And did you have anything to do with instituting further corrective procedures to bring the bank into compliance with the administrative agreement which had been executed between the board of directors and the OCC?

Mr. RUSSELL. We were not requested to do so, no, sir.

Mr. WEBER. Thank you very much, Mr. Russell.

The CHAIRMAN. Mr. Wortley?

Mr. WORTLEY. I have no questions, Mr. Chairman.

The CHAIRMAN. Mr. Leach, did you have anything further?

Mr. LEACH. No, sir.

The CHAIRMAN. Mr. Russell, there is another question I am tempted to ask but I am not going to ask. Again, we want to thank you for your patience in staying with us, and for your assistance and willingness to cooperate.

[Subsequent to the August 16 hearing, Arthur Young & Co. issued this statement in regard to the Lytel letter:]

PENN SQUARE

During the Congressional hearings on Monday, the Committee introduced a copy of a letter from John Lytel of Continental Bank to William Patterson. This letter, which we obtained in the course of our audit, related only to loans which Michigan National had acquired. It did not indicate that any other bank had a right to resell loan participations to Penn Square. And, in fact, the letter suggests that it was Continental and not Penn Square which had agreed to reacquire the loans.

In the course of our audit of First Penn Corp., we confirmed well in excess of 90 percent of the participation loans with the banks who purchased participations from Penn Square. With the exception of the Michigan National loans covered by this letter, none of the confirmations disclosed any repurchase arrangements.

With respect to the Michigan National participation loans identified in the letter, those loans were in fact disclosed in the footnotes to the financial statements.

The CHAIRMAN. At this point, I would like to put in the record the following: First, the February 11, 1980 auditor's letter from Arthur Young & Co. regarding First Penn Corp.'s yearend 1979 consolidated statements; second, the February 18, 1980, Arthur Young "Management Letter"; third, the January 6, 1981, letter from Arthur Young & Co. re: scope of yearend 1980 audit; fourth, March 13, 1981 "qualified" audit letter; fifth, Arthur Young "Management Letter" dated May 20, 1981; sixth, filings of First Penn Corp. with the Federal Reserve Bank, received in records section, June 22, 1981; seventh, letter dated November 20, 1981 from Bill P. Jennings to Harold L. Russell, Arthur Young & Co., informing them that Peat, Marwick, Mitchell & Co. will do yearend 1981 audit.

[The material follows:]

ARTHUR YOUNG & COMPANY

1900 LIBERTY TOWER
OKLAHOMA CITY, OKLAHOMA 73102

The Board of Directors
First Penn Corporation

We have examined the accompanying balance sheets (company and consolidated) of First Penn Corporation at December 31, 1979 and the related statements (company and consolidated) of income, stockholders' equity and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statements mentioned above present fairly the financial position (company and consolidated) of First Penn Corporation at December 31, 1979 and the results of operations (company and consolidated) and the changes in financial position (company and consolidated) for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Arthur Young & Company

February 11, 1980

ARTHUR YOUNG & COMPANY

1900 LIBERTY TOWER
OKLAHOMA CITY, OKLAHOMA 73102

Mr. Bill P. Jennings, Chairman of
the Board
First Penn Corporation and Penn
Square Bank N.A.
Dr. Marvin K. Margo, Chairman,
Examining Committee, Penn Square
Bank, N.A.
1919 Penn Square
Oklahoma City, Oklahoma 73118

Dear Mr. Jennings and Dr. Margo:

We have examined the consolidated financial statements of First Penn Corporation for the year ended December 31, 1979, and have issued our report thereon dated February 11, 1980. As part of our examination, we studied and tested the Company's system of internal accounting control to the extent we considered necessary under generally accepted auditing standards. This was done to establish a basis for relying on such system in determining the nature, timing and extent of the other auditing procedures necessary to enable us to express an opinion on the Company's consolidated financial statements and otherwise to assist us in planning and performing our examination of the financial statements.

Our examination of the Company's consolidated financial statements, including our study and evaluation of its system of internal accounting control, would not necessarily have disclosed all conditions requiring attention in the system of internal accounting control because both the audit and the study employed, as is customary, selected tests of accounting records and related data. However, our examination disclosed the following conditions relating to Penn Square Bank, N.A. as to which we believe corrective action should be taken or documentation (including cost/benefit considerations) should be prepared as to the reasons why corrective action was not considered necessary in the circumstances. (In general, corrective action need not be taken when the cost of installing or improving a control procedure would exceed the benefit expected to be derived. Since precise measurement of costs and benefits usually is not possible, any evaluation of such relationship requires estimates and judgments by management.)

The following conditions captioned, "Conditions Requiring Attention" were considered, to the extent necessary in determining the nature, timing and extent of our audit tests applied in our examination of the Company's consolidated financial statements.

CONDITIONS REQUIRING ATTENTION

Reconciliations

The following were noted in our review of the reconciliations of various general ledger accounts at December 31, 1979.

1. Eleven official checks totaling $1,372,337 issued at year end by the Bank were either unrecorded or recorded in the wrong account at the time loan disbursements were made.

2. Accrued interest receivable on investment securities according to the general ledger exceeded the amount per the investment portfolio EDP printout by $19,446. It was also noted that during the year two unexplained journal entries had been made, apparently in an attempt to balance the general ledger to the investment portfolio EDP printout. In addition, the pledging status of six securities as listed on the investment portfolio EDP printout did not agree with confirmation reponses of the various state and political subdivisions for which the securities were pledged.

3. The accrued interest related to the single pay notes carried on the instalment loan EDP printout was not reconciled to the general ledger.

4. Company personnel were unable to locate 46 shares of the Bank's stock which is supposed to be in custody of First Penn Corporation.

5. The detail EDP printout of participation loans sold included numerous classification errors and some unrecorded transactions (see further comments immediately following under transactions not recorded timely).

Transactions not recorded timely

Due to banks reconciliations - Our review of reconciling items on the Healdton Bank account reconciliation at December 31, 1979 disclosed that two checks had been issued by Healdton to purchase loans under participation agreements; however, the Bank had not recorded these particular loans as being sold. We were told by the Loan Department personnel that the Loan Officer had not notified the Credit and Collateral Department of the transaction. The transaction was subsequently recorded by the Bank on January 9, 1980.

Charged-off loans - Control ledgers and individual loan subledgers are maintained by the Accounting Department for all past and current year charge-offs and related recoveries. However, these subledger cards are not balanced on a regular basis. On loans charged-off and subsequent payments, the subledgers should be reconciled to the control ledgers on a monthly basis.

Charged-off loan customers - At our request, the Bank's internal auditor made an investigation of an official check payable to the Bank not clearing in a reasonable time period which disclosed a series of events resulting in two commercial loans, one on an unsecured basis, being made in 1980 to a borrower. This borrower had three instalment loans which were charged-off in 1979 by the Bank. The internal auditor submitted a report setting out the details of the transaction to the Bank's president in February 1980.

Trust department income - During our review of the Trust Department, it was noted that 1979 income from the purchases and sales of gold certificates had not been recorded by the Bank at December 31, 1979.

While the amounts proved to be immaterial in 1979, all transactions should be recorded timely. The failure to do so frequently leads to a breakdown in discipline which leads to other accounts not being recorded.

Loans

Documentation - While loan file documentation has improved since our last examination, we noted several technical deficiencies in documentation during our loan file review. The technical deficiencies noted are listed in Exhibit I. Among the more significant deficiencies noted were:

1. We noted four oil and gas loans on which the collateral mortgages had not been filed.

2. In several instances current financial statements, engineering reports and appraisals were not in the files but had been received by bank personnel. To maintain up-to-date credit information in loan files, the responsible individuals should route all documents to the Credit and Collection Department in a timely manner.

<u>Loan policies</u> - As mentioned in our 1977 and 1978 management letters, we believe a formal loan policy statement should be adopted by the Board of Directors. In 1978, we were informed that a draft loan policy was being prepared; however, the minutes of the Board of Directors do not indicate that such a policy has been adopted. We continue to believe strongly that a definitive loan policy should be formalized and adopted by the Board.

With the Bank's continued activity in the oil and gas area, the loan policies for this type of loan should include detail standards for documentation, nature of oil and gas reserves on which loans will be made, methods of reserve estimation and discount factors which will be acceptable and the maximum amount to be loaned as a percent of discounted values for each method of reserve estimation.

<u>Letters of credit</u> - It appears that the various loan officers may extend a letter of credit to a customer without approval or review from a second loan officer or the Loan Discount Committee. In response to one of our inquiries, we were informed there are no reconciliation procedures in effect for balancing the individual letters of credit to the total letter of credit liability ledger. Due to the increased volume of letters of credit during 1979, we suggest that the individual letters of credit be balanced to the liability control ledger at least monthly and that approval policies for letters of credit be instituted.

<u>Loans in excess of legal lending limitations</u> - At December 31, 1979, our review of loan concentrations (obligations direct or indirect of the same or affiliated interests) revealed one line in excess of the Bank's legal lending limitation under the Comptroller of the Currency's regulations by approximately $250,000. Loan concentrations must be constantly monitored to insure that lines of credit do not exceed lending limits. The members of the Board of Directors are personally liable for loans in excess of lending limits.

COMMENTS ON OTHER MATTERS

Interest income on municipal securities

The Bank maintains two separate general ledger accounts for interest income on municipal securities, municipal - other and municipal - Oklahoma. The EDP printout received from R. J. Edwards, Inc. does not segregate the Oklahoma municipal interest from other municipal securities. During the year arbitrary percentages were applied to record monthly accrued income. The misstatement of income between the two accounts was approximately $30,000. At year end we made adjustments to classify the interest properly. Since the income tax treatment for state return purposes is different for Oklahoma and other municipal interest, we recommend that a detail analysis be manually prepared each month and income recorded to the proper account.

Travel and entertainment expenditures

A review of selected travel and entertainment expenditures and the related documentation disclosed that employee expenses were not always properly supported or documented. To comply with Internal Revenue Service Regulations, proper documentation and support should accompany each travel and entertainment report. Bank management has notified bank personnel of the documentation requirements and new expense report formats were implemented in January 1980.

Overdrawn accounts

When a customer's overdrawn balance is charged-off, the "fees on checking" income general ledger account is charged for the total balance. To improve the accounting for losses incurred from overdrawn accounts and properly reflect fees on checking income, we recommend the loss be recorded to a specified expense account and the "fees on checking" income account be reduced only by the portion of charges to the customer's account.

Prepaid expenses

No detail schedule of prepaid expenses and the related monthly amortization to expense is maintained. Our review of the prepaid balance at December 31, 1979 disclosed certain expenses amounting to $14,696 which should have been fully expensed. A schedule should be maintained of prepaid expenses to support the monthly amortization to expense. This schedule should be reviewed for propriety at least quarterly by the controller. We also noted that some relatively minor amounts were recorded as prepaid expenses to be amortized. To facilitate monitoring prepaid expenses, a policy should be established setting out the type and a minimum dollar amount of prepaid expenses which would be deferred. Expenditures not meeting these criteria should be expensed.

Safekeeping of investment securities

We noted in our verification of securities held in safekeeping by Liberty National Bank that the listing contained the Bank's securities, securities held for the Bank's customers, and securities purchased by the Bank's Trust Department. To facilitate reconciliations of Bank-owned securities, including the related pledging of certain securities, we suggest Bank personnel request Liberty's safekeeping department to segregate the various securities held by type.

Expense checks

We noted several instances where invoices were marked "paid" but no indication of the expense check number or date paid was made.

Paid invoices should be stamped paid and the related check number, date paid and account distribution also should be indicated on the invoice. In addition, we recommend the establishment of a combination check register and expense distribution journal. This record facilitates accounting for all checks issued and serves as a source for verifying all paid expenses were charged to the proper account.

Signature cards on demand deposit accounts

Our review of selected demand deposit accounts revealed two instances where unsigned temporary signature cards were on file for over a year. We recommend that check file clerks prepare, on a monthly basis, detail lists of accounts with temporary signature cards which are over 30 days old. This customer list should be submitted to the head bookkeeper and reviewed by the internal auditor periodically.

General ledger

The Bank still does not have a chart of accounts. To facilitate general ledger postings and location of cards, each account should be assigned a number and cards numbered sequentially by account number when more than one card required for account activity. The debit and credit slips prepared should include account name and number which would facilitate postings to the proper general ledger account.

Electronic data processing

Processing of accounting and operational information of the Bank is dependent upon the data processing services provided by Fidelity Computer Services. As a result of our review of Fidelity's EDP Service Center, we developed the following comments which we believe the Bank's management should discuss with Fidelity management:

Disaster plan - We were told by Fidelity personnel that, with the proposed move of the processing facilities, arrangements for alternative processing will be formulated. However, at the time of our review Fidelity had no alternative processing arrangements for emergency processing in the event of disaster or prolonged loss of use of EDP equipment.

We believe that a EDP Service Center such as Fidelity's should develop a comprehensive plan directed towards providing alternative manual and mechnical means for continued processing in the event the computer systems are destroyed or become inoperative for an extended period of time.

The contents of such a plan should include:

- Location and description of alternative processing sites.
- Production schedules and priorities.
- Data conversion methods.
- Procedures for establishing updated data and program files.

After a disaster plan has been developed, the Bank should be notified that it has been tested under simulated emergency conditions. During the test the disaster plan should be evaluated for its effectiveness, and modifications, if necessary, should then be incorporated in the plan.

Standards manual - No formalized standards manual exists for program development. Such a manual is a valuable aid in understanding the role of various EDP techniques utilized in processing data. The development of a standards manual documenting programming and system development methodology is an important factor in continuity of data processing functions. Such a manual should be developed which details the approach utilized in the following:

- Systems analysis and design activities.
- Program development and testing procedures.
- Program interface techniques to accessing data base.
- User coordination and acceptance procedures.
- Documentation efforts concerning:
  - System specification.
  - Individual program narratives, flowcharts.
  - Operations and control instructions.
  - User processing and control instructions.

Production control - Production efforts are scheduled and controlled by a manual production control system. In an EDP service center the size of Fidelity Computer Service, enhanced service can be provided by utilizing an automated production control system. Such a system to lessens the possibility of incomplete or misrouted output of the user bank's data. We were told Fidelity has plans to implement an automated system.

Automated tape library system - Currently, all backup of master files is managed by the production personnel in a manual fashion. Files are stored offsite on tape and rotated according to a predetermined schedule. Due to the large number of tapes handled, the possibility exists for failure to create and retain necessary backup copies of critical files. We recommend that an automated tape librarian system be implemented to provide greater assurance that proper backup is created for user banks.

* * * * * *

This letter is issued solely for the information of the Company's board of directors, management and counsel; it should not be presented or quoted to anyone outside the Company because of the possibility of misunderstanding by other persons who may not be aware of the objectives and limitations of internal controls and of our study and evaluation thereof.

We would like to express our appreciation for the cooperation and assistance received from your personnel during the course of the audit.

We would be pleased to discuss the matters reported or to answer any questions you may have at your convenience.

Very truly yours,

Arthur Young & Company

Oklahoma City, Oklahoma
February 18, 1980

Exhibit I
Page 1

Borrower	Bank's portion at 12-31-79	Loan file deficiency
Roger Casida	$ 3500	Note not made payable to Penn Square Bank
ASA Energy Corp.	36,232	No financial statements
James J. Cook	150,000	No financial statements
Eagle Drilling	-0-	No financial statements
Equity Drilling	280,000	No financial statements
Lambdin-Dawson	34,285	No financial statements or appraisal in file
George C. Martin	225,000	No financial statements
Paramount Drilling	86,887	Insurance expired 1-1-79 on airplane collateral
Steele Construction	31,000	No financial statements
Bill Stubbs Co.	97,162	No financial statements
Thomas Oil Co.	19,258	No financial statements
Robert Daughterty	86,225	Financial statements (3-77) and appraisal (1965) old
Century Oil & Gas Co.	145,356	Engineering report (2-77) and financial statements (5-78) old
Dahlgren Contracting, Inc.	100,087	Financial statements (1-78) old
C. Hubert Gragg	125,000	Appraisal (1-77) and financial statements (12-77) old
Publishing Industries, Inc.	394,449	Financial statements (9-77) old

Exhibit I
Page 2

Borrower	Bank's portion at 12-31-79	Loan file deficiency
Ivan Thompson	$200,000	No appraisal on horse collateral and collateral title not in Borrower's name
A Perm-O-Green Lawn	35,709	No appraisals of collateral and financial statements (3-78) old
Rick Mason	40,000	Oil and gas mortgage filed on one of two leases
E. M. McDowell Sr. & Jr.	-0-	No financial statements
Delhi Pacific Mines Ltd.	500,000	Oil and gas mortgages had not been signed or filed. Title opinions and engineering reports not in borrower's name
J. D. Helms	403,000	Engineering reports and title opinions not obtained on all leases
David Hostelly	700,000	Engineering report does not segregate information individual for lease mortgaged.
David Kennedy	51,260	No assignment of oil and gas mortgages in Borrower's name
L & T Oil & Gas Inc.	50,000	Oil and gas mortgages had not been filed
Stanmark Petroleum	400,000	Oil and gas mortgages had not been filed on all leases
Copeland Energy Corp.	296,429	Title opinions not obtained on all leases
Bob Carroll and Peter Massion	290,000	Title opinions not in borrower's name and no assignments in file

ARTHUR YOUNG & COMPANY

1900 LIBERTY TOWER
OKLAHOMA CITY, OKLAHOMA 73102

January 6, 1981

Mr. Bill P. Jennings,
Chairman of the Board
First Penn Corporation
Dr. Marvin K. Margo,
Chairman, Audit Committee
Penn Square Bank, N.A.
1919 Penn Square
Oklahoma City, Oklahoma 73118

Gentlemen:

The purpose of this letter is to confirm our existing relationship as certified public accountants for First Penn Corporation and to provide an understanding of the scope of services to be performed by our firm.

Our examination of your annual consolidated and parent company financial statements will be made in accordance with generally accepted auditing standards and accordingly will include such tests as we consider necessary in the circumstances. Unless unusual conditions not now foreseen make it impracticable for us to do so, we will submit a report on our examination of these financial statements which will express an opinion as to the fairness of their presentation in conformity with generally accepted accounting principles.

Under generally accepted auditing standards, the independent auditor has the responsibility, within the inherent limitations of the auditing process, to plan the examination to search for errors or irregularities (as defined in authoritative professional literature) that would have a material effect on the financial statements. Our search for material errors or irregularities ordinarily is accomplished by performing those auditing procedures that in our judgment are appropriate in the circumstances to form an opinion on the financial statements as a whole. Our examination, which is based on the concept of selective testing of the data being examined, is subject to the inherent risk that material errors or irregularities, if they exist, will not be detected.

In conducting our examination, we will be aware of the possibility that illegal acts (as defined in authoritative professional literature) may have occurred that may have a material effect on the financial statements. Examinations conducted in accordance with generally accepted auditing standards are of limited effectiveness in discovering possible illegal acts and cannot be expected to provide assurance that illegal acts will be detected, although procedures that are performed primarily for the purpose of forming an opinion on the financial statements as a whole may also bring possible illegal acts to the auditor's attention.

During the course of our examination, we may observe opportunities for economies in or improved controls over your operations. It is our practice to bring such opportunities to the attention of an executive at the appropriate level of management, either orally or in writing. Should you desire any further information concerning our responsibilities and functions as an independent auditor in making the examination, we shall be pleased to furnish information to you upon request.

We will also prepare the Company's annual United States Federal and Oklahoma consolidated income tax returns.

In addition to the preparation of the returns, upon your request, we are also prepared to advise you generally on tax problems and tax planning. In this connection, in order to be of greatest assistance in minimizing the Company's tax burdens, we should be advised in advance of any major transactions the Company proposes to undertake.

Should the Company be selected for examination by the Internal Revenue Service or by other tax authorities, we will also be pleased to represent the Company or to assist you in discussions with these authorities and in preparing any refund claims or protests that may be necessary to obtain a final determination of the Company's tax liability.

We would like to caution you that tax rules change constantly. For this reason, any opinion expressed in connection with a transaction at one time may not apply to a similar transaction at a later date. Therefore, to be most helpful, we should be able to take a fresh look each time a transaction of a material nature is proposed.

Our fees for the annual examination and other accounting and auditing services (as requested) will be based on hours worked by the various grades of personnel, at our standard rates applicable to each, plus out-of-pocket expenses.

We anticipate reducing the fees at our standard rates by a discount of 23% for 1980. Other work, including preparation of the Federal and Oklahoma income tax returns and specific tax planning related projects upon special request, will be billed separately at our standard rates, plus out-of-pocket expenses.

Our report and accompanying financial statements will be in the format required for the Company's filing of the FR Y-6 with the Federal Reserve Board.

If this letter meets with your approval, please sign one copy and return it to us.

Yours very truly,

Arthur Young & Company

The arrangements described above are acceptable to us.

FIRST PENN CORPORATION:

By____________________
Bill P. Jennings,
Chairman of the Board

Date____________________

PENN SQUARE BANK, N.A.:

By Marvin K. Margo
Marvin K. Margo, M.D.,
Chairman, Audit Committee

Date January 30, 1981

ARTHUR YOUNG

ARTHUR YOUNG & COMPANY
1900 LIBERTY TOWER
OKLAHOMA CITY, OKLAHOMA 73102

The Board of Directors
First Penn Corporation

We have examined the accompanying balance sheets (company and consolidated) of First Penn Corporation at December 31, 1980 and 1979 and the related statements (company and consolidated) of income, stockholders' equity and changes in financial position for the years then ended. Except as stated in the following paragraph, our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

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 values of certain loans.

In our opinion, except for the effects of such adjustments, if any, on the 1980 financial statements (company and consolidated) as might have been determined to be necessary had we been able to satisfy ourselves as to the adequacy of the reserve for possible loan losses, the statements mentioned above present fairly the financial position (company and consolidated) of First Penn Corporation at December 31, 1980 and 1979 and the results of operations (company and consolidated) and the changes in financial position (company and consolidated) for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

Arthur Young & Company

March 13, 1981

ARTHUR YOUNG

ARTHUR YOUNG & COMPANY
1900 LIBERTY TOWER
OKLAHOMA CITY, OKLAHOMA 73102

May 20, 1981

Examining Committee, Penn
Square Bank, N.A.
Mr. Bill P. Jennings,
Chairman of the Board
First Penn Corporation and
Penn Square Bank
1919 Penn Square
Oklahoma City, Oklahoma 73118

Gentlemen:

We have examined the parent company and consolidated financial statements of First Penn Corporation for the year ended December 31, 1980, and have issued our report thereon dated March 13, 1981. As part of our examination, we made a study and evaluation of the Company's system of internal accounting control to establish the level of our reliance on such system in determining the nature, timing, and extent of other auditing procedures necessary to enable us to express an opinion on the Company's financial statements.

Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control of First Penn Corporation, taken as a whole. Accordingly, we do not express such an opinion. Because of its limited nature, our study and evaluation would not necessarily disclose all material weaknesses or other conditions requiring attention in the system of internal accounting control.

Our study and evaluation disclosed the following conditions that we believe results in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the Company and consolidated financial statements of First Penn Corporation may occur and not be detected within a timely period.

Our report on the financial statements of First Penn Corporation at December 31, 1980 was qualified since we were unable to satisfy ourselves as to the adequacy of the reserve for loan losses due to the lack of supporting documentation of collateral values of certain loans. With the significant growth of Penn Square Bank's loan portfolio implementing sound loan policies and procedures is a critical factor in both the decision process in making loans and monitoring the portfolio.

Loan file documentation

Both our review and that of the national bank examiners disclosed documentation deficiencies in the loan files, the most significant of which related to information supporting collateral values. It is critical that the Bank correct the loan file documentation deficiencies and implement procedures to obtain all applicable information from new borrowers prior to loan approval and to monitor existing loan files for complete and current information.

Loan policies

Although the Bank has adopted a loan policy, we believe that a more definitive loan policy specifically tailored for the Bank's portfolio should be formalized and adopted by the Board. The policy should include provisions which define by type of loan (real estate, construction, oil and gas) criteria for: (a) acceptance of loan, (b) review of applications, (c) acceptable appraisal or valuation techniques, (d) required documentation and (e) procedures for monitoring the loan.

With the Bank's continued activity in the oil and gas area, the loan policies for this type of loan should include detail standards for documentation, nature of oil and gas reserves on which loans will be made, methods of reserve estimation and discount factors which will be acceptable and the maximum amount to be loaned as a percent of discounted values for each method of reserve estimation.

Reserve for loan losses

Currently, the Bank's reserve for loan losses is based on a percent of outstanding loans, which, in the opinion of management, is adequate to absorb potential losses in the loan portfolio. To properly monitor the loan portfolio and related reserve for loan losses, we believe a more definitive policy should be implemented to provide for review of individual loans or lines of credit. The policy should include procedures for review of the adequacy of the reserve at least quarterly with documentation of the loans reviewed and conclusions reached. The policy should also include criteria for actual charge-off of loans and subsequent monitoring of the charge-offs.

OTHER CONDITIONS REQUIRING ATTENTION:

The following conditions also came to our attention as to which we believe corrective action should be taken or documentation (including cost/benefit considerations) should be prepared as to the reasons why corrective action was not considered necessary in the circumstances.

Participation loans

At December 31, 1980, there were approximately $23 million of participation loans effected by the Bank which had participation maturity dates prior to that of the loan. Subsequent to year end the terms of the majority of such participation loans were amended to conform with that of the underlying loan. In addition approximately $2 million of participation loans were not reflected in the Bank's subsidiary records due to a direct transfer by the participating bank of the funds advanced.

The Bank has had increasing activity in the participation loan area. Accordingly, establishing specific procedures related to processing of such loans is critical. Such procedures should include a review by a responsible employee of the terms of any agreements, the amounts involved and proper recording in the accounting and subsidiary records.

In addition, our confirmation procedures related to participation loans disclosed some differences in interest rates and loan balances. All differences were reconciled by the Bank's internal audit department and reviewed by us. We believe a periodic confirmation program of participation loan balances and terms by the internal audit department should be established. This procedures should identify any differences on a timely basis.

Letters of credit

As mentioned in our 1979 management letter, there are no standard procedures in effect regarding the issuance of letters of credit including approval by a second loan office or the loan discount committee. A policy should be established defining dollar limits for each officer and related approval for letters of credit in excess of such limits. In addition, policies should be implemented to define (1) acceptable customers, (2) documentation, and (3) method of determining and monitoring collateral value. The letters of credit should be reconciled to the subsidiary records at least monthly.

Payroll and payroll tax reports

Our review of the payroll tax reports for 1980 disclosed differences between the amounts reported on the payroll tax reports for total compensation and that recorded in the general ledger. The Bank's internal audit department is reviewing these differences and determined that a portion of the difference appears to relate the Saturday pay to employees.

Quarterly payroll tax reports should be reconciled to the general ledger compensation expense prior to filing. Consideration should be given to making payments for Saturday work in the normal payroll process rather than the cash payments.

* * * * * *

These conditions were considered in determining the nature, timing, and extent of audit tests applied in our examination of the Company's parent company and consolidated financial statements and this report does not affect our report on those financial statements dated March 13, 1981.

COMMENTS ON OTHER MATTERS:

Commercial paper

The Company began issuing commercial paper during 1980. We noted a trend toward a negative interest factor due to the short-term of the paper being issued not allowing for an offsetting investment of funds in revenue producing investments. We understand that subsequent to year end, the controller of the Bank who was responsible for commercial paper transactions has terminated her employment.

Due to the highly regulated nature of commercial paper and an indicated trend of negative cash flow, we suggest a qualified employee be placed in charge of commercial paper transactions.

General ledger postings

The Bank still does not have a chart of accounts with assigned account numbers. We also noted some general ledger tickets which lacked adequate information documenting the purpose of the entry. To facilitate postings to the proper general ledger account, we suggest assigning each an account number and including this number on the general ledger ticket. Additionally, the tickets should include a brief description of the purpose of the entry and bear the approval of a supervisor. An additional control which would facilitate subsequent review of the entries would be to indicate the offsetting debit or credit on the general ledger ticket.

Wire transfers

At the time of our review, the Bank had no formal procedures relating to wire transfers. Due to the nature and volume of transactions, a system with good controls is imperative. We noted a lack of segregation of duties. In addition, there were no formal limits or criteria for persons, both in the bank and customers who were authorized to initiate transactions. We suggest an evaluation of the existing system be prepared and control features be determined and implemented. Reference is made to the national bank examiners' comments on wire transfers under internal control deficiencies for a summary of areas which should be considered.

Accounts payable

At December 31, 1980, the liability for operating expenses incurred at year end but not paid was accrued. As payments were made subsequent to year end, the liability was reduced. In the past, the Bank has not accrued such expenses as management did not feel they were significant.

We understand there has been no procedure adopted regarding the handling of such expenses in 1981 and that expenses will be recorded as paid. For January 1981, expenses will be understated by the amount of expense incurred at January 1981 but paid subsequently as payment of expenses in January will have been offset against the liability set up at year end. To properly reflect monthly and year-to-date expenses, accounts payable for accrued liabilities should be set up monthly. This could be accomplished by setting up a voucher system whereby liabilities are recorded as incurred. Subsequent payment should then be offset against the liability.

An alternative would be to record an estimate of such accrued liabilities and adjust this payable to actual at year end. For monthly and year to date information to be as accurate as possible the estimate should be compared to actual on at least a quarterly basis and infrequent or unusual items should be accrued for separately.

Dual controls

Internal controls are strengthened by dual control. Areas we noted for which such controls could be implemented are as follows:

- Receipt and preparation of currency shipments.
- Mail deposits.
- Verification of night deposits.
- Access to automated teller machine.

* * * * * *

The management of First Penn Corporation and its subsidiary, Penn Square Bank, N.A. is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgements by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions, or that the degree of compliance with the procedures may deteriorate.

This report is intended solely for the use of management and should not be used for any other purpose.

We would be pleased to discuss the matters reported or to respond to any questions, at your convenience.

Very truly yours,

Arthur Young & Company

REPORT ITEMS

1. Consolidated and Parent Holding Company Financial Statements.

The required financial statements, at year ended December 31, 1980 are provided, attached as Exhibit I, hereto.

2. Annual Reports to Stockholders and to the Securities and Exchange Commission (SEC).

a. The registrant does not prepare an annual stockholder report; attached as Exhibit I please find the consolidated financial statements of First Penn Corporation.

b. Neither the registrant nor its subsidiary files annual reports with the SEC.

3. Information on Subsidiaries

Information on the registrant's subsidiary is provided in Schedule A.

4. Non-Bank Subsidiary Financial Statements

Information on the registrant's non-bank subsidiary is provided on Schedule A. Financial statements are not submitted on this non-bank subsidiary, since it is a subsidiary of the bank that is fully consolidated on a line-by-line basis in the registrant's consolidated report of condition.

5. Information on Organizations Other Than Subsidiaries

The registrant has no direct or indirect interest in any organization other than its wholly owned subsidiary, Penn Square Bank, N.A.

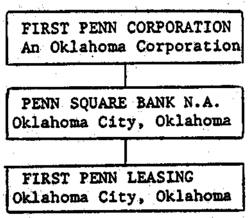
6. Activities of the Parent Bank Holding Company

Registrant engages in the activity of owning or controlling its wholly owned subsidiary bank as set forth in the completed Schedule C attached hereto and as a distributor of commercial paper.

7. Terminations

No organization has ceased being a part of the bank holding company organization during the registrant's fiscal year.

8. Organization Chart - December 31, 1980



9. Amendments to Organizational Documents

The registrant has not amended the documents under which it was organized and operates.

10. Shareholders

The following shareholders of registrant, all of whom are either United States citizens or corporations, own, control or hold, with the power to vote 5% or more of the outstanding voting shares of registrant:

a. Mr. Bill P. Jennings, of Oklahoma City, Oklahoma, owns beneficially and of record 56,049 shares of registrant's common stock.

b. The Rooney Corporation, located in Tulsa, Oklahoma, owns beneficially and of record 15,080 shares of registrant's common stock.

11. Directors and Officers

Information concerning the directors and principal officers of registrant is as follows:

a. Mr. Bill P. Jennings of Oklahoma City, Oklahoma, owns 56,049 shares of registrant's common stock and serves as President and a Director of registrant, and Chairman of registrant's subsidiary bank, which constitutes his principal occupation. In addition, Mr. Jennings serves as Vice Chairman and a Director of the Bank of Healdton, Healdton, Oklahoma, and exercises voting control over 19.7% of the shares of that bank as a result of shares individually owned and shares voted as a trustee. Mr. Jennings also serves as President and a Director of First Healdton Corporation, in which he controls the same percentage of shares as he controls in the bank. Mr. Jennings serves as Director of Community Bank & Trust Company and

Community Corporation in Enid, Oklahoma, and has a 13% ownership in each entity. In addition, Mr. Jennings, has the following business interests:

Penn Northwestern Land Development Co.	25% Stock Limited Partnership
Petro Building Limited	25% Stock Limited Partnership
J-Mc Aircraft Corporation	50% Stock Ownership Interest
TSJ, Inc.	25% Stock Ownership Interest
Chi-Chi's of Atlanta, Inc.	30% Stock Ownership Interest
Trans-Central Airlines, Inc.	20% Stock Ownership Interest
American Gypsum Company	10% Stock Ownership Interest
Northwest Investors, Ltd.	15% Limited Partnership Interest
Skirvin Plaza Investors	16.6% Limited Partnership Interest
JJS, A Partnership	33.3% Limited Partnership Interest

b. Mr. Frank L. Murphy of Oklahoma City, Oklahoma, owns 225 shares of registrant's common stock and serves as Secretary/Treasurer of registrant and as President of registrant's subsidiary bank, which is his principal occupation. In addition, Mr. Murphy serves as Secretary and a Director of Edgewater Heights Development Corporation in which he has a 50% ownership interest.

c. Mr. John E. Rooney of Tulsa, Oklahoma, owns 1,960 shares of registrant's common stock and serves as a Director of registrant. Mr. Rooney's principal occupation is as President of the Rooney Corporation in which he has a 50% ownership. The following entities are subsidiaries of Rooney Corporation or a subsidiary of the subsidiaries which Mr. Rooney has a 50% ownership:

East Side Development Company
Fleet Finance Company
Lake Country Beverage
Leland Equipment Company
Leland-Manhattan Joint Venture
Penn Square, Inc.
Manhattan Construction Company
The Rooney Company

In addition, Mr. Rooney serves as Secretary and a Director of Hope Lumber and Supply Company, in which he owns 140 shares. He also owns 14% of the outstanding shares of Citizens National Bank of Muskogee, Oklahoma. He is an operating partner in the Rooney Oil Company in which he has a 1/3 interest.

d. Mr. W. A. Ross of Oklahoma City, Oklahoma, owns 2,944 shares of registrant's common stock and serves as a Director of registrant. Mr. Ross's principal occupation is as President and owner of Dub Ross Company, in which he has a 100% ownership. In addition, Mr. Ross has the following interest:

Northwest Investors, Inc.	10% Limited Partnership Interest
Colcord Association Ltd.	Limited Partnership Interest
Skirvin Plaza Investors	20% Limited Partnership Interest

e. Mr. Carl W. Swan of Oklahoma City, Oklahoma, owns 9,819 shares of registrant's common stock and serves as a Director of the registrant. Mr. Swan's principal occupation is as an independent oil producer. Mr. Swan has the following interests:

Copeland Energy		23% Stock Ownership Interest
Swan Aviation	Director & President	100% Stock Ownership Interest
World of Travel	Director	80% Stock Ownership Interest
Longhorn Oil & Gas Co.	Director	50% Stock Ownership Interest
Swan Coal Company	Director & President	100% Stock Ownership Interest
American Gypsum Co.	Director	16.66% Stock Ownership Interest
Intrepid Drilling Corp.	Director	15% Stock Ownership Interest
Continental Drilling Corp.	Director	40% Stock Ownership Interest
Swan Petroleum	Director & President	100% Stock Ownership Interest
Haymaker Farms		11% Stock Ownership Interest
Midwest National Bank		20% Stock Ownership Interest
Texas Oilfield Supply		15% Stock Ownership Interest
Olympic Expl		40% Stock Ownership Interest
High Plains Drilling		40% Stock Ownership Interest

f. Mr. Ronald H. Burks of Oklahoma City, Oklahoma, owns 7,500 shares of registrant's common stock and serves as a Director of registrant's subsidiary bank and of registrant. Mr. Burks' principal occupation is as President of Ronald Burks Investments, Inc. in which he has 100% ownership. In addition, Mr. Burks has the following interests:

Chi-Chi's of Atlanta	11.1% Land & Building Interest
Chi-Chi's of Sunrise, Florida	11.1% Land & Building Interest
Peachtree Hospitalities	33% Stock Ownership Interest
Northwest Investors	25% Stock Ownership Interest

12. Insider Loans

The bank holding company organization has made no loans to any insider, or his interests, aggregating more than 10% of the equity capital accounts of the registrant.

FIRST PENN CORPORATION

FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 1980 AND 1979

with

REPORT OF CERTIFIED PUBLIC ACCOUNTANTS

ARTHUR YOUNG

FOR FILES
Cherie Suess

ARTHUR YOUNG

ARTHUR YOUNG & COMPANY
1900 LIBERTY TOWER
OKLAHOMA CITY, OKLAHOMA 73102

The Board of Directors
First Penn Corporation

We have examined the accompanying balance sheets (company and consolidated) of First Penn Corporation at December 31, 1980 and 1979 and the related statements (company and consolidated) of income, stockholders' equity and changes in financial position for the years then ended. Except as stated in the following paragraph, our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and sucn other auditing procedures as we considered necessary in the circumstances.

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 values of certain loans.

In our opinion, except for the effects of such adjustments, if any, on the 1980 financial statements (company and consolidated) as might have been determined to be necessary had we been able to satisfy ourselves as to the adequacy of the reserve for possible loan losses, the statements mentioned above present fairly the financial position (company and consolidated) of First Penn Corporation at December 31, 1980 and 1979 and the results of operations (company and consolidated) and the changes in financial position (company and consolidated) for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

Arthur Young & Company

March 13, 1981

FIRST PENN CORPORATION

CONSOLIDATED BALANCE SHEETS

December 31, 1980 and 1979

ASSETS	1980	1979
Cash and due from banks	$ 59,625,519	$ 25,671,661
Investment securities (Note 3)	42,627,346	22,982,819
Loans, less reserve for possible loan losses of $2,004,587 ($1,002,097 in 1979) (Notes 4, 5 and 12)	199,894,664	106,484,882
Federal funds sold	16,000,000	1,100,000
Premises and equipment (Notes 6 and 8)	3,724,388	1,936,348
Accrued interest receivable	7,372,553	2,495,276
Other assets (Note 2)	1,213,248	1,033,114
Total assets	$330,457,718	$161,704,100
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Demand	$135,029,063	$ 79,701,722
Savings	13,341,126	13,261,028
Time	136,522,794	56,717,078
Total deposits	284,892,983	149,679,828
Federal funds purchased	650,000	400,000
Other liabilities (Note 7)	4,636,579	1,975,341
Notes payable (Note 8)	8,606,800	3,160,001
Commercial paper	14,640,252	-
Loans sold under agreement to repurchase	2,795,561	-
Total liabilities	316,222,175	155,215,170
Stockholders' equity (Note 10):		
6.5% cumulative preferred stock, $60 par value; 5,000 shares authorized, 4,225 shares issued	253,500	253,500
Common stock, $1 par value; 250,000 shares authorized, 162,466 shares issued (108,311 shares in 1979)	162,466	108,311
Surplus	7,420,753	3,142,508
Retained earnings	6,398,824	2,984,611
Total stockholders' equity	14,235,543	6,488,930
Total liabilities and stockholders' equity	$330,457,718	$161,704,100

See accompanying notes.

FIRST PENN CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

Years ended December 31, 1980 and 1979

	1980	1979
Interest income:		
Interest and fees on loans	$24,665,544	$11,038,809
Interest on investment securities:		
Taxable	299,778	277,397
Tax exempt	1,308,326	908,630
Total interest on investment securities	1,608,104	1,186,027
Interest on federal funds sold	282,715	14,933
Total interest income	26,556,363	12,239,769
Interest expense:		
Interest on deposits:		
Savings	715,844	734,974
Time	11,834,081	4,360,560
Other	2,745	56,650
Total interest on deposits	12,552,670	5,152,184
Interest on commercial paper	1,055,686	-
Interest on federal funds purchased	871,220	710,847
Interest on notes payable	791,024	189,450
Interest on subordinated notes	-	59,656
Total interest expense	15,270,600	6,112,137
Net interest earnings	11,285,763	6,127,632
Provision for possible loan losses	1,407,830	615,000
Net interest earnings after provision for possible loan losses	9,877,933	5,512,632
Other income:		
Service charges on deposit accounts	366,920	108,212
Other service charges and fee income	431,738	279,050
Other	89,312	61,536
Total other income	887,970	448,798

(Continued on following page)

FIRST PENN CORPORATION

CONSOLIDATED STATEMENTS OF INCOME
(CONTINUED)

Years ended December 31, 1980 and 1979

	1980	1979
Other expense:		
Salaries	$ 1,997,560	$ 1,243,156
Employee benefits	341,656	237,381
Occupancy and equipment expense	618,828	390,363
Other	2,410,459	1,208,478
Total other expense	5,368,503	3,079,378
Income before income taxes, minority interest and securities losses	5,397,400	2,882,052
Provision for income taxes (Note 9)	1,966,710	969,675
Income before minority interest and securities losses	3,430,690	1,912,377
Minority interest	-	232,112
Income before securities losses	3,430,690	1,680,265
Securities losses, net of related income taxes and minority interest	-	7,111
Net income	$ 3,430,690	$ 1,673,154

See acompanying notes.

FIRST PENN CORPORATION
(consolidated and parent company)

STATEMENTS OF STOCKHOLDERS' EQUITY

Years ended December 31, 1980 and 1979

	Preferred stock	Common stock	Surplus	Retained earnings
Balance at December 31, 1978	$ -	$ 64,552	$1,387,918	$1,311,457
Net income	-	-	-	1,673,154
Exchange of stock for stock of subsidiary bank (Note 2)	253,500	18,759	779,590	-
Exchange of stock for subordinated notes of subsidiary bank (Note 2)	-	25,000	975,000	-
Balance at December 31, 1979	253,500	108,311	3,142,508	2,984,611
Net income	-	-	-	3,430,690
Common stock issued	-	54,155	4,278,245	-
Preferred stock dividends	-	-	-	(16,477)
Balance at December 31, 1980	$253,500	$162,466	$7,420,753	$6,398,824

See accompanying notes.

FIRST PENN CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION

Years ended December 31, 1980 and 1979

	1980	1979
Source:		
Net income	$ 3,430,690	$ 1,673,154
Charges against (credits to) income not involving funds in the current period:		
Depreciation and amortization	307,887	187,858
Excess of provision for possible loan losses over net loan charge-offs	1,002,490	374,606
Amortization of premiums on securities	129,209	57,303
Accretion of discounts on securities	(36,625)	(16,890)
Deferred federal income taxes	76,710	(26,000)
Amortization of cost in excess of net assets of subsidiary bank	21,348	21,314
Net book value of property dispositions	12,562	-
Funds provided from operations	4,944,271	2,271,345
Decrease in federal funds sold	-	2,900,000
Proceeds of borrowings	5,606,800	1,000,000
Increase in deposits	135,213,155	59,033,185
Increase in federal funds purchased	250,000	400,000
Increase in other liabilities	2,584,528	-
Increase in commercial paper	14,640,252	-
Loans sold under agreement to repurchase	2,795,561	-
Common stock issued in exchange for subordinated notes of subsidiary bank (Note 2)	-	1,000,000
Common stock issued in exchange for subordinated notes of subsidiary bank (Note 2)	-	786,226
Preferred stock issued in exchange for stock of subsidiary bank (Note 2)	-	265,623
Proceeds from the sale of common stock	4,332,400	-
	$170,366,967	$67,656,379

(Continued on following page)

FIRST PENN CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN FINANCIAL POSITION
(Continued)

Years ended December 31, 1980 and 1979

	1980	1979
Application:		
Increase in cash and due from banks	$ 33,953,858	$15,075,152
Increase in securities	19,737,111	5,351,876
Increase in loans	94,412,272	43,252,807
Increase in federal funds sold	14,900,000	-
Additions to premises and equipment	2,106,886	236,838
Increase in accrued interest receivable	4,877,277	1,238,279
Increase in other assets	203,085	11,141
Decrease in other liabilities	-	1,390,286
Payments on notes payable	160,001	100,000
Cancellation of indebtedness of subordinated notes of subsidiary bank (Note 2)	-	1,000,000
Preferred stock dividends	16,477	-
	$170,366,967	$67,656,379

See accompanying notes.

FIRST PENN CORPORATION
(parent company only)

BALANCE SHEETS

December 31, 1980 and 1979

ASSETS	1980	1979
Cash on deposit with subsidiary bank	$ 7,595,651	$ 7,442
Certificate of deposit of subsidiary bank	8,300,000	-
Receivable from subsidiary bank	873,083	701,500
Investment in stock of subsidiary (Note 2):		
Equity in net assets	20,422,403	8,936,511
Cost in excess of net assets acquired	747,180	767,322
	21,169,583	9,703,833
Land (Note 8)	1,242,721	-
Other assets	48,046	18,782
Total assets	$39,229,084	$10,431,557
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Other liabilities:		
Income taxes payable	$ 977,535	$ 766,490
Interest payable	752,089	1,271
Other	16,865	14,865
	1,746,489	782,626
Commercial paper	14,640,252	-
Notes payable (Note 8)	8,606,800	3,160,001
Total liabilities	24,993,541	3,942,627
Stockholders' equity (Note 10):		
6.5% cumulative preferred stock, $60 par value; 5,000 shares authorized, 4,225 shares issued	253,500	253,500
Common stock, $1 par value; 250,000 shares authorized, 162,466 shares issued (108,311 shares in 1979)	162,466	108,311
Surplus	7,420,753	3,142,508
Retained earnings	6,398,824	2,984,611
Total stockholders' equity	14,235,543	6,488,930
Total liabilities and stockholders' equity	$39,229,084	$10,431,557

See accompanying notes.

FIRST PENN CORPORATION
(parent company only)

STATEMENTS OF INCOME

Years ended December 31, 1980 and 1979

	1980	1979
Income from subsidiary bank:		
Dividends	$ 300,000	$ 233,125
Interest on subordinated notes	-	7,533
Interest on certificates of deposit	270,375	-
Total income from subsidiary bank	570,375	240,658
Expenses:		
Interest	1,846,710	189,450
Amortization	22,951	22,946
Other expenses	4,305	13,959
Total expenses	1,873,966	226,355
Income (loss) before income tax benefit, equity in undistributed earnings of subsidiary and securities losses	(1,303,591)	14,303
Income tax benefit (Note 9)	749,183	95,225
Income (loss) before undistributed earnings of subsidiary and securities losses	(554,408)	109,528
Equity in undistributed earnings of subsidiary before securities losses	3,985,098	1,570,737
Income before securities losses	3,430,690	1,680,265
Equity in securities losses of subsidiary, net of related income taxes	-	7,111
Net income	$3,430,690	$1,673,154

See accompanying notes.

FIRST PENN CORPORATION
(parent company only)

STATEMENTS OF CHANGES IN FINANCIAL POSITION

Years ended December 31, 1980 and 1979

	1980	1979
Source:		
Net income	$ 3,430,690	$1,673,154
Charges against (credit to) income not involving funds in the current period:		
Equity in undistributed earnings of subsidiary	(3,985,098)	(1,563,626)
Amortization of organization costs	1,603	1,632
Amortization of cost in excess of net assets of subsidiary bank	21,348	21,314
Funds provided from (absorbed by) operations	(531,457)	132,474
Proceeds of borrowings	5,606,800	1,000,000
Increase in taxes payable	211,045	600,413
Increase in accrued interest payable	750,818	1,270
Increase in commercial paper	14,640,252	-
Increase in other liabilities	2,000	14,000
Common stock issued in exchange for subordinated notes of subsidiary bank (Note 2)	-	1,000,000
Common stock issued in exchange for stock of subsidiary bank (Note 2)	-	786,226
Preferred stock issued in exchange for stock of subsidiary bank (Note 2)	-	265,623
Proceeds from sale of common stock	4,332,400	-
	$25,011,858	$3,800,006
Application:		
Increase in cash	$ 7,588,209	$ 7,021
Increase in certificates of deposit	8,300,000	-
Increase in receivable from subsidiary	171,583	623,956
Purchase of land	1,242,721	-
Increase in other assets	30,867	17,180
Additional equity investment in subsidiary bank through (Note 2):		
Capital contribution	7,500,000	1,000,000
Cancellation of indebtedness of subordinated notes of subsidiary bank	-	1,000,000

(Continued on following page)

FIRST PENN CORPORATION
(parent company only)

STATEMENTS OF CHANGES IN FINANCIAL POSITION
(CONTINUED)

Years ended December 31, 1980 and 1979

	1980	1979
Acquisition of subsidiary bank stock	$ 2,000	$1,051,849
Payment on notes payable	160,001	100,000
Preferred stock dividends	16,477	-
	$25,011,858	$3,800,006

See accompanying notes.

FIRST PENN CORPORATION
(consolidated and parent company)

NOTES TO FINANCIAL STATEMENTS

December 31, 1980 and 1979

1. Summary of significant accounting policies

Principles of consolidation - The consolidated financial statements include the accounts of First Penn Corporation ("the Company") and its subsidiary, Penn Square Bank N.A. ("the Bank"). All significant intercompany transactions and accounts have been eliminated.

Investment securities - Investment securities are stated at cost adjusted for amortization of premiums and accretion of discounts on the straight-line method to maturity. Gains and losses on sales of investment securities are computed on the specific cost identification method.

Interest on loans - Interest on commercial and real estate loans is accrued based on the principal amount outstanding. Interest on instalment loans is recognized as revenue based on the sum-of-the-months-digits method.

Reserve for possible loan-losses - The reserve for possible loan losses is a valuation reserve which has been provided from charges to earnings in the form of provisions for possible loan losses. The provision charged to earnings is the amount which, in the opinion of management, is considered necessary to maintain the balance in the reserve for possible loan losses at a level adequate to absorb potential losses in the loan portfolio. The provision is based on loans specifically identified as probable losses and other factors which, in management's judgment, deserve recognition in estimating possible loan losses.

Premises and equipment - Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line and declining balance basis over the estimated useful lives of the individual assets.

Retirement plan - The Bank has a noncontributory retirement plan covering substantially all full-time employees. The Bank's policy is to fund costs accrued, including amortization of prior service costs.

Income taxes - The Company and its subsidiary bank file a consolidated income tax return. Income tax charges are allocated to the Bank on the basis of its taxable income included in the consolidated financial statements.

FIRST PENN CORPORATION
(consolidated and parent company)

NOTES TO FINANCIAL STATEMENTS

December 31, 1980 and 1979

1. Summary of significant accounting policies (continued)

Deferred income taxes are provided on all significant timing differences. These differences relate primarily to (1) the difference between the provision for possible loan losses reported for income tax purposes and that reported for financial statement purposes and (2) amortization over a ten-year period of the effect of the change for income tax purposes in 1978 from the cash basis to the accrual basis of reporting certain revenues and expenses.

Investment tax credits are accounted for on the flow-through method.

2. Investment in subsidiary

During 1976 and 1977, the Company acquired 83,259 shares of the 100,000 outstanding shares of the Bank. This acquisition was accounted for as a purchase and the excess of cost over fair market value of the net assets acquired of $851,792 is being amortized on a straight-line basis over a period of forty years. The unamortized balances of $747,180 and $767,322 at December 31, 1980 and 1979, respectively, are included in other assets in the consolidated balance sheet.

During 1979, the Company offered to issue to the minority shareholders of the Bank for each share of the Bank's common stock owned either (1) one and one-half shares of the Company's $1 par value common stock or (2) one share of the Company's preferred stock.

In September 1979 the following exchanges were effected:

Number of shares of bank stock exchanged	Number of shares of company stock issued	
	Common	Preferred
16,731	18,759	4,225

The additional investment acquired in the Bank was recorded at net book value of the Bank stock which in management's opinion approximated fair market value of the net assets acquired.

FIRST PENN CORPORATION
(consolidated and parent company)

NOTES TO FINANCIAL STATEMENTS

December 31, 1980 and 1979

2. Investment in subsidiary (continued)

In addition, the Company offered to exchange one share of its common stock for each $40 of principal face value of the Bank's $1,000,000 subordinated notes. All note holders exercised their options in exchange for 25,000 shares of the Company's common stock. In October, the Company canceled the Bank's liability on these notes resulting in an additional $1,000,000 investment in the subsidiary bank. In addition, a cash capital contribution of $1,000,000 was made by the Company to its subsidiary bank in 1979.

In January, 1980, the Company purchased the remaining 10 outstanding shares of the Bank at a cost of $200 per share. The excess of cost over fair market value of the shares acquired was $1206. This amount is included in the unamortized excess cost at December 31, 1980. A cash capital contribution of $7,500,000 was made by the Company to its subsidiary bank in 1980.

3. Investment securities

The carrying values and estimated market values of investment securities at December 31, 1980 and 1979 are as follows:

	Consolidated	
	1980	
	Carrying value	Market value
United States Treasury securities	$10,992,420	$10,643,000
Obligations of states and political subdivisions	31,334,926	26,546,000
Other	300,000	300,000
	$42,627,346	$37,489,000
	1979	
United States Treasury securities	$ 3,181,184	$ 2,816,000
Obligations of states and political subdivisions	19,741,635	18,013,000
Other	60,000	60,000
	$22,982,819	$20,889,000

97-830 O - 82 - 23

FIRST PENN CORPORATION
(consolidated and parent company)

NOTES TO FINANCIAL STATEMENTS

December 31, 1980 and 1979

3. Investment securities (continued)

At December 31, 1980 and 1979 investment securities with book values aggregating $18,549,000 and $9,460,000, respectively, were pledged to secure public funds.

4. Loans

Loans are stated at face value less unearned income. The amount of unearned income at December 31, 1980 and 1979 was $1,537,889 and $1,903,264, respectively. Loans at December 31, 1980 and 1979 are as follows:

	Consolidated	
	1980	1979
Commercial	$155,798,134	$ 83,424,493
Real estate	26,763,002	10,532,265
Instalment	16,356,789	13,263,098
Other	2,981,326	267,123
	201,899,251	107,486,979
Reserve for possible loan losses	(2,004,587)	(1,002,097)
	$199,894,664	$106,484,882

Included in outstanding loans at December 31, 1980 were loans totaling $3,846,129 to officers and directors, or their affiliates. Also during 1980 the Bank purchased loans from and sold loans to two banks in which an officer-director of the Company held an equity interest. At December 31, 1980 outstanding transactions with these banks consisted of:

Loan participations purchased	$1,737,484
Loan participations sold	$6,767,646

Management believes all such loans are made in the ordinary course of business.

5. Reserve for possible loan losses

Changes in the reserve for possible loan losses during 1980 and 1979 were as follows:

FIRST PENN CORPORATION
(consolidated and parent company)

NOTES TO FINANCIAL STATEMENTS

December 31, 1980 and 1979

5. Reserve for possible loan losses (continued)

	Consolidated 1980	Consolidated 1979
Balance at beginning of year	$1,002,097	$ 627,491
Provision charged to operating expense	1,407,830	615,000
Recoveries of loans previously charged off	212,061	19,038
Losses charged off	(617,401)	(259,432)
Balance at end of year	$2,004,587	$1,002,097

6. Premises and equipment

An analysis of premises and equipment follows:

	Consolidated 1980	Consolidated 1979
Land	$1,712,146	$ 469,426
Building	1,607,244	1,461,562
Furniture and equipment	1,158,227	845,699
Other	459,455	74,259
	4,937,072	2,850,946
Less accumulated depreciation	1,212,684	914,598
	$3,724,388	$1,936,348

The land account is composed of land on which the drive-in facility is located and unimproved land.

7. Other liabilities

Other liabilities consist of the following:

	Consolidated 1980	Consolidated 1979
Accrued interest payable	$3,186,239	$1,012,187
Income taxes payable	1,032,859	821,789

FIRST PENN CORPORATION
(consolidated and parent company)

NOTES TO FINANCIAL STATEMENTS

December 31, 1980 and 1979

7. Other liabilities (continued)

	Consolidated	
	1980	1979
Deferred federal income taxes	$ 176,710	$ 75,000
Other	240,771	66,365
	$4,636,579	$1,975,341

8. Notes payable

Notes payable consist of the following obligations of the parent company:

	Parent Company and consolidated	
	1980	1979
Demand notes payable secured by 98,354 shares of the Bank's stock:		
Due February 26, 1981 at Chicago floating prime interest rate	$7,500,000	$ -
Due February 26, 1980 at New York prime interest rate not to exceed 8%	-	2,160,001
Due December 28, 1980 at New York prime interest rate	-	1,000,000
Demand note payable, due February 27, 1981 at Dallas prime interest rate, secured by land held by the parent company at cost of $1,242,721	1,106,800	-
	$8,606,800	$3,160,001

Subsequent to year end, the $7,500,000 demand note was extended to February 26, 1982 and the $1,106,800 demand note was extended to May 29, 1981. It is the intention of management to seek to renew the debt upon maturity of the demand notes.

FIRST PENN CORPORATION
(consolidated and parent company)

NOTES TO FINANCIAL STATEMENTS

December 31, 1980 and 1979

9. Income taxes

Consolidated income tax expense, including the tax effects of securities losses, consists of the following components:

	1980	1979
Current tax:		
Federal	$1,710,000	$888,400
State	180,000	100,000
	1,890,000	988,400
Deferred	76,710	(26,000)
	$1,966,710	$962,400

A reconciliation of the amount computed by applying the federal statutory rate of 46% and the effective income rate follows:

	1980	1979
Income tax at statutory rate	$2,482,804	$1,318,468
Tax exempt interest	(585,059)	(392,375)
Investment tax credit	(42,955)	(12,200)
State taxes, net of federal benefit	97,200	54,000
Other	14,720	(5,493)
	$1,966,710	$ 962,400

An analysis of the provision (credit) for deferred income taxes follows:

Provision for possible loan losses for income tax purposes in excess of financial provision	$72,400	$ 15,400
Amortization of effect of the change for income tax purposes in 1978 from the cash basis to the accrual basis of reporting certain revenues and expenses	(10,800)	(10,800)
Provision for state income taxes for financial purposes in excess of tax provision	-	(32,000)
Other	15,110	1,400
	$76,710	$(26,000)

FIRST PENN CORPORATION
(consolidated and parent company)

NOTES TO FINANCIAL STATEMENTS

December 31, 1980 and 1979

9. Income taxes (continued)

The income tax benefit for the parent company represents the excess of amounts payable by its subsidiary in lieu of paying federal income taxes on a separate return basis over the taxes payable on the consolidated return.

10. Common and preferred stock

On September 6, 1979, the stockholders approved an amendment to the Articles of Incorporation increasing the number of $1 par value common stock authorized to 250,000 shares from the previously authorized 100,000 shares. The stockholders also approved the authorization of 5,000 non-voting preferred shares with a par value of $60 and with dividends cumulative at the annual rate of 6.5%. Each preferred share is convertible into one share of the common stock of the Company at any time at the option of the holder and is subject to redemption at the option of the Company upon payment of the par value plus accrued dividends at any time following January 1, 1989. No cash dividends may be paid on common stock if the dividends on the preferred stock is in arrears.

11. Commitments

The Bank has lease agreements for (1) the land under the main bank, which expire in 2029, and (2) office facilities one of which expires in 1985 with renewal options for three five-year terms, one of which expires in 1981, and two which expire in 1984 both with renewal options for three one-year terms. Minimum annual rentals under these leases are as follows:

1981	$118,353
1982-1983	122,752
1984	21,119
1985	7,980
1986-1989	7,200
1990-2029	3,000

In addition to the minimum rental for one of the office facility leases, the Bank also pays additional rental based on a percent of average total deposits as defined for each lease year. The lease covering the land provides for rental payments to be adjusted every 10 years based on a cost of living index. Total rental expense for 1980 amounted to approximately $99,000.

FIRST PENN CORPORATION
(consolidated and parent company)

NOTES TO FINANCIAL STATEMENTS

December 31, 1980 and 1979

12. Participation loans

At December 31, 1980, there were participation agreements in effect with maturity dates prior to that of the underlying loans. Subsequent to December 31, 1980, the majority of the agreements totaling $18,651,497 were amended to reflect terms that coincide with the terms of the note.

Accordingly, the participation agreements amounting to $20,969,203 at December 31, 1980 have not been reflected in the accompanying balance sheet as loans outstanding. However, the National Bank Examiners required that certain of these loans be reflected as loans outstanding in reports submitted to their office. After renegotiation of the terms of agreements subsequent to December 31, 1980, these amounts will not be included in such reporting.

13. Subsequent event

Subsequent to December 31, 1980 the Company acquired, from certain officer-stockholders, all of the outstanding stock of a company involved in a real estate development project for approximately $1,250,000. The acquired company's principal asset is the uncompleted development project which is subject to debt of approximately $3,000,000. Approximately $400,000 of this debt, at December 31, 1980, was payable to the Bank. The lead lending bank has filed foreclosure proceedings on the project. In addition, certain suppliers of the project have filed third party claims against the Bank for materials supplied the project and punitive damages. Management is of the opinion that no significant loss will be incurred in connection with this transaction.

DOMESTIC BANK HOLDING COMPANY

JUN 23 1981

ANNUAL REPORT F. R. Y - 6

OFFICIAL RECORD COPY

YEAR ENDING 1980/12/31

SUPPLEMENT

NAME OF BANK HOLDING COMPANY: FIRST PENN CORPORATION

MAILING ADDRESS

STREET:	1919 PENN SQUARE	/ /
P.O. BOX	26208	/ /
CITY:	OKLAHOMA CITY	/ /
STATE:	OKLAHOMA	/ /
ZIP CODE:	73126	/ /

LOCATION OF PRINCIPAL OFFICE:

CITY:	OKLAHOMA CITY	/ /
COUNTY:	OKLAHOMA	/ /
STATE:	OKLAHOMA	/ /
ZIP CODE:	73126	/ /

I (NAME) JENNNINGS, BILL P

(TITLE) PRESIDENT

AN AUTHORIZED OFFICER OF THE HOLDING COMPANY NAMED ABOVE,HEREBY CERTIFY ON THE /___/ DAY OF /___________/ 19/__/,THAT THIS REPORT HAS BEEN EXAMINED BY ME AND IS TRUE AND COMPLETE TO THE BEST OF MY KNOWLEDGE AND BELIEF.

SIGNATURE /______________________/

NAME,TITLE,AND PHONE NUMBER OF PERSON TO WHOM INQUIRES MAY BE DIRECTED:

NAME: TRUESDELL, PATTI

TITLE: ACCT SUPERVISOR

TELEPHONE NUMBER: (405) 842-7441 /___________/
(AREA CODE)-NUMBER

THIS REPORT IS REQUIRED BY SECTION 5(C) OF THE BANK HOLDING COMPANY ACT (12U.S.C 1844) AND SECTION 225.5(B) OF REGULATION Y (12C.F.R. 255.5(B)).

SCHEDULE A

INFORMATION ON SUBSIDIARIES<1>
SEE F.R. Y-6, REPORT ITEM 3.

TO BE COMPLETED FOR EACH BANK AND NONBANK, DIRECT AND INDIRECT, FOREIGN AND DOMESTIC SUBSIDIARY OF THE BANK HOLDING COMPANY.

NAME: FIRST PENN LEASING CORPORATION

CITY: OKLAHOMA CITY

STATE: OKLAHOMA

COUNTY: OKLAHOMA

ZIP CODE: 73126

DATE OF SUBSIDIARY'S FISCAL YEAR END: 1980/12/31

1. IF THIS SUBSIDIARY BECAME PART OF THE BHC ORGANIZATION DURING THE LAST FISCAL YEAR, ENTER THE DATE AND NATURE OF CONSIDERATION PAID IF OTHER THAN MONETARY: (WHICH SHOULD BE REPORTED IN ITEM 13 ON PAGE 3 OF THIS SCHEDULE)

   DATE(YYMMDD):
   CONSIDERATION:

FOR ITEMS 2 AND 3, PLACE THE APPROPRIATE NUMBER IN THE BOX PROVIDED.

2. THIS SUBSIDIARY IS:
   A. (1) A BANK (AS DEFINED IN THE ACT) /2/
      (2) A NONBANK ORGANIZATION<2>
   B. (1) A JOINT VENTURE /2/
      (2) NOT A JOINT VENTURE
   C. (1) A CORPORATION /1/
      (2) A PARTNERSHIP
      (3) NOT A CORPORATION OR PARTNERSHIP
         (SPECIFY TYPE:)
   D. (1) ACTIVE /1/
      (2) INACTIVE
   E. (1) DOMESTIC<3> /1/
      (2) FOREIGN<4>

3. IF THIS IS A SUBSIDIARY OF A BANK, IS IT FULLY CONSOLIDATED WITH THE BANK?
   (1) YES(NAME OF BANK) PENN SQUARE BANK, N. A. /1/
   (2) NO
   (3) NOT APPLICABLE(NOT A SUBSIDIARY OF A BANK)

<1> REFER TO DEFINITIONS 5 AND 7 IN GENERAL INSTRUCTIONS FOR SUBSIDIARY DEFNS.
<2> QUESTIONS 2A2: A NONBANK IS ANY ORGANIZATION THAT IS NOT A BANK, AS DEFINED IN THE BHC ACT.
<3> QUESTION 2E: A BANK(AS DEFINED IN THE BHC ACT) IS CONSIDERED DOMESTIC.
<4> REFER TO DEFINITIONS 6 AND 7 IN THE GENERAL INSTRUCTIONS FOR FOREIGN ORGANIZATIONS.

(FIRST PENN LEASING CORPORATION

SCHEDULE A

INFORMATION ON SUBSIDIARIES

4. LIST EACH ORGANIZATION WITHIN THE BANK HOLDING COMPANY ORGANIZATION THAT DIRECTLY OWNS OR CONTROLS VOTING SECURITIES OF THIS SUBSIDIARY, AND INDICATE THE TYPE(S) OR CLASS(ES) OF SHARES OWNED OR CONTROLLED AND PERCENTAGE(TO THE NEAREST TENTH OF ONE PERCENT) OF OUTSTANDING SHARES OF EACH TYPE OR CLASS OWNED OR CONTROLLED.

DIRECT PARENT	CLASS OF SHARES	PER CENT OWNED
PENN SQUARE BANK, N. A.	COMMON STOCK-VOTING	100.00

5. SPECIFY THE EXEMPTIVE PROVISION AND REGULATION OR BOARD ORDER(INDICATE DATE) RELIED UPON FOR RETENTION OF THIS SUBSIDIARY.<1>

SECTION 4(C) 5

SECTION 4(C) 5

6. LIST CURRENT ACTIVITIES CONDUCTED BY THIS SUBSIDIARY IN ORDER OF IMPORTANCE.

ACTIVITY CODE<2>	CONDUCTED IN U.S.(1=YES,2=NO)
06AA	1
06AC	1

7. LIST ACTIVITIES COMMENCED BY THIS SUBSIDIARY THIS YEAR.

ACTIVITY CODE<2>	CONDUCTED IN U.S.(1=YES,2=NO)	EFFECTIVE DATE(YYMMDD)
06AA	1	79/01/01
06AC	1	79/01/01

8. LIST ACTIVITIES TERMINATED BY THIS SUBSIDIARY DURING THE FISCAL YEAR.

ACTIVITY CODE<2>	EFFECTIVE DATE(YYMMDD)
0140	79/01/01

9. LIST ACTIVITIES NOT CURRENTLY CONDUCTED BY THIS SUBSIDIARY BUT FOR WHICH APPROVAL EXISTS.

ACTIVITY CODE<2>

<1> QUESTION 5: REFER TO DEFINITIONS 9 AND 10 IN THE GENERAL INSTRUCTIONS.
<2> QUESTIONS 6,7,8,9: REFER TO THE BHC ACTIVITY MANUAL FOR CODES, USE THE 4 DIGIT ALPHANUMERIC CODES WHENEVER POSSIBLE.

(FIRST PENN LEASING CORPORATION ,

SCHEDULE A PAGE 3 OF 3

INFORMATION ON SUBSIDIARIES

10. IF THIS SUBSIDIARY'S HEAD OFFICE IS LOCATED IN THE UNITED STATES, FURNISH THE FOLLOWING INFORMATION:<1>

A. NUMBER OF EXISTING OFFICES	1	/___/
B. NUMBER OF OFFICES ESTABLISHED DURING FISCAL YEAR		/___/
C. NUMBER OF OFFICES TERMINATED DURING FISCAL YEAR		/___/
D. NUMBER OF OFFICES APPROVED BUT UNOPENED		/___/

11. IF THIS SUBSIDIARY'S HEAD OFFICE IS LOCATED IN A FOREIGN COUNTRY, FURNISH THE FOLLOWING INFORMATION:

COUNTRY OF HEAD OFFICE	NUMBER OF OFFICES
/______/	/___/
COUNTRY OF OTHER OFFICES	NUMBER OF OFFICES
/______/	/___/

AMOUNTS IN THOUSANDS OF U.S. DOLLARS

12. TOTAL AMOUNT AT WHICH THIS SUBSIDIARY IS CARRIED ON THE BOOKS OF ITS OWNER(S) WITHIN THE BANK HOLDING COMPANY ORGANIZATION.	226	/_____/
13. TOTAL HISTORIC COST OF THIS SUBSIDIARY	100	/_____/
14. BANK HOLDING COMPANY'S(PARENT ONLY) INCOME FROM THIS SUBSIDIARY DURING THE PARENT'S FISCAL YEAR:<2>		
A. DIVIDENDS DECLARED(PAID OR PAYABLE DIRECTLY TO THE PARENT).		/_____/
B. OTHER (INTEREST, MANAGEMENT, AND SERVICE FEES, ETC.) EXCLUDING THE PARENT'S EQUITY IN UNDISTRIBUTED EARNINGS OF THIS SUBSIDIARY.		/_____/
15. OUTSTANDING LOANS AND ADVANCES TO THIS SUBSIDIARY AS OF THE END OF THE BANK HOLDING COMPANY'S(PARENT ONLY) FISCAL YEAR:<2>		
A. FROM THE BANK HOLDING COMPANY(PARENT ONLY)		/_____/
B. FROM SUBSIDIARY BANKS OF THE HOLDING COMPANY		/_____/
C. FROM OTHER SUBSIDIARIES OF THE BANK HOLDING COMPANY		/_____/
16. LOANS AND LEASES, NET OF UNEARNED INCOME AND RESERVE FOR POSSIBLE LOAN LOSSES<3>		/_____/
17. TOTAL ASSETS<3>		/_____/
18. STOCKHOLDERS' EQUITY<3>		/_____/
19. TOTAL OPERATING REVENUE<3>		/_____/
20. TOTAL OPERATING EXPENSES<3>		/_____/
21. NET INCOME<3>		/_____/
22. DO THE AMOUNTS FOR THIS SUBSIDIARY IN ITEMS 16 THROUGH 21 CONSOLIDATE ON A LINE BY LINE BASIS THE ACCOUNTS OF ANY OF ITS SUBSIDIARIES? ENTER "1" FOR YES, "2" FOR NO, "3" FOR INAPPLICABLE.	3	/__/

23. IF THE FINANCIAL STATEMENTS OF THIS SUBSIDIARY HAVE NOT BEEN SUBMITTED IN REPORT ITEM 4 BECAUSE ITS ACCOUNTS HAVE BEEN CONSOLIDATED ON A LINE-BY-LINE BASIS WITH ANOTHER SUBSIDIARY FOR WHICH STATEMENTS HAVE BEEN SUBMITTED, INDICATE THE NAME OF THAT SUBSIDIARY.<3>

/______________________________/

<1> QUESTION 10: NEED NOT BE COMPLETED FOR ANY BANKS(AS DEFINED IN THE BHC ACT)

<2> QUESTION 14,15: NEED NOT BE COMPLETED FOR COMPANIES THAT FILE FR 2314 OR FR 2886B.

<3> QUESTIONS 16-21: NEED NOT BE COMPLETED FOR A BANK, A SUB OF A BANK CONSOLIDATED IN ITS PARENT'S CONSOLIDATED REPORT OF CONDITION, OR ANY SUBSIDIARY FILING AN FR 2314 OR FR 2886B: REFER TO REPORT ITEM 3 INSTRUCTIONS.

402365

SCHEDULE A

PAGE 1 OF 3

INFORMATION ON SUBSIDIARIES<1>
SEE F.R. Y-6, REPORT ITEM 3.

TO BE COMPLETED FOR EACH BANK AND NONBANK,DIRECT AND INDIRECT,FOREIGN AND DOMESTIC SUBSIDIARY OF THE BANK HOLDING COMPANY.

NAME: PENN SQUARE BANK, N. A.
/______________________________/

CITY: OKLAHOMA CITY
/____________________/

STATE: OKLAHOMA
/____________________/

COUNTY: OKLAHOMA
/______________/

ZIP CODE: 73118
/________/

DATE OF SUBSIDIARY'S FISCAL YEAR END: 1980/12/31 /__________/

1. IF THIS SUBSIDIARY BECAME PART OF THE BHC ORGANIZATION DURING THE LAST FISCAL YEAR,ENTER THE DATE AND NATURE OF CONSIDERATION PAID IF OTHER THAN MONETARY:(WHICH SHOULD BE REPORTED IN ITEM 13 ON PAGE 3 OF THIS SCHEDULE)

DATE(YYMMDD): /__________/
CONSIDERATION: /____________________/

FOR ITEMS 2 AND 3,PLACE THE APPROPRIATE NUMBER IN THE BOX PROVIDED.

2. THIS SUBSIDIARY IS:
A. (1) A BANK (AS DEFINED IN THE ACT) /1/ /__/
(2) A NONBANK ORGANIZATION<2>
B. (1) A JOINT VENTURE /2/ /__/
(2) NOT A JOINT VENTURE
C. (1) A CORPORATION /1/ /__/
(2) A PARTNERSHIP
(3) NOT A CORPORATION OR PARTNERSHIP
(SPECIFY TYPE:)
D. (1) ACTIVE /1/ /__/
(2) INACTIVE
E. (1) DOMESTIC<3> /1/ /__/
(2) FOREIGN<4>

3. IF THIS IS A SUBSIDIARY OF A BANK, IS IT FULLY CONSOLIDATED WITH THE BANK?
(1) YES(NAME OF BANK) /3/
/____/ /__/
(2) NO
(3) NOT APPLICABLE(NOT A SUBSIDIARY OF A BANK)

- -

<1> REFER TO DEFINITIONS 5 AND 7 IN GENERAL INSTRUCTIONS FOR SUBSIDIARY DEFNS.
<2> QUESTIONS 2A2: A NONBANK IS ANY ORGANIZATION THAT IS NOT A BANK,AS DEFINED IN THE BHC ACT.
<3> QUESTION 2E: A BANK(AS DEFINED IN THE BHC ACT) IS CONSIDERED DOMESTIC.
<4> REFER TO DEFINITIONS 6 AND 7 IN THE GENERAL INSTRUCTIONS FOR FOREIGN ORGANIZATIONS.

(PENN SQUARE BANK, N. A.

SCHEDULE A

INFORMATION ON SUBSIDIARIES

4. LIST EACH ORGANIZATION WITHIN THE BANK HOLDING COMPANY ORGANIZATION THAT DIRECTLY OWNS OR CONTROLS VOTING SECURITIES OF THIS SUBSIDIARY, AND INDICATE THE TYPE(S) OR CLASS(ES) OF SHARES OWNED OR CONTROLLED AND PERCENTAGE(TO THE NEAREST TENTH OF ONE PERCENT) OF OUTSTANDING SHARES OF EACH TYPE OR CLASS OWNED OR CONTROLLED.

DIRECT PARENT	CLASS OF SHARES	PER CENT OWNED
FIRST PENN CORPORATION	COMMON STOCK-VOTING	100.00
/ /	/ /	/ /
/ /	/ /	/ /
/ /	/ /	/ /
/ /	/ /	/ /
/ /	/ /	/ /

5. SPECIFY THE EXEMPTIVE PROVISION AND REGULATION OR BOARD ORDER(INDICATE DATE) RELIED UPON FOR RETENTION OF THIS SUBSIDIARY.<1>
SECTION 3(A) (1)
/ /
/ /
/ /
/ /
/ /

6. LIST CURRENT ACTIVITIES CONDUCTED BY THIS SUBSIDIARY IN ORDER OF IMPORTANCE.

ACTIVITY CODE<2>	CONDUCTED IN U.S.(1=YES,2=NO)
6025 / /	1 / /
/ /	/ /
/ /	/ /
/ /	/ /
/ /	/ /

7. LIST ACTIVITIES COMMENCED BY THIS SUBSIDIARY THIS YEAR.

ACTIVITY CODE<2>	CONDUCTED IN U.S.(1=YES,2=NO)	EFFECTIVE DATE(YYMMDD)
/ /	/ /	/ / / /
/ /	/ /	/ / / /
/ /	/ /	/ / / /

8. LIST ACTIVITIES TERMINATED BY THIS SUBSIDIARY DURING THE FISCAL YEAR.

ACTIVITY CODE<2>	EFFECTIVE DATE(YYMMDD)
/ /	/ / / /
/ /	/ / / /
/ /	/ / / /

9. LIST ACTIVITIES NOT CURRENTLY CONDUCTED BY THIS SUBSIDIARY BUT FOR WHICH APPROVAL EXISTS.
ACTIVITY CODE<2>
/ /
/ /
/ /

<1> QUESTION 5: REFER TO DEFINITIONS 9 AND 10 IN THE GENERAL INSTRUCTIONS.
<2> QUESTIONS 6,7,8,9: REFER TO THE BHC ACTIVITY MANUAL FOR CODES,USE THE 4 DIGIT ALPHANUMERIC CODES WHENEVER POSSIBLE.

(PENN SQUARE BANK, N. A.

SCHEDULE A

INFORMATION ON SUBSIDIARIES

10. IF THIS SUBSIDIARY'S HEAD OFFICE IS LOCATED IN THE UNITED STATES, FURNISH THE FOLLOWING INFORMATION:<1>

A. NUMBER OF EXISTING OFFICES 1 /___/

B. NUMBER OF OFFICES ESTABLISHED DURING FISCAL YEAR /___/

C. NUMBER OF OFFICES TERMINATED DURING FISCAL YEAR /___/

D. NUMBER OF OFFICES APPROVED BUT UNOPENED /___/

11. IF THIS SUBSIDIARY'S HEAD OFFICE IS LOCATED IN A FOREIGN COUNTRY, FURNISH THE FOLLOWING INFORMATION:

COUNTRY OF HEAD OFFICE — NUMBER OF OFFICES

/______________________________/ /___/

COUNTRY OF OTHER OFFICES — NUMBER OF OFFICES

/______________________________/ /___/

AMOUNTS IN THOUSANDS OF U.S. DOLLARS

12. TOTAL AMOUNT AT WHICH THIS SUBSIDIARY IS CARRIED ON THE BOOKS OF ITS OWNER(S) WITHIN THE BANK HOLDING COMPANY ORGANIZATION. 21,170 /_____/

13. TOTAL HISTORIC COST OF THIS SUBSIDIARY 7,134 /_____/

14. BANK HOLDING COMPANY'S(PARENT ONLY) INCOME FROM THIS SUBSIDIARY DURING THE PARENT'S FISCAL YEAR:<2>

A. DIVIDENDS DECLARED(PAID OR PAYABLE DIRECTLY TO THE PARENT). 360 /_____/

B. OTHER (INTEREST, MANAGEMENT, AND SERVICE FEES, ETC.) EXCLUDING THE PARENT'S EQUITY IN UNDISTRIBUTED EARNINGS OF THIS SUBSIDIARY. /_____/

15. OUTSTANDING LOANS AND ADVANCES TO THIS SUBSIDIARY AS OF THE END OF THE BANK HOLDING COMPANY'S(PARENT ONLY) FISCAL YEAR:<2>

A. FROM THE BANK HOLDING COMPANY(PARENT ONLY) /_____/

B. FROM SUBSIDIARY BANKS OF THE HOLDING COMPANY /_____/

C. FROM OTHER SUBSIDIARIES OF THE BANK HOLDING COMPANY /_____/

16. LOANS AND LEASES, NET OF UNEARNED INCOME AND RESERVE FOR POSSIBLE LOAN LOSSES<3> /_____/

17. TOTAL ASSETS<3> /_____/

18. STOCKHOLDERS' EQUITY<3> /_____/

19. TOTAL OPERATING REVENUE<3> /_____/

20. TOTAL OPERATING EXPENSES<3> /_____/

21. NET INCOME<3> /_____/

22. DO THE AMOUNTS FOR THIS SUBSIDIARY IN ITEMS 16 THROUGH 21 CONSOLIDATE ON A LINE BY LINE BASIS THE ACCOUNTS OF ANY OF ITS SUBSIDIARIES? ENTER "1" FOR YES, "2" FOR NO, "3" FOR INAPPLICABLE. 2 /_/

23. IF THE FINANCIAL STATEMENTS OF THIS SUBSIDIARY HAVE NOT BEEN SUBMITTED IN REPORT ITEM 4 BECAUSE ITS ACCOUNTS HAVE BEEN CONSOLIDATED ON A LINE-BY-LINE BASIS WITH ANOTHER SUBSIDIARY FOR WHICH STATEMENTS HAVE BEEN SUBMITTED, INDICATE THE NAME OF THAT SUBSIDIARY.<3>

/______________________________/

- -

<1> QUESTION 10: NEED NOT BE COMPLETED FOR ANY BANKS(AS DEFINED IN THE BHC ACT)

<2> QUESTION 14,15: NEED NOT BE COMPLETED FOR COMPANIES THAT FILE FR 2314 OR FR 2886B.

<3> QUESTIONS 16-21: NEED NOT BE COMPLETED FOR A BANK, A SUB OF A BANK CONSOLIDATED IN ITS PARENT'S CONSOLIDATED REPORT OF CONDITION, OR ANY SUBSIDIARY FILING AN FR 2314 OR FR 2886B: REFER TO REPORT ITEM 3 INSTRUCTIONS.

SCHEDULE C

ACTIVITIES OF PARENT BHC

NAME: FIRST PENN CORPORATION
/______________________________/

CITY: OKLAHOMA CITY /______________________/

STATE: OKLAHOMA /______________________/

COUNTY: OKLAHOMA /____________________/

ZIP CODE: 73126 /_____/

1. LIST CURRENT ACTIVITIES CONDUCTED BY PARENT IN ORDER OF IMPORTANCE:
ACTIVITY CODE<1> CONDUCTED IN US(1=YES,2=NO)

ACTIVITY CODE<1>	CONDUCTED IN US
GOAA	1

2. LIST ACTIVITIES COMMENCED BY THE PARENT THIS FISCAL YEAR:
ACTIVITY CODE<1> CONDUCTED IN US(1=YES,2=NO) EFFECTIVE DATE(YYMMDD)

ACTIVITY CODE<1>	CONDUCTED IN US	EFFECTIVE DATE
		/ /
		/ /
		/ /

3. LIST ACTIVITIES TERMINATED BY PARENT THIS FISCAL YEAR:
ACTIVITY CODE<1> EFFECTIVE DATE

ACTIVITY CODE<1>	EFFECTIVE DATE
	/ /
	/ /
	/ /

4. LIST ACTIVITIES NOT CURRENTLY CONDUCTED BY PARENT FOR WHICH A VALID APPROVAL BY AUTHORITIES IS IN EFFECT.
ACTIVITY CODE<1>
/_____/
/_____/
/_____/

5. NUMBER OF OFFICES OF THE PARENT COMPANY:
A. NUMBER OF EXISTING OFFICES(INCLUDING HEAD OFFICE). 1 /___/
B. NUMBER OF OFFICES ESTABLISHED DURING FISCAL YEAR. /___/
C. NUMBER OF OFFICES TERMINATED DURING FISCAL YEAR. /___/
D. NUMBER OF OFFICES APPROVED BUT UNOPENED. /___/
6. DOES COMPANY FILE WITH SEC? (1-YES,2-NO) 2 /___/
7. SPECIFY THE EXEMPTIVE PROVISIONS AND REGULATION OR BOARD ORDER(INDICATE DATE) RELIED UPON FOR AUTHORITY TO CONTINUE TO ENGAGE IN THE BUSINESS ACTIVITIES LISTED IN ITEM 1 ABOVE.<2>

NOT APPLICABLE OR NONE
/______________________________________/
/______________________________________/
/______________________________________/
/______________________________________/
/______________________________________/

<1> QUESTIONS 1,2,3,4: REFER TO BHC MANUAL FOR ACTIVITY CODES,USE THE 4 DIGIT ALPHANUMERIC CODES WHENEVER POSSIBLE.
<2> QUESTION 7: REFER TO DEFINITION 11 IN THE GENERAL INSTRUCTIONS.

SCHEDULE D

TERMINATIONS

PROVIDE THE FOLLOWING INFORMATION FOR ANY ORGANIZATION(SUBSIDIARY AND"ORGANIZATION OTHER THAN A SUBSIDIARY",BANK AND NONBANK,DOMESTIC AND FOREIGN) THAT CEASED BEING PART OF THE BANK HOLDING COMPANY ORGANIZATION DURING THE BANK HOLDING COMPANY'S FISCAL YEAR. INCLUDE ALL ORGANIZATIONS THAT WERE LIQUIDATED, DIVESTED, OR MERGED OUT OF EXISTENCE. IF MORE SPACE IS NEEDED,ATTACH A SEPARATE PAGE SUPPLYING THE INFORMATION IN THE SAME FORMAT.

IF THE ORGANIZATION WAS DISPOSED OF: DESCRIBE THE MANNER AND TERMS OF DISPOSITION; INDICATE THE AMOUNT OF CREDIT EXTENDED TO THE PURCHASER BY THE BANK HOLDING COMPANY ORGANIZATION,IF ANY; AND INDICATE WHETHER THE PURCHASER HAS ONE OR MORE OFFICERS,DIRECTORS,TRUSTEES,OR BENEFICIARIES IN COMMON WITH,OR SUBJECT TO CONTROL BY, THE BANK HOLDING COMPANY ORGANIZATION.

COL A. NAME AND ADDRESS OF EACH ORGANIZATION TERMINATED.
NAME:
/____/
CITY: /_____________________/ STATE: /_____________________/
COUNTY: /______________/ ZIP CODE: /_____/

COL B. NAME AND ADDRESS OF EACH ORGANIZATION THAT ABSORBED A MERGED ORGANIZATION.
NAME:
/____/
CITY: /_____________________/ STATE: /_____________________/
COUNTY: /______________/ ZIP CODE: /_____/

COL C. EFFECTIVE DATE OF TERMINATION 19 / / /__________/
COL D. ENTER(1=LIQUIDATED,2=DIVESTED,3=MERGER,4=OTHER) /__/
******
COL A. NAME AND ADDRESS OF EACH ORGANIZATION TERMINATED.
NAME:
/____/
CITY: /_____________________/ STATE: /_____________________/
COUNTY: /______________/ ZIP CODE: /_____/

COL B. NAME AND ADDRESS OF EACH ORGANIZATION THAT ABSORBED A MERGED ORGANIZATION.
NAME:
/____/
CITY: /_____________________/ STATE: /_____________________/
COUNTY: /______________/ ZIP CODE: /_____/

COL C. EFFECTIVE DATE OF TERMINATION 19 / / /__________/
COL D. ENTER(1=LIQUIDATED,2=DIVESTED,3=MERGER,4=OTHER) /__/
******

TELEPHONE MESSAGES

REC'D IN RECORDS SECTION
JUN 23 1981

CONTACT Patti Trumbull	PHONE NUMBER (Area Code & Number) (405)-842-7441	BANK HOLDING COMPANY NUMBER 2283
BANK HOLDING COMPANY NAME Fred Perm		DATE OF PHONE CALL 5/5/81

☑ ANNUAL REPORT AMENDMENTS TO Y-6 ☐ REGISTRATION STATEMENT

REMARKS:
P.2. SCH. A FOR "LEASING": #5 from N.A. to 4(c)(5)
#6 from 6½ to 06AA & 06AC

P.3 SCH. A FOR "BANK": #10 to N.A.
SHC. C : #1 from 03AA & 01CE to 03AA
#2 from 01CB to nothing
ALSO: reminded her to send all + income reports in future

ASSISTANT EXAMINER: John F. Moore

BSS 16 (1…) OFFICIAL RECORD COPY …ROL CLERK SUPPLEMENT 2

0520

FR Y-9
Approved by the Federal Reserve Board
November 29, 1978
Approval expires January 1, 1981

OFFICIAL RECORD COPY

REC'D IN RECORDS SECTION
MAR 03 1981

1981 FEB 27 AM 9 55
DIVISION OF BANKING SUPERVISION & REGULATION

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
Washington, D.C. 20551

BANK HOLDING COMPANY FINANCIAL SUPPLEMENT

Reporting period (fill in appropriate line below)
For the fiscal year period ending on December 31, 19 80
For the 6-month period ending on ________, 19 ___

Name of bank holding company: First Penn Corporation

Mailing address: P. O. Box 26208
Street
Oklahoma City Oklahoma 73126
City State Zip Code

Location of principal office: Oklahoma City Oklahoma
City County
Oklahoma 73126
State Zip Code

I, Bill P. Jennings President
Name Title

an authorized officer of the bank holding company named above, hereby declare that this report has been examined by me and is true and complete to the best of my knowledge and belief.

[signature] February 12, 1981
Signature Date

Name, title, and phone number of person to whom inquiries may be directed:

Sheryl A. Walker Controller
Name Title

405 842-7441 Ext. 274
Area Code Number

General Instructions

Who must report: This report is to be filed by domestic bank holding companies that have $50 million or more in total consolidated assets. The following companies are not required to file the report: (a) a bank holding company that is a subsidiary of another domestic bank holding company; (b) a bank holding company that has been granted an exemption under Section 4(d) of the Act; and (c) a bank holding company that is organized under the laws of a foreign country, and more than half of whose consolidated assets are located, or half of whose consolidated revenues are derived, outside the United States. The Federal Reserve Bank may require this report from bank holding companies that are not required to file this report under the above criteria.

Full year reporting: Bank holding companies that have $50 million or more in total consolidated assets must file this report once a year for the 12-month period covering their fiscal year.

Midyear reporting: In addition to full-year reporting, bank holding companies that have $300 million or more in consolidated assets must file this report for the 6-month period covering the first half of their fiscal year.

Time and place of filing: The report must be filed within 45 days after the end of the reporting period. Submit the original and three copies of the report to the Federal Reserve Bank of the district in which the bank holding company is registered.

Confidentiality: The report will be made publicly available after the bank holding company has released its financial statements to the public or 90 days after the end of the reporting period, whichever comes first. In the interim period, the information contained in this report will be regarded as confidential by the Federal Reserve System. If it should be determined that any information contained in this report must be released during this period, respondents will be notified.

Detailed instructions: Please refer to the instructions manual for the Bank Holding Company Financial Supplement.

FOR FILES
Cherie Suess

This report is required by Section 5(c) of the Bank Holding Company Act (12 U.S.C. 1844) and Section 225.5(b) of Regulation Y (12 CFR 225.5(b)).

Page 2
FR Y-9, Part A

FR BANK USE ONLY

Year		Dist.
1	Y 9 8 2 1 (3)	9
BHC No. (11)	Yr. (23) Mo. (25) Day (27)	2 (30)

Consolidated Balance Sheet 1/
(Including foreign and domestic subsidiaries)

As of the close of business on 12-31, 19 80

ASSETS		Bil	Mil	Thou	
1. Cash and due from depository institutions:					
a. Interest-bearing balances	01			0	1a
b. Other			59	626	1b
2. U.S. Treasury securities			10	992	2
3. Obligations of other U.S. Government agencies and corporations				0	3
4. Obligations of States and political subdivisions in the United States			31	335	4
5. Other bonds, notes, and debentures				0	5
6. Federal Reserve stock and corporate stock	02			300	6
7. Trading account securities				0	7
8. Federal funds sold and securities purchased under agreements to resell in domestic offices including those of Edge and Agreement subsidiaries			16	000	8
9. Loans:					
a. Loans made at domestic offices:					
(1) Real estate loans			29	433	9a1
(2) Loans to financial institutions				0	9a2
(3) Commercial and industrial loans			144	099	9a3
(4) Loans to individuals for household, family, and other personal expenditures	03		13	375	9a4
(5) All other loans			13	490	9a5
b. Loans made at foreign offices and at Edge and Agreement subsidiaries				0	9b
c. Less: Unearned income on loans reflected in items above 2/			1	467	9c
d. Less: Allowance for possible loan losses 2/			2	005	9d
e. Loans, net			196	925	9e
10. Lease financing receivables	04			0	10
11. Company premises, furniture, fixtures, and other assets representing company premises			3	688	11
12. Real estate owned other than company premises				0	12
13. Investments in unconsolidated subsidiaries and associated companies				0	13
14. Intangible assets				747	14
15. Other assets			8	196	15
16. TOTAL ASSETS	05		327	809	16

1/ Bank holding companies with less than $100 million in total consolidated assets need not complete the consolidated balance sheet and income statement (parts A and B of this report).

2/ Do not enclose amount in parentheses.

Remarks:

Page 3
FR Y-9, Part A

FR BANK USE ONLY

Year		Dist.
1	Y 9 8 2 1 (3)	9

BHC No.	Yr.	Mo.	Day	
11	23	25	27	3 (30)

Consolidated Balance Sheet - continued

LIABILITIES AND STOCKHOLDERS' EQUITY		Dollar amounts			
		Bil	Mil	Thou	
17. DEPOSITS:					
a. Deposits in domestic offices:	06		135	029	17a1
(1) Demand deposits					
(2) Time deposits:			105	243	17a2a
(a) Time deposits of $100,000 or more			31	280	17a2b
(b) Other time deposits					
(3) Savings deposits:			1	593	17a3a
(a) Corporations and other profit organizations			11	748	17a3b
(b) Other savings deposits				0	17b
b. Deposits in foreign offices and in Edge and Agreement subsidiaries	07		284	893	17c
c. TOTAL DEPOSITS					
18. Federal funds purchased and securities sold under agreements to repurchase in domestic offices				650	18
including those of Edge and Agreement subsidiaries			14	640	19
19. Commercial paper			8	607	20
20. Other borrowings with an original maturity of one year or less					
21. Other borrowings with an original maturity of more than one year (excluding mortgage				0	21
indebtedness and subordinated debt)				0	22
22. Mortgage indebtedness and liability for capitalized leases	08			0	23
23. Subordinated notes and debentures			4	772	24
24. Other liabilities	313562			~~0~~	25
25. TOTAL LIABILITIES				0	26
26. Minority interest in consolidated subsidiaries			14	247	27
27. STOCKHOLDERS' EQUITY			327	809	28
28. TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY					
MEMORANDA					
29. Amount of debt reported above in Items 21, 22, and 23 that is scheduled to mature within	09		~~8~~	~~607~~	29
one year			27	724	30
30. Standby letters of credit outstanding					
31. Deferred taxes (included in Item 24, "Other liabilities"):				0	31a
a. IRS bad debt reserve				108	31b
b. Other				747	32
32. State the amount of intangible assets reported in Item 14 that is subject to amortization					

Remarks: Line 20 & 29 . It is the intention of management to seek to renew the debt upon maturity of the demand note.

Page 4
FR Y-9, Part B

FR BANK USE ONLY

Year		Dist.
1	Y 9 8 2 1 (3)	9
BHC No. (11)	Yr. (23) Mo. (25) Day (27)	4 (30)

Consolidated Report of Income[1]

(Including foreign and domestic subsidiaries)

Reporting period (fill in appropriate line below)
For the fiscal year ending on 12-31, 19 80
For the 6-month period ending on ________, 19____

		Bil	Mil	Thou	
		Year-to-date Dollar amounts			
1. OPERATING INCOME:		Bil	Mil	Thou	
a. Interest and fees on loans	10		24	650	1a
b. Interest on balances with depository institutions				0	1b
c. Income on Federal funds sold and securities purchased under agreements to resell in domestic offices including those of Edge and Agreement subsidiaries				283	1c
d. Interest on U.S. Treasury securities				314	1d
e. Interest on obligations of other U.S. Government agencies and corporations				0	1e
f. Interest on obligations of States and political subdivisions in the United States			1	294	1f
g. Interest on other bonds, notes, and debentures	11			0	1g
h. Dividends on stock				10	1h
i. Trading account income, net (including commissions and fees)				0	1i
j. Income from lease financing				19	1j
k. Income from fiduciary activities				700	1k
l. Service charges, commissions, and fees				121	1l
m. Other operating income[2]	12			58	1m
n. TOTAL OPERATING INCOME (sum of Items 1a through 1m)			27	449	1n
2. OPERATING EXPENSE:					
a. Salaries and employee benefits			2	336	2a
b. Interest on deposits			12	550	2b
c. Expense of Federal funds purchased and securities sold under agreements to repurchase in domestic offices including those of Edge and Agreement subsidiaries				739	2c
d. Interest on borrowed funds (excluding subordinated notes and debentures)			1	982	2d
e. Interest on subordinated notes and debentures	13			0	2e
f. Net occupancy expense, and furniture and equipment expense				652	2f
g. Provision for possible loan losses			1	408	2g
h. Other operating expenses			2	380	2h
i. TOTAL OPERATING EXPENSE (sum of Items 2a through 2h)			22	047	2i
3. INCOME (LOSS) BEFORE TAXES AND APPROPRIATE ITEMS BELOW (Item 1n minus Item 2i)			5	402	3
4. Applicable income taxes (foreign and domestic)	14		1	960	4
5. Minority interest (required to be reported here only if material)[2]			~~3~~	~~442~~	5 0
6. INCOME (LOSS) BEFORE SECURITIES GAINS OR LOSSES AND EXTRAORDINARY ITEMS				~~0~~	6 3442
7. Securities gains (losses), net of applicable taxes and minority interest				0	7
8. Extraordinary items, net of applicable taxes and minority interest				0	8
9. NET INCOME (LOSS)			3	442	9
MEMORANDA					
10. Total operating income on a fully taxable equivalent basis (Item 1n, adjusted)	15		29	845	10
11. Allowance for possible loan losses:					
a. Balance at end of previous year			1	002	11a
b. Recoveries credited to allowance				212	11b
c. Changes incident to mergers and absorptions, net				0	11c
d. Provisions for possible loan losses			1	408	11d
e. Less: Losses charged to allowance[3]				617	11e
f. Foreign currency translation adjustments	16			0	11f
g. Balance at end of period (must equal Item 9d of Page 2.)			2	005	11g

1/ Bank holding companies with less than $100 million in total consolidated assets need not complete the consolidated balance sheet and income statement (parts A and B of this report).
2/ Minority interest may be reported in Item 1m if it is not material (see detailed instructions).
3/ Do not enclose amount in parentheses.

Page 5
FR Y-9, Part C

FR BANK USE ONLY

Year			Dist.
1	Y 9 (3)	8 2 1	9
BHC No. (11)	Yr. (23)	Mo. (25) Day (27)	5 (30)

Parent Company Only: Balance Sheet

As of the close of business on Dec. 31, 1980

		Dollar amounts Bil	Mil	Thou	
ASSETS					
1. Cash and cash items	17		7	596	1
2. Securities 1/			8	300	2
3. Loans, net				0	3
4. Lease financing receivables				0	4
5. Investments in and receivables due from subsidiaries and associated companies (sum of Items 15a(1) through 16b(2) below)			21	877	5
6. Premises, furniture, fixtures, and equipment			1	243	6
7. Other assets	18			56	7
8. TOTAL ASSETS			39	072	8
LIABILITIES AND STOCKHOLDERS' EQUITY					
9. Borrowings with an original maturity of one year or less:					
a. Commercial paper			14	640	9a
b. Other			8	607	9b
10. Other borrowed funds				0	10
11. Subordinated notes and debentures				0	11
12. Other liabilities	19		1	578	12
13. Stockholders' equity:					
a. Preferred stock (par value)				254	13a
b. Common stock (par value)				162	13b
c. Capital surplus			7	421	13c
d. Retained earnings			6	410	13d
e. Less: Treasury stock 2/				0	13e
f. TOTAL STOCKHOLDERS' EQUITY	20		14	247	13f
14. TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY			39	072	14
MEMORANDA					
15. a. Equity investments in *bank* subsidiaries and associated banks: 3/					
(1) Common and preferred stock (net of amount reported in Item 15a(2))			20	422	15a1
(2) Excess of cost over fair value of net assets acquired, net of amortization				747	15a2
b. Nonequity investments in and receivables due from *bank* subsidiaries and associated banks:					
(1) Loans, advances, notes, bonds, and debentures				0	15b1
(2) Other receivables				708	15b2
16. a. Equity investments in *nonbank* subsidiaries and associated nonbank companies: 3/					
(1) Common and preferred stock (net of amount reported in Item 16a(2))	21			0	16a1
(2) Excess of cost over fair value of net assets acquired, net of amortization				0	16a2
b. Nonequity investments in and receivables due from *nonbank* subsidiaries and associated nonbank companies:					
(1) Loans, advances, notes, bonds, and debentures				0	16b1
(2) Other receivables				0	16b2
17. Loans and advances from subsidiaries and associated companies (included in Items 9, 10, and 11):					
a. Bank				0	17a
b. Nonbank				0	17b
18. Amount of borrowings included in Items 10 and 11 that is scheduled to mature within one year	22			0	18
19. Does the amount reported in Item 13f equal that reported in Item 27 of page 3 of this report? Enter "1" for Yes; "2" for No; and "3" if Page 3 was not reported. If the amounts are not equal, attach a statement of reconciliation.				1	19

1/ Exclude investments in subsidiaries and "associated companies." See Item 5.
2/ Do not enclose amount in parentheses.
3/ The sum of Items 15a(1) through 16b(2) must equal the amount reported in Item 5.

Page 6
FR Y-9, Part D

FR BANK USE ONLY
Year [ ] Y 9 8 2 1 Dist. [ ]
1 3 9
BHC No. [ ] Yr. [ ] Mo. [ ] Day [ ] 6
11 23 25 27 30

Parent Company Only: Income Statement

Reporting period (fill in appropriate line below)
For the fiscal year ending on Dec. 31, 19 80
For the 6-month period ending on ____________, 19____

		Year-to-date Dollar amounts Bil	Mil	Thou		
1. OPERATING INCOME:						
a. Income from *bank* subsidiaries and associated banks excluding equity in undistributed income:						
(1) Dividends	23			300	1a1	
(2) Interest				270	1a2	
(3) Management and service fees				0	1a3	
(4) Other				0	1a4	
(5) Total of Items 1a(1) through 1a(4)				570	1a5	
b. Income from *nonbank* subsidiaries and associated nonbank companies excluding equity in undistributed income:						
(1) Dividends				0	1b1	
(2) Interest	24			0	1b2	
(3) Management and service fees				0	1b3	
(4) Other				0	1b4	
(5) Total of Items 1b(1) through 1b(4)				0	1b5	
c. All other operating income				0	1c	
d. TOTAL OPERATING INCOME (Sum of Items 1a(5), 1b(5), and 1c)				570	1d	
2. OPERATING EXPENSE:						
a. Salaries and employee benefits	25			0	2a	
b. Interest expense			1	847	2b	
c. Provision for possible loan losses				0	2c	
d. All other expenses				~~0~~	2d	27
e. TOTAL OPERATING EXPENSE				~~27~~	2e	187
3. INCOME (LOSS) BEFORE TAXES AND APPROPRIATE ITEMS BELOW (Item 1 d minus Item 2e)			~~1~~	~~874~~	3	(13
4. Applicable income taxes	26		~~(1~~	~~304)~~	4	(76
5. Extraordinary items, net of tax effect				~~(761)~~	5	0
6. INCOME (LOSS) BEFORE UNDISTRIBUTED INCOME OF SUBSIDIARIES AND ASSOCIATED COMPANIES				(543)	6	
7. Equity in undistributed income (losses) of subsidiaries and associated companies:						
a. Bank			3	985	7a	
b. Nonbank				0	7b	
8. NET INCOME (LOSS)			3	442	8	
MEMORANDA						
9. Cash dividends declared:						
a. Common	27			0	9a	
b. Preferred				16	9b	

Remarks:

Penn Square

R

BILL P. JENNINGS
Chairman of the Board
Chief Executive Officer

Penn Square Bank N.A.

November 20, 1981

Mr. Harold L. Russell
Arthur Young & Company
1900 Liberty Tower
Oklahoma city, Oklahoma 73102

Dear Harold:

At a recent meeting of our Bank's executive management, a decision was made to change accounting firms. This was not an easy decision, considering your firm's years of service to us and was only made after thoughtful consideration. Please be assured that we have the highest regard for your firm, and have been most pleased with the high professional standard evidenced by your associates.

We have asked that Peat, Marwick, Mitchell & Co., become our accounting firm for all professional accounting services beginning for the year ending December 31, 1981. We hope the timing of our decision will not place your firm in a difficult situation with respect to year end scheduling and personnel staffing.

I know certain communication has to take place between predecessor and successor accounting firms and ask that your firm cooperate with Peat, Marwick, Mitchell & Co. in making the transition as smooth as possible. Messrs. Jim Blanton or Dean York, Partners with Peat, Marwick, Mitchell, & Co., will be in touch with you to make arrangements to review prior year working papers, tax files, etc.

Should you have any questions please contact me.

Sincerely,

Bill Jennings

Bill P. Jennings
Chairman of the Board

RECEIVED
NOV 23 1981
ARTHUR YOUNG & CO.
OKLAHOMA CITY, OKLA.

The CHAIRMAN. Now, the moment we have all been waiting for. That is, we will call upon Mr. Clifton Poole, the Regional Administrator of the Comptroller's office, Mr. James Barton, Regional Surveillance Chief, and Stephen Plunk, National Bank Examiner. And if my colleagues on the committee would like to join me in the swearing in of these gentlemen, you could look upon this as a seventh inning stretch.

[Witnesses sworn.]

The CHAIRMAN. If all of you would like to stand for a few seconds, why don't we just stand and let the blood circulate a little bit? I tell you, you Oklahoma City attorneys, you didn't know how we northern attorneys operate, did you?

[Laughter.]

[Pause.]

The CHAIRMAN. We have with us now Mr. Poole, Mr. Barton and Mr. Plunk. I see another individual whom I understand is counsel to these people, and so I would repeat my caution to the effect that we will hear from the witnesses, and they may want to consult counsel if possible. But your appearance, Mr. Serino, is a distinct surprise to us. We thought that these gentlemen could handle it.

Mr. SERINO. I am sure they can, Mr. Chairman.

The CHAIRMAN. Mr. Poole, I understand you have a very brief statement. If you would like to enunciate it, you may proceed.

TESTIMONY OF CLIFTON A. POOLE, JR., REGIONAL ADMINISTRATOR, OFFICE OF THE COMPTROLLER; JIMMY FRANK BARTON, REGIONAL DIRECTOR FOR SPECIAL SURVEILLANCE; AND STEPHEN PLUNK, NATIONAL BANK EXAMINER

Mr. POOLE. I have some brief remarks I would like to make with regard to the statement that I have submitted. As you indicated Mr. Serino is also counsel for the Comptroller and is head of our Division of Enforcement and Compliance in Washington.

The CHAIRMAN. We have seen him before.

Mr. POOLE. What I would like to do is just very briefly cover the series of events that found our office involved with Penn Square, beginning in early 1980 and concluding with July 5, 1982 with the closure of the bank and its declaration of insolvency.

As you have indicated and as you requested, I brought Mr. Jimmy Barton and Mr. Plunk with me. Mr. Barton, also as you indicated, is the Regional Director for Special Surveillance in the regional office and is in charge of our problem banks in that capacity.

Mr. Barton is an examiner with some 12 years of experience with the Comptroller's office. Mr. Plunk is an examiner with 10 years of experience. He is currently examiner in charge of the Oklahoma City subregion, and was the examiner in charge of the last examination of Penn Square National Bank.

I have been with the Comptroller's office myself for 26 years; 19 of those years were spent in the field as an examiner, and the last 7 years as the Regional Administrator; three of them in the fifth region in Richmond, Va.; one of them in Memphis, Tennessee, and then three years in Dallas, Tex.

The Dallas region encompasses the States of Texas and Oklahoma where we supervise the activities of some 900 national banks. As I indicated, I will begin with the examination of April 1980, and most of what I will say will pretty well follow the pattern of the comments made by the directors of the bank and by the other individuals testifying here today.

We did conduct an examination completed in April of 1980. That examination rated the bank as a 3 bank. We found a wide variety of deficiencies in the bank, and I might add, however, that the quantitative deficiencies that normally would cause us to rate a bank 3 and put it in our special projects program and use administrative action were not present to a degree that we normally see in a problem bank.

Such things as classified asset totals and other such data were not of sufficient magnitude to cause us to have any great alarm, but there were other factors that did cause us considerable concern; namely, the bank's lack of liquidity and difficulty in the funds management area; its lack of capitalization and the rapid growth of the institution, as many people have pointed out, and in the face of that rapid growth, the understaffing of the institution.

As a result of that examination and based upon the information that we drew up a formal from that examination, we gathered into or drew up a formal agreement on the bank, and as I have indicated before, that formal agreement was a close call because the factors that tipped us over the edge in using the formal agreement were the somewhat subjective judgments which we made regarding capital adequacy, and primarily the weaknesses in the funds management area of the bank, and as I said, rapid growth of the institution.

We decided to have, as is our procedure in region 11, a meeting of the board in the regional office. It is our procedure, as I indicated, to do this. We feel that by bringing the board of directors to the regional office it impresses them with the seriousness of the situation, and we have found it to be a procedure that works well.

We held a board meeting on August 27, 1980, at which time we presented the formal agreement to the board. We discussed the deficiencies that we found in our examination and went over the formal agreement in detail.

At that board meeting, Mr. Jennings was resistive, openly resistive, to our efforts. He was concerned that our efforts and the use of an administrative agreement would thwart the bank's progress, and I might point out that to that point and continuing after that, the bank was making money. It was very profitable. The bank was growing rapidly, and as I indicated previously, we did not have an inordinately high percentage of classified or problem loans, as identified by our examination.

He was, as I recall, concerned that our administrative action and our actions in the bank would displace management's discretion. In spite of the objections, the board did sign the administrative agreement and returned it to the regional office. They also indicated at that point that they were already doing much of what was called for by the agreement.

We subsequently conducted a visitation of the bank on September 9, 1980, and we noted some improvement, but were still noting problems in funds management, and growth was continuing and also, the understaffing conditions remained.

Because of these continuing concerns we conducted an examination as of December 31, 1980, which was concluded on February 27, 1981. As several have indicated, I personally handpicked the crew that conducted that examination. I was personally concerned regarding the funds management area of the bank and its lack of determination to address the problems in that area and the exposure that this was presenting to the bank.

The individuals who conducted that examination were some of our best people from the regional office, from the Oklahoma subregions, and other subregions around the region. That examination showed a significant deterioration in the condition of the bank; classified assets had increased, the loan documentation was very poor, the bank continued to experience rapid growth in the face of the continuing condition of being understaffed, capital growth was not keeping pace with the overall asset growth of the bank, and the bank had substantially failed to comply with the formal agreement which we had placed on the bank at the previous full examination.

After reviewing the report, the Washington amd regional offices were faced with what steps to take to correct the situation. Basically, we had two choices; we could either go with a cease-and-desist order which was a more formal type of administrative action, or we could stick with our administration agreement, which was also a formal document.

Arguing for the use of a cease-and-desist order were our concerns regarding the attitude of the board of directors of the bank, as exhibited by their failure to comply with the agreement that we had in place, and by their apparent inability or unwillingness to correct the deficiencies that we had identified at previous examinations.

The CHAIRMAN. Excuse me, Mr. Poole, have you been here today during the day?

Mr. POOLE. Yes, sir.

The CHAIRMAN. Did you hear the two panels of the outside directors testify?

Mr. POOLE. Yes, sir.

The CHAIRMAN. What you just said does not square with what they told us. They impressed us that they were very concerned individuals and perhaps were not given enough guidance as to what they should do.

Now, one of the individuals said when he complained, he was told well, why don't you get off the board. He said that came from the Comptroller's Office. How do you square that with what you are saying to us.

Mr. POOLE. I am not sure I understand.

The CHAIRMAN. What do you mean, you don't understand. I will repeat my question.

Mr. POOLE. All right, sir.

The CHAIRMAN. You have been here today. Forget the statement. We will put it all in the record for you. It is all in the record, by unanimous consent, OK?

You state just now in your statement that the board of directors either were not that concerned or did not know how to go about making changes. Isn't that what you just said?

Mr. POOLE. Yes, sir.

The CHAIRMAN. I repeat. We have listened to the board, the outside directors. It seems to me they were very concerned. If anything, perhaps they did not have enough guidance given to them.

Mr. POOLE. I would have to disagree with that because the administrative agreement was a detailed document which, if followed, would have, in my opinion and I think everyone else's in the office, have corrected the deficiencies in the bank.

The CHAIRMAN. But that was ignored, was it not?

Mr. POOLE. It had been ignored substantially up to that point.

The CHAIRMAN. Now, what did you do about it? Did you recommend to Washington the removal of a few people like maybe Mr. Patterson or Mr. Jennings or what have you?

Mr. POOLE. There were no grounds for the removal of those gentlemen.

The CHAIRMAN. There weren't?

Mr. POOLE. No, sir.

The CHAIRMAN. Did you read the exchange between Mr. Homan and myself in Washington on that?

Mr. POOLE. I am not certain.

The CHAIRMAN. You are not certain. Well, we did have an exchange.

Mr. POOLE. In my opinion, sir, there were no grounds for the dismissal of any officer of the bank at that point in time.

The CHAIRMAN. OK. Let me ask you this: Were you quoted correctly when you were quoted as saying to the board of directors at one point in time, "There are those who wanted a cease-and-desist order, but I argued against that, and we have gone into this letter of agreement instead."

Mr. POOLE. What I believe what I said in the board meeting—well, prior to the board meeting, the Washington office and our office discussed the appropriate type of administrative action to take, and we decided that what we would do would be to go to the board meeting with the idea of telling the board that if they did not give us the impression that they were going to correct, or did not convince us that they were going to correct the deficiencies that we had found, we would use a cease-and-desist order. But what I would like to point out is that the level of deficiencies, in my estimation, would not have at that time fully supported the use of a cease-and-desist order. If we had used it, it would have been a very marginal situation.

The CHAIRMAN. Let me see if I can help you here, because I think this is the way I read you when I read this last night.

You were using a little psychology here that said, "Hey, listen, you have this management letter, this compliance thing, and there were those who wanted a cease-and-desist. Now, if you shape up here, if you make the necessary corrections and changes, then you don't end up with a cease-and-desist. But unless you do,"—is that what basically you felt they should read between the lines?

Mr. POOLE. Yes, sir. There was some use of psychology, as you put it, in my statement.

The CHAIRMAN. I have no quarrel with that. I commend you for it.

Mr. POOLE. However, there was basis in the fact that there were people in Washington, during our discussions, and also in the region who felt that we should use it, and sometimes I felt that we should have used a cease-and-desist order.

The CHAIRMAN. Let me ask you this for the benefit of the committee. In the face of a cease-and-desist, what would the classification have been? Would it still have remained a 3?

Mr. POOLE. We have used cease-and-desist orders in some cases on banks rated 3, but the majority of them I would say would probably be—well, I don't have any statistics, but many of them would be 4's and in some cases 3.

The CHAIRMAN. We are told that you are very experienced and that is why we are asking for your opinions in this matter.

Mr. POOLE. Yes, sir.

The CHAIRMAN. So you don't have to qualify your answers. It is just your best judgment and we accept it.

Mr. POOLE. I would say really I don't remember. I don't recall what number of banks that we have dealt with that were 3's or 4's with cease-and-desist orders, or in which, you know, ones.

The CHAIRMAN. Well, let me put the question to you this way: There would be more likelihood of a bank being classified 4 if it were under a cease-and-desist than if it were just under this letter agreement?

Mr. POOLE. Yes, sir, probably.

The CHAIRMAN. OK. Do you want to proceed with your statement?

Mr. POOLE. Yes, sir.

In any case, we viewed that we had the two choices and, as you put it, one of the reasons for the statement I made in the meeting was to use psychology to some degree. But it was a statement of fact, and we told the board that if we did not see significant improvement in compliance we would indeed convert the formal agreement to a cease-and-desist order.

And I would also like to point out that the contents of the cease-and-desist order, had we drawn it up, would have been virtually, probably virtually the same as the formal agreement, the document would have covered the same areas.

We did decide to use the agreement, or at least proceed in the manner which I indicated, to go into the meeting with an open mind and then determine by our assessment of the attitude of the board as to which action we would take. We did feel, however, that the administrative agreement in both content and detail covered all of the problems in the bank. And as I indicated before, I felt that if they were to respond and comply with that agreement it would solve the bank's problems and bring it to a recuperative position.

At the board meeting, as in previous board meetings and in all of our board meetings, we presented the condition of the bank as detailed in the examination report. We detailed the areas of noncompliance with the agreement. We told the bank of the extremely serious situation of any bank which does not comply with an agreement which they have signed. We told them of the basis for our decision.

Throughout the meeting, in stark contrast to the previous meeting, Mr. Jennings was completely silent until the very end, and at the end of the meeting he acknowledged that we had been—had done an accurate job of examining the bank. He agreed with our conclusions and our findings and he promised and committed himself to the correction of all of these deficiencies to bring the bank into full compliance.

Also at that meeting was Mr. Beller and several other members of the new senior staff of the bank. As indicated previously in testimony today, these individuals were known to the Comptroller's Office, they were known to our examiners in Oklahoma City, who had known them in their previous capacity with a large, conservative, well-managed institution in Oklahoma City.

We felt that they represented, as they were presented to us, a meaningful addition to the staff of the bank. Because of this we determined, as the record shows, that we would stay with the administrative agreement.

And I would like to point out that at the end of that board meeting almost to a person every director came up to me personally, shook my hand and thanked me for our attention and pledged themselves individually to correct the deficiencies in the bank and to bring the bank into full compliance with our wishes.

Following that examination, we conducted our visitation as of September 30, 1981, and I would like to point out that, while there are several comments this morning I think by members of the board regarding comments made to them at the board meeting in December, I believe it was, or January, the examination actually was as of September 30, 1981. So our representation was as of the picture of the bank in September.

That visitation found—well, first of all, that visitation was conducted by an examiner who had been in Mr. Barton's position as Regional Director of Special Surveillance throughout our dealings with Penn Square up to that point in time, and that examiner had been present at both board meetings and had recently been appointed as examiner in charge of the Oklahoma City subregion. And I felt that he was, and still do feel that at that time he was, the examiner best suited to conduct that examination.

As a result of that examination, we found that the bank had made in our opinion significant progress in beginning the correction of the systems, installing the systems and correcting the deficiencies that they had to correct to bring the bank back into compliance.

As several people have indicated and I will also support, the bank was not anywhere near a position where we would be willing to take it out of special projects or rate it other than a three at that time. But we had—we did find that the directors appeared to be following through on their promise to us at the earlier board meeting, as most of them have stated today.

In keeping with our policies, thereafter we conducted our examination, beginning on April 19, 1982. On May 13, Examiner Plunk telephoned me to report that he was finding significant deterioration of the condition of the bank. He indicated it was far too soon for him to accurately identify exactly how bad the situation would be, but he did say that he felt the situation had certainly worsened since our last examination and could be truly significantly increased in severity.

On May 21 I was in contact with Mr. Roy Jackson, Regional Director with the FDIC in Dallas, on another matter and indicated Mr. Plunk's phone call to him at the end of that conversation. On June 23 I spoke further with Mr. Jackson regarding the status of our examination.

I might also point out that the FDIC also gets copies of all of our examination reports and numerous other forms that attest to the condition of our banks, and we normally have ongoing telephone conversations between various levels of staff and Mr. Barton and his counterpart there on an ongoing basis with regard to all of our problem banks.

I think it bears repeating briefly the degree of deterioration that took place between September 30, 1981, and July 5, 1982: As has been indicated previously, $45.7 million in loans that were classified as loss in our last examination. Approximately $30 million were booked by the bank after September 30, 1981. There was an increase in the loan portfolio in that same period of $161 million and an increase of $1 billion in the participations sold over that same period. This represents an increase in the loan portfolio of 63 percent and an almost doubling of the participations sold by the bank during that period.

In hindsight, I think there were two major causes for the bank's problems. One was the failure of the board to follow through on the corrective action which they promised to the Comptroller's Office at the board meeting in the regional office that they would make at that meeting on July 29, 1981, and the corrective action which our examination of September 30, 1981, showed to have been underway.

The second major cause was the downturn or the slump in the oil and gas industry. It was unprecedented and it was unpredicted, and that slump in the oil and gas industry, to which the bank had a large concentration of loans, with the absence of controls in the bank, left the bank in an extremely vulnerable position, a vulnerable position which led to its failure.

There has—I might say that in conclusion I'm fully satisfied that our supervision of Penn Square was completely consistent with the OCC guidelines and procedures, and I think it was totally appropriate to the condition of the bank as revealed to us by our supervisory efforts.

There has been some discussion by a number of people regarding the appropriateness of the action of examiners in charging off the loans that they did, which totaled I think $49 million in total assets charged off. I can tell you that in my estimation these loans were dead losses. This does not mean that there could not be some recovery, and I have no idea what that could be. But these are losses in the truest sense of losses as classified by bank regulatory agencies.

They were, the examiners in the bank, were the best examiners we had in the region and some of the best we have in the country. We strengthened the examination force in the bank on several occasions during the examination, and I am fully confident that the losses that we classified are definitely losses.

The bank had roughly $37 million in capital, and with losses of nearly $50 million in my estimation the Comptrollers Office had no choice but to declare the bank insolvent. When a bank has a book insolvency, you cannot allow it to stay open, especially if the Fed will not continue to fund the liquidity needs of the bank, which were materializing at the latter days of this bank's existence.

I just might add that in my own personal experience I would have to say that the Penn Square Bank as we found it as a result of our April examination was in the worst condition that I have ever seen a bank in my 26 years of experience as a national bank examiner and a regional administrator. It doesn't even have any close rivals in that condition.

And the only reason I say that is to get my feelings on the record as to the reasoning behind the Comptroller's Office's decision to close the bank.

In essence, I feel we did our job in an exemplary fashion in notifying the board again and again as to the condition of the bank. We examined the bank a number of times. The condition of the bank, as the question has been raised, it was rated a 3 up and through our examination of September 1981 and it was ultimately closed 8 to 9 months later.

In my personal estimation, based upon my experience and based upon the examinations, the bank was simply a 3 bank through the series of examinations that we conducted, and we could not and should not have taken actions any different from those that we took in view of the condition of the bank as revealed to us through our examinations.

The CHAIRMAN. Let me ask you this. After 26 years, you say this is the most horrible thing that you've ever approached. How could they do it so quickly? September 30, not too bad, things are improving. October, November, December, January, February, March. April Mr. Plunk goes in with his team, right? You started in April?

Mr. PLUNK. Right.

The CHAIRMAN. Seven months, and you go from a 3 classification to the worst example you have seen in 26 years.

Mr. POOLE. Yes, sir.

The CHAIRMAN. Now, the economy certainly—aren't there other banks around this area of the country with a lot of energy loans, a lot of oil and gas and drilling and so forth?

Mr. POOLE. Yes, sir.

The CHAIRMAN. Aren't there other banks that also are pretty heavily involved in this type of lending?

Mr. POOLE. Yes, sir.

The CHAIRMAN. And the slump in energy would have affected them as well, didn't it?

Mr. POOLE. I've seen no more Penn Squares.

The CHAIRMAN. But did that slump—you gave two reasons, the failure of the board of directors to comply with your letter of agreement and the slump in the economy as far as energy is concerned. I'm reading from your statement. Right?

Mr. POOLE. Yes, sir, the interaction of the two.

The CHAIRMAN. And you agree that there are other banks heavily committed to energy loans. So that all we are left with, therefore, is the failure of the board of directors to comply. And yet, September of 1981 you conclude that the board is doing a pretty good job, they are moving forward, they've got Mr. Beller onboard and a new general counsel, et cetera, et cetera, right?

What happened?

Mr. POOLE. The comments we made regarding the job being done by the board as of September did in no way indicate that the job had been done. It was that it had been started.

The CHAIRMAN. That's the same comment Mr. Conover made in Washington.

Mr. POOLE. I think Mr. Beller, his comments this morning, indicated that the loan review process, which is an essential process in any bank, an independent loan review function where the bank assesses the quality of its own loans, had only begun the function and had not at that time gotten into the oil and energy credits, which, as you pointed out, were the great bulk.

The CHAIRMAN. Mr. Poole, that is inaccurate.

Mr. POOLE. Had not gotten into.

The CHAIRMAN. Had not gotten into? You have understated it.

Were you aware of the agreement or the memoranda or what have you, the directive to Mr. Beller: Hands off energy loans, Patterson and I, Mr. Jennings, are going to handle the energy loans and your loan review committee is not to get involved with energy loans?

Mr. POOLE. No, sir. We were under the impression of—we had information to the contrary, that Mr. Beller was indeed—and I remember your comments this morning, your questions to Mr. Beller, or some others, regarding his lack of background in the oil and energy area.

We knew that he did not have a background in oil and energy credits directly. But we felt that what the bank needed was good loan administration.

The CHAIRMAN. OK, a loan review committee, a good loan review committee.

Mr. POOLE. Right.

The CHAIRMAN. Were you aware of the fact that the loan review committee was not allowed to look at the energy loans?

Mr. POOLE. We were not aware of that.

The CHAIRMAN. When did you find this out?

Mr. POOLE. I would have to say that we found it out at the April examination.

Mr. LEACH. Would the gentleman yield?

The CHAIRMAN. Sure.

Mr. LEACH. Were you aware of the job descriptions?

Mr. POOLE. No, sir.

Mr. LEACH. As part of your examination process don't you look at job description?

Mr. POOLE. I don't know the extent to which the examiners did in this case. In some cases we would look at job descriptions, but in this particular case I don't believe—I think the job description, and I'm operating from memory—indicated that Mr. Beller and Mr. Patterson both reported to Mr. Jennings, that Mr. Beller was not over——

Mr. LEACH. Excuse me. You said you didn't read the job descriptions and now you remember the job descriptions?

Mr. POOLE. I remember the discussion this morning, the testimony.

Mr. LEACH. I see.

Mr. POOLE. But I do not believe that that in any way conflicted with Mr. Beller's responsibility as head of loan administration to oversee the lending function and to have control of and commit to us that he was going to install a loan review function at the bank.

The CHAIRMAN. Mr. Poole, you were here. Mr. Beller read his job description to us, and it wasn't one he made up himself. That is the one that he was handed and said, here, you are going to be paid *x* number of dollars per year plus bonuses, you've got a 5-year contract, and this, man, is what you're going to do: You're going to keep hands off energy loans.

Mr. Plunk, you were in there. You were in Penn Square. Did you see those job descriptions?

Mr. PLUNK. No, sir, I did not.

The CHAIRMAN. Were you in there in September of 1981?

Mr. PLUNK. No, sir.

The CHAIRMAN. Who was there? Who did the examining that time?

Mr. BARTON. The bank was examined by Jerry Lanier, who is no longer with our Office.

The CHAIRMAN. He left the Comptroller totally?

Mr. BARTON. Yes, sir.

The CHAIRMAN. At that time did he make any mention of the restrictions placed on Mr. Beller?

Mr. BARTON. No, sir, not that I'm aware of.

The CHAIRMAN. Mr. Plunk, in May of this year, May 13, you called Mr. Poole and you told him how bad things were.

Mr. PLUNK. I told him that I suspected the bank could be in a serious condition.

The CHAIRMAN. Right. Now, subsequently—how many examiners did you have with you?

Mr. PLUNK. I had somewhere around 15 examiners.

The CHAIRMAN. Subsequently, subsequent to that May 13 phone call, did you indeed leave the bank for a period of time, for a week?

Mr. PLUNK. We had a mandatory training session, yes, sir, that involved, among other things, equal employment and so forth. That is mandated pretty much by the Treasury Department.

The CHAIRMAN. How often are those held?

Mr. PLUNK. That's the first meeting in I believe 3 years.

Mr. POOLE. We had a combination staff conference, the first time in 3 years, and a training session which covered, as Mr. Plunk indicated, EEO, personnel evaluations, and several other areas.

The CHAIRMAN. Where was that held, by the way?

Mr. POOLE. It was held in Austin, Tex.

The CHAIRMAN. For the Dallas region?

Mr. POOLE. For the whole Dallas region.

It was my decision to pull the examiners out of Penn Square at that point in time, for two reasons: One, I wanted them to attend the conference. There were a significant number of our people there. And I also felt that the pulling them out for 1 week would not, in my opinion, and did not detrimentally affect the examination.

And as a matter of fact, there was an indication that we needed to give the bank some time to gather records for us regarding certain large credits which we were accumulating at that time, and we felt that with the benefits of the training, plus the time given the bank to pull together records, it would be as a total package beneficial.

The CHAIRMAN. Even though Mr. Plunk said, hey, Mr. Poole, things are very bad, very bad?

Mr. POOLE. Yes, sir.

The CHAIRMAN. The worst you've seen in 26 years.

Mr. POOLE. Not at that time.

The CHAIRMAN. Oh, you mean they got bad after the seminar? What were the dates of the seminar?

Mr. POOLE. It was in May. I don't remember the exact date.

The CHAIRMAN. Do you remember the dates, Mr. Plunk?

Mr. PLUNK. It was May 24.

The CHAIRMAN. May 24 through 31?

Mr. POOLE. It was the week after he called me.

It was not the worst bank I had ever seen at that point. It was a judgment call.

Mr. BARNARD. Will the gentleman yield for a question?

The CHAIRMAN. Mr. Barnard.

Mr. BARNARD. Mr. Poole, who scheduled the examination in April of 1982?

Mr. BARTON. I would have set up the schedule for that examination.

Mr. BARNARD. Mr. Barton, how far in advance was it scheduled?

Mr. BARTON. How far in advance? We have a scheduling process which looks forward two quarters. So we would have set up the schedule for the second quarter of 1982 in the fourth quarter of 1981.

Mr. BARNARD. It's very interesting that on April 26, 1982, a very exhaustive article appeared in "The American Banker," one of the best I've ever read about a financial institution, and you went in there on April 28. This article didn't prompt you to make that examination so hurriedly, did it?

Mr. BARTON. No, sir, it did not.

Mr. BARNARD. If I would have been you, I would have——

Mr. POOLE. That was purely coincidental. As a matter of fact, I didn't read the article until after the examination commenced.

Mr. BARNARD. Well, it was an excellent article. And as a matter of fact, the fellow who wrote the article ought to be a bank examiner.

Thank you, Mr. Chairman.

[The article referred to follows:]

American Banker
The Only Daily Banking Newspaper
VOL. CXLVII NO. 80 Monday, April 26, 1982 147th Year

Oklahoma's Penn Square Bank, Maverick Oil Patch Lender: Some Say It's Bet Too Heavily on Energy

By PHILLIP L. ZWEIG

OKLAHOMA CITY — They call it Continental Illinois' Oklahoma City loan production office. Its real name is Penn Square Bank NA, the principal subsidiary of Penn Square Corp. But judging from the pace at which the $400 million-asset institution sells oil and gas loans to its friends in Chicago, the distinction may be more nominal than real.

What was just six years ago a sleepy, $30 million-asset suburban retail bank is today a mammoth loan brokerage operation that is originating and participating out energy loans at a rate that gives some veteran energy lenders and correspondent bankers the shivers.

Here in oil and gas country, energy-related credits have for years constituted a large portion — as much as 30% or more — of the portfolios of most large banks. In contrast, 80% of Penn Square's portfolio is made up of these loans.

Lately, however, declining oil and gas prices, the surge in idle rigs, and the well-publicized cash flow squeeze of some large independent oil and gas producers have given rise to concern among some bankers and analysts that the bank may have bet too heavily on the energy business.

Having sold more than $2 billion in participations — almost seven times the $300 million in loans the bank now has on its own books — Penn Square may well have originated more loans relative to its own portfolio than any other bank in the nation. The volume of participations relative to loans varies considerably from bank to bank, but it is certainly unusual for outstanding participations to exceed net loans.

Energy lending and correspondent banking are so tightly knit at the bank that the five-man correspondent department is actually melded into the oil and gas division.

Of the $2 billion in participations, most have been sold upstream to four banks: Continental Illinois (which Penn Square says holds close to half of the total), Chase Manhattan, Seafirst, and Northern Trust. About $125 million (6%-7% of the total) have been sold to some 30 or so smaller correspondents, mainly loan-hungry Oklahoma country banks.

This volume of energy deals is

➸ Penn Square: Page 14

Penn Square . . .

Continued from page 1

particularly awesome when one considers that the energy loan portfolios of Manufacturers Hanover Trust and Chase Manhattan Bank at yearend 1981 were approximately $4 billion and $3.5 billion, respectively.

Object of Some Sharp Criticism

In recent months, the bank's huge volume of participations, rapid growth, highly aggressive lending practices, some acknowledged snafus in loan documentation, and a dramatic rise in chargeoffs in 1981 have made it the object of some sharp criticism in Oklahoma banking circles.

The bank's flamboyant 58-year-old chairman and largest stockholder, Bill P. Jennings, and a large coterie of admirers in the energy business attribute this criticism to jealousy over Penn Square's phenomenal growth and

➸ Penn Square: Page 15

Penn Square . . .

Continued from page 14

profitability. "When you've grown as fast as we have," says the feisty, white-haired banker, "people tend to shoot at you."

To be sure, merchant banking has so far paid off handsomely for Penn Square. In 1980, the bank earned $4.2 million on average assets of $358 million, a return of almost 2.1%, far above the average for its peer group. Return on average equity was a phenomenal 33%. These results reflect primarily an abundance of fee income as well as relatively low noninterest expenses.

But traditional lenders question whether the bank can sustain these results over the longer term, particularly if energy prices continue to deteriorate. Indeed, 1981 was a year of reckoning in which the operational and administrative strains of originating billions in loans took their toll. Acknowledges one director, "The bank has had to run to keep up."

Big Hike in Loan Loss Provision

Although net operating earnings rose last year to $4.7 million, the increase was due mainly to a lower income tax provision, since pretax operating revenues essentially remained flat. Noninterest expense doubled, while the provision for loan losses was boosted five fold, from $1.4 million to $6.3 million. Loan chargeoffs rose from a comfortable $405,000 in 1980 (0.27% of net loans) to more than $4.2 million in 1981 (1.8% of net loans).

In 1980, average net chargeoffs for banks in Penn Square's regional peer group were 0.36% of net loans, according to Cates Consulting Analysts Inc. (Comparisons for 1981 were not yet available.) Consequently, return on average assets and average equity slipped to 1.3% and 18.6%, respectively.

Rather than pay dividends to its wealthy stockholders, Penn Square has ploughed earnings back into capital, creating a capital base that amounted to $30.4 million by yearend 1981. That resulted in an equity-to-assets ratio of 7.7%, about the norm for banks of this size.

Many of the bank's customers are also stockholders. A closely held institution, Penn Square has 120 shareholders, 10 of whom own 80% of the bank.

The personal wealth of the bank's stockholders and directors is said to be one of the bank's key strengths. As one observer put it, "The board has very deep pockets" that could probably see the bank through a downturn in the energy picture.

The bulk of the energy portfolio consists of reserve loans and letters of credit made to independent producers operating in Oklahoma, according to the bank. The remainder — about 10% — consists of rig and equipment loans and loans to energy service firms. The bank says it is involved in virtually no national or major oil company credits.

Deep Anadarko Basin

Many of Penn Square's customer base of some 200 independents are active in the Deep Anadarko Basin, a vast natural gas pool in the western part of the state.

These customers include some of the most illustrious figures in the Oklahoma oil and gas business, such as Robert L. Hefner 3d, head of GHK Corp., a pioneer in exploration and development of the Anadarko Basin; An-Son Corp.'s Carl Andersen Jr., and Carl W. Swan, co-chairman of Continental Drilling Co. and a director of the bank.

But there are also some lesser names believed to be experiencing serious cash flow difficulties. Several other Oklahoma banks have lately become so concerned about the outlook for small independent operators that they have established lists of firms requiring special monitoring.

According to Mr. Jennings, almost all its loans are secured, floating-rate credits priced at about ½% to 2% above the prime rates of its upstream correspondents. Typically, Penn Square, whose legal lending limit is $3.5 million, will sell off about 80% of a loan — and sometimes even the entire loan — receiving an origination fee of ½% to 1%. So on a $5 million loan, $4 million of which is sold, Penn Square would receive an origination fee of $20,000 to $40,000.

Penn Square and the upstream correspondent will usually charge ½% on the unused portion, though Mr. Jennings says this is rare "because our customers use their money." Individual participations average $1 million, though some have exceeded $30 million, according to Mr. Jennings.

But he says there is no "typical" deal, because rates, balances, and fees are juggled differently on every credit.

Penn Square's portfolio is funded with a liability mix that consists of about 40% demand deposits and 60% time, savings, and NOW accounts.

Although Penn Square is where many banks say they'd like to be — specializing in a particular market and earning plenty of fee income by originating rather than holding assets — the older, downtown Oklahoma City banks say they are uneasy with the degree to which Penn Square has embraced this practice, and they disclaim any intention of imitating it.

Violating Taboos

According to conversations with senior officials of some of Penn Square's competitors and downstream correspondents, the upstart bank appears to have violated some of the taboos of energy lending and correspondent banking. They believe it has based its reserve lending on an overly optimistic view of oil prices and interest rates, that it lends on brand-new properties and to inexperienced oil and gas operators — criticisms dismissed as "sour grapes" by Penn Square officials.

Correspondent bankers say that the Penn Square's volume of participations exceeds their own "comfort level" because of what they called the customary "moral obligation" of a loan originator to buy back loans that go bad, particularly loans sold downstream. They point out that most of their own downstream participations are not made as overlines but rather as accomodations to their country banker customers.

But one local banker concedes that "about 50% of the criticism is sour grapes and the other 50% is deserved."

At least some of the snickering stems from the fact that Penn Square has built its oil and gas division by pirating energy lending officers, an increasingly scarce commodity, from its competitors, namely First National Bank and Trust of Oklahoma City, Fidelity, and Liberty National Bank and Trust. For example, Penn Square's new president, Eldon L. Beller, was recruited last year from First National, where he had been an executive vice president.

Even More Painful

What pains them even more is that Penn Square has snared some of their most valued customers. For example, First National Bank of Oklahoma City, the cornerstone of the Vose family's Oklahoma banking empire, is said to be smarting over the loss to Penn Square a few months ago of Mr. Andersen's An-Son Corp.

Whatever reservations bankers have about Penn Square, oilmen admire its hustling, entrepreneurial style and fast response to big loan requests. Pointing toward the high-rise tower of a well-established Oklahoma City bank from his downtown office window, one leading independent, who also happens to be a Penn Square stockholder, says, "They may be good for a few million without much difficulty. But if you need $50 million, they want to tell you how to run your business." Adds James G. Randolph, president of Kerr McGee Coal Corp. and a Penn Square director, "They're a bunch of good old boys who understand the language of oil and gas. And Bill Jennings is a good salesman and promoter."

What is indisputable is that since 1975, when it was acquired by a group of investors headed by Mr. Jennings, Penn Square has been transformed from an undistinguished shopping center bank to a go-go institution that is one of the major originators of energy loans in the Southwest.

Returned to Buy It

Known to his friends as "Billy Paul" or "Beep," Mr. Jennings first joined the bank as executive vice president when it was founded as a consumer bank in 1960, then quit in 1964 to work for Fidelity in the same capacity. After 10 years with Fidelity, he returned to Penn Square to buy it.

Penn Square maintains correspondent relationships with Fidelity, the First National Bank, and Liberty National, among others. Fidelity, for example, handles the transaction processing of Penn Square's commercial and instalment loans and checking and savings accounts.

Located in the sprawling Penn Square shopping mall in the northwest quadrant of this city, the bank's whitewashed, three-story headquart building, drive-in facility, and a instalment loan office are today little more than vestiges of an earlier era. Only a small fraction of its business is now consumer related.

Having outgrown these facilities, the bank expects to move into a new 22-story office tower in mid-1983. The $36 million building is being financed as an off-balance sheet joint venture involving several Penn Square customers.

'Continental's Local LPO'

Having his bank called Continental Illinois' local LPO doesn't seem to bother Mr. Jennings, an old-school entrepreneur who also owns a large share of the fledgling Trans-Central Airlines ("more of it than I'd like," he quips), dabbles in real estate as a partner in three local hotels, and is said to have sizable oil and gas holdings of his own.

Indeed, he relishes the association with banks that he regards as the top names in the oil and gas business, and protests with mock scorn that if Penn Square is an LPO for Continental, it is also an LPO for Chase, Seafirst, and Northern Trust.

However, he bristles at what he calls the "street talk" about his institution being stretched too thin in the energy business. Taking a short puff on his ever-present cigar, Mr. Jennings asserts that his institution has been a boon to the expansion of the capital-intensive oil and gas industry in Oklahoma, a state he describes as relatively cash-poor despite its robust energy economy.

The loan origination concept, he says, is particularly well suited to Oklahoma, a unit banking state where the capital needs of bank customers are often greater than the ability of individual banks to meet them. Moreover, Oklahoma's banking laws make it difficult for an out-of-state bank to operate there, which explains the absence of money-center-bank loan production offices in the state.

Growing Up with Oil and Banks

In a lengthy and candid interview, Mr. Jennings and his top associates sought to dispel the bank's high-flying image, stressing that contrary to all the rumors, Penn Square lends money in much the same way as its downtown competitors, using credit criteria that are "standard in the industry."

"Our growth," he says, "appears so dramatic because we started with such a small base. By moving into an active posture early, and concentrating efforts on independent producers, perhaps when other banks were not, we established an orginal base of producers who are our very best salesmen. Word gets out pretty quickly that Penn Square is interested in the oilman."

Mr. Jennings himself grew up around oil and banks. His 85-year-old mother still runs the Bank of Healdton in Healdton, Okla. (pop. 3,380), a small southern Oklahoma town located in one of the state's original, Depression-era oil patches. "I've seen rigs stacked for years," the affable Oklahoman recalls. "I've seen boom and bust. I have a great attraction and feeling for the oil and gas business."

No one questions Mr. Jennings' interest in the oilman. But some criticize his interest in operators just going into business for themselves — precisely the reason Mr. Jennings offers for the success of Penn Square. He says that while some of his customers may not have been in business for themselves for very long, most of them have extensive experience in the oil and gas industry, having been employed as engineers, geologists, and "even mud salesmen." Mud is any fluid used to remove dirt, rock, and other "cuttings" produced while drilling for oil and gas.

➤ Penn Square: Page 16

Penn Square . . .

Continued from page 15

"Most of our customers were not customers of other banks," he says. "We recognized the potential of independent producers just getting started. These were producers who did not have substantial net worth but who had experience, integrity, and a willingness to work."

A Practice Frowned Upon

Asked if Penn Square was actually supplying venture capital, Mr. Jennings replied, "We'd like to be," noting that he was thinking about forming a venture capital subsidiary.

According to a lender who says he has turned away loan requests later approved by Penn Square, the bank is also willing to lend on "brand-new" properties, a practice frowned upon by most energy lenders. Generally, the performance of one or more wells is used as collateral for loans to finance additional drilling, whereas investor capital is used to fund the first wells on new properties. Mr. Jennings acknowledges that Penn Square lends on new properties, but only when "supplemented by seasoned properties or other assets."

Penn Square's chairman insists that the $4.2 million in 1981 chargeoffs represented a one-time writeoff of bad real estate loans, not energy credits, much of which he says he expects to recover. At the same time, he acknowledges that nonaccruals also rose "substantially" in 1981.

Moreover, he says that the decision to take the chargeoffs in one lump was the bank's, not the Comptroller of the Currency's, as some sources have suggested.

Mr. Beller, regarded by some observers as a force for discipline in the bank, responded with a terse "yes" when asked if the move to charge off the bad loans reflected his influence.

No Acceleration of Chargeoffs

Despite the weakening of oil and gas prices, Mr. Jennings says that he does not expect chargeoffs of energy loans to increase dramatically in 1982, adding that there are a variety of mitigating factors that would cushion his institution even if oil dropped to $20 a barrel.

For one thing, he says, most of his customers are diversified into natural gas as well as oil, often deriving as much as 70% of their revenues from deep gas production. Prices for deep gas — reserves found below 15,000 feet — are unregulated and lately have ranged between $8.50 and $10 per cubic thousand feet.

Second, he says that because of the margin of safety built into his reserve loans, a drop in prices would simply require the stretching out of the loan, and the loans still would be repaid before reserves run out.

Three Years Becomes Four Years

Even if "oil hits $20 a barrel, a three-year loan would become a four-year loan," Mr. Beller says. Experts agree that because of the windfall profits tax on oil selling for more than $25 a barrel, a substantial drop in prices must occur before oilmen incur a dollar-for-dollar loss. This is because higher priced oil is more heavily taxed than lower priced oil under the extremely complex windfall profits tax formula.

Banks generally lend about half of the discounted net cash flow from oil and gas production for three to four years. Before the oil glut really took hold, many banks were discounting cash flows at about 12% and escalating prices about 8% per year on a base of $32 per barrel.

A survey taken by Fidelity Bank of major energy lenders indicated that many were revising these assumptions to reflect lower prices and the higher cost of funds. Penn Square says that for the last two months it has figured on oil prices holding at $30 a barrel for two years, then rising at 8% per year. It is now discounting reserves at 15%.

"It's realistic," Mr. Jennings says, "to asume that for a year or more oil will hold at $30-$32, and possibly decline to $28 or $25. But we don't look for oil to go below $25. Any prudent oil and gas lender will have a substantial cushion," he adds. "There is adequate coverage for reduction in the price of product."

The spot market for OPEC oil has recently ranged from $28.50 to $32 per barrel, depending on the grade, according to the New York-based Petroleum Intelligence Weekly.

A Number of Shakeouts

Energy lenders at other institutions agree that most loans could simply be extended if oil prices continue to drop, but only if the engineering estimates of reserves prove to be accurate. But one prominent energy lender says that "in the past, rising oil prices covered up a lot of mistakes" that would be accented by declining prices. As a result, there will be a number of "shakeouts" of energy operators, large and small, in 1982, he says.

The market for used drilling equipment has fallen off 50% in the last six months, he adds, "so if you've got a bad rig loan, you've really got a problem."

As for rig loans, Mr. Jennings says that they make up a small portion of the total energy portfolio and are generally secured with long-term contracts. However, one knowledgeable source contends that these loans are more often secured by one-year contracts.

In the week ending April 18, there were 3,422 active rotary rigs in the U.S., a drop of almost 10% from the same time last year, according to the Hughes Tool Co. of Houston, which maintains a running count of working units. The 827 active rigs in Oklahoma represented a significant rise over last year, but the number has been declining fairly steadily since last January.

Upsurge in Problems

There has also been what one Oklahoma City energy lender called a "tremendous upsurge" in problems — including lawsuits alleging misrepresentation — with drilling fund loans backed by standby letters of credit. Because the oil revenues in many of these deals have not been forthcoming, Oklahoma City banks are drawing on the letters of credit at an increasing rate.

Often, bankers say, letters of credit for drilling funds have been bought by limited partners and issued by a bank without the expectation that they would ultimately have to be funded.

Another criticism that has been leveled at the bank is that its lending staff is not large or experienced enough to service a portfolio of this size. Indeed, the bank's growth has been achieved with a commercial lending staff of fewer than 20 officers, most of

Penn Square Bank N.A.

them young lenders recently hired away from First National Bank, Liberty, Fidelity, as well as Continental and several New York institutions. The oil and gas division also includes four full-time petroleum engineers, according to Mr. Jennings.

"In this business," says one energy lender, "it pays to have a few grey hairs and to have lived through boom and bust."

A few of the bank's downstream correspondents are known to have rejected or sold participations back to Penn Square because of what one termed "sloppy documentation." An officer at a major southwestern bank said it had refused to buy Penn Square participations because "they weren't up to our standards." He would not elaborate.

One of the bank's upstream institutions, which also asked not to be identified, concedes that "there was a time when they were really stretched," but it adds that "now they've got that behind them." Says Mr. Jennings, "We have problems with documentation and so do other banks. It's a constant problem."

Understaffed, Overstaffed

Mr. Jennings acknowledges that "two years ago, we were understaffed. Today," he says, "I think we're overstaffed. Our staff is more than adequate when coupled with assistance we receive from participating banks. The state banking department and the national examiners have been helpful, in many instances, in making recommendations on procedures and documentation."

Mr. Jennings emphasizes that "our credit criteria are the credit criteria of the upstream banks" and that Penn Square is under no obligation, moral or contractual, to buy back loans. "Their engineers get together with our engineers before a commitment is made," insists Bill G. Patterson, senior executive vice president in charge of the oil and gas division.

Mr. Jennings explains that while his engineers occasionally differ with their counterparts at the upstream banks, those differences are inevitably "resolved in favor of the upstream banks." And Mr. Patterson declares, "No correspondent has ever lost a penny on a Penn Square loan."

However, one source says that Penn Square has avoided letting its correspondents take losses by arranging, in several instances, for stronger customers to buy out weaker clients whose loans were on the verge of going bad.

Some Decline to Comment

Responding to the controversy surrounding Penn Square, a spokesman for Chase Manhattan said, "Penn Square is a strong and competent bank, but our future relationship would depend on what they bring to us." John R. Boyd, senior vice president for energy lending at Seafirst, said, "They have been a strong and close correspondent of ours for the last five years and we feel they re well managed. They have a strong board and excellent acceptance in their community." Continental and Northern Trust declined to comment.

One leading correspondent banker said he "took comfort" in knowing that Continental, one of the nation's leading oil and gas lenders, would certainly have scrutinized a Penn Square-originated credit as thoroughly as it would one of its own.

While Mr. Jennings and his colleagues do not seem to be rattled by criticism from their fellow bankers ("We don't care what bankers and analysts think, we only care what our customers think," he says), they do acknowledge that their future growth will be less dramatic and more diversified than it has been.

Mr. Jennings says he expects assets to rise by about 25% a year to about $1 billion within five years, substantially less than the frenzied pace of the last few years. Earnings for 1982 should increase to about $6.0 million, a gain of about 28%, he says. "Future growth won't be allowed to be as fast as in the past," adds Mr. Beller.

Branching Out

Asked if a more formal affiliation with Continental Illinois or another upstream correspondent might occur when and if the banking laws permit it, Mr. Jennings said, "That is a potential that exists for us or any other bank in the state." Then, he adds, he is not worried that the upstream banks may attempt to steal his customers because of their "strong loyalty to the bank that helped them get started."

Meanwhile, "We'll probably do more in real estate and construction lending, industrial financing and leasing, and mortgage servicing," he says. To that end, Penn Square has recently joined with four other institutions — which he refuses to name — in creating a financial and estate planning firm — Thompson, Tuckman, and Andersen — based in Palo Alto, Calif. The firm will soon open offices in Oklahoma City and other cities, according to Mr. Jennings.

Although he admits to being concerned about the sensitivity of his institution to the vagaries of the energy market, he says with a touch of smugness, "I'm awfully grateful we're not diversified into apartment houses, car loans, cattle ranching, and wheat farming."

The CHAIRMAN. At page 5 of your statement you say that:

> We are still not at a level at which you would normally find us using a formal letter of agreement, let alone a formal cease and desist. Also, although we see the bank's funds tend to be very risky, those activities are extremely profitable. On the one hand, the classified assets totals and other quantifiable measures of the bank's lending were not at a level which would by themselves normally find us using a formal agreement, let alone a formal cease and desist order.

For how long a period of time had they been making these energy loans when you reached this conclusion? In other words, how old were these loans? Relatively new, weren't they? You know, looking at the charts, these charts of the Comptroller's Office, total loan growth rates for 1979, 1980, 1978, 1979, and 1980, the big push was in 1980, was it not?

Mr. POOLE. I believe so.

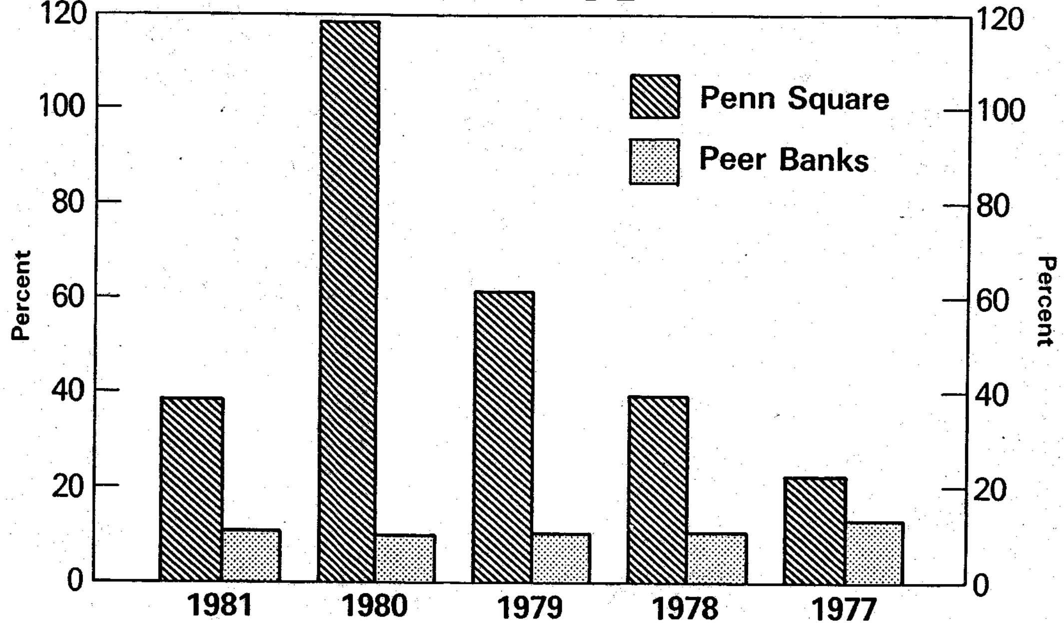
The CHAIRMAN. That compares to the chart——

Mr. POOLE. I can't see the chart.

The CHAIRMAN. Well, we will have them brought up a little closer.

[The charts referred to follow:]

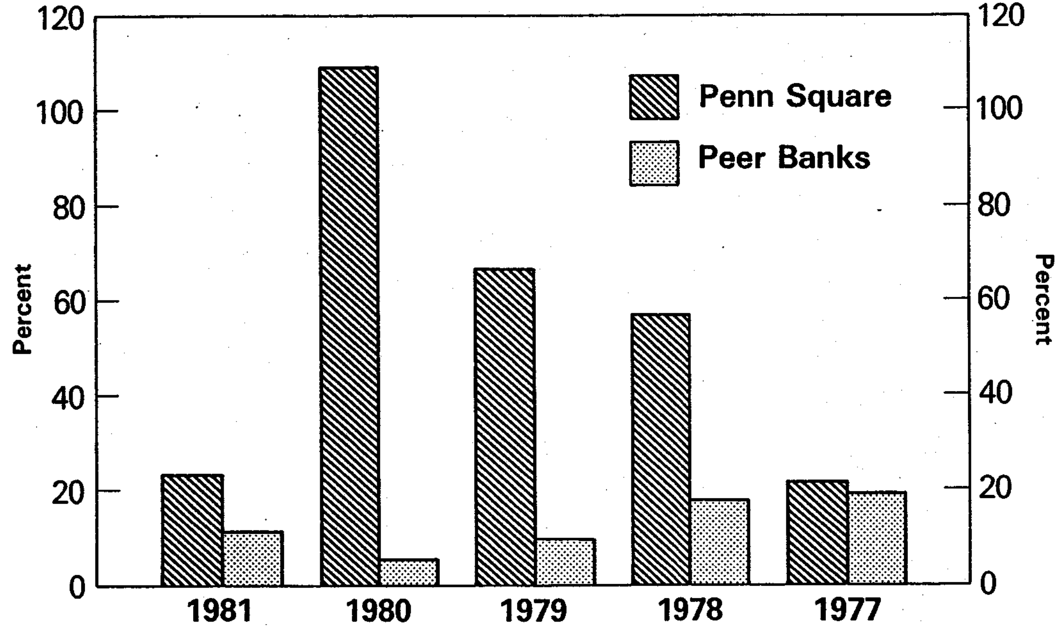
GROWTH RATE
Penn Square Bank, N.A. Compared with Peer Group Banks
ASSETS



DATA Source: Comptroller of the Currency

GRAPH PREPARED BY STAFF OF THE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE

GROWTH RATE
Penn Square Bank, N.A. Compared with Peer Group Banks
TOTAL LOANS

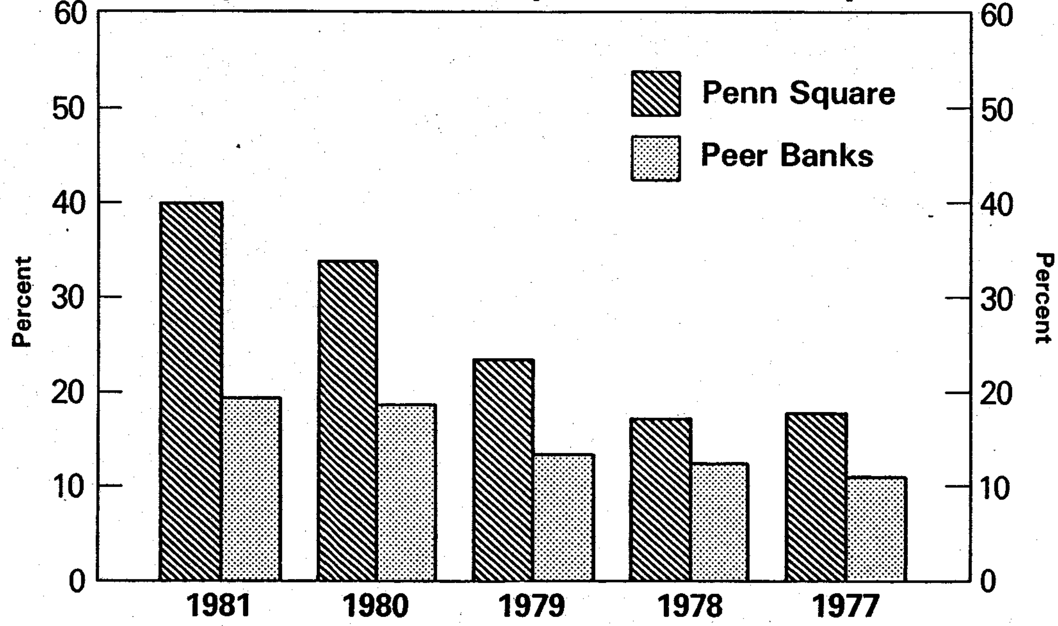


DATA Source: Comptroller of the Currency

GRAPH PREPARED BY STAFF OF THE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE

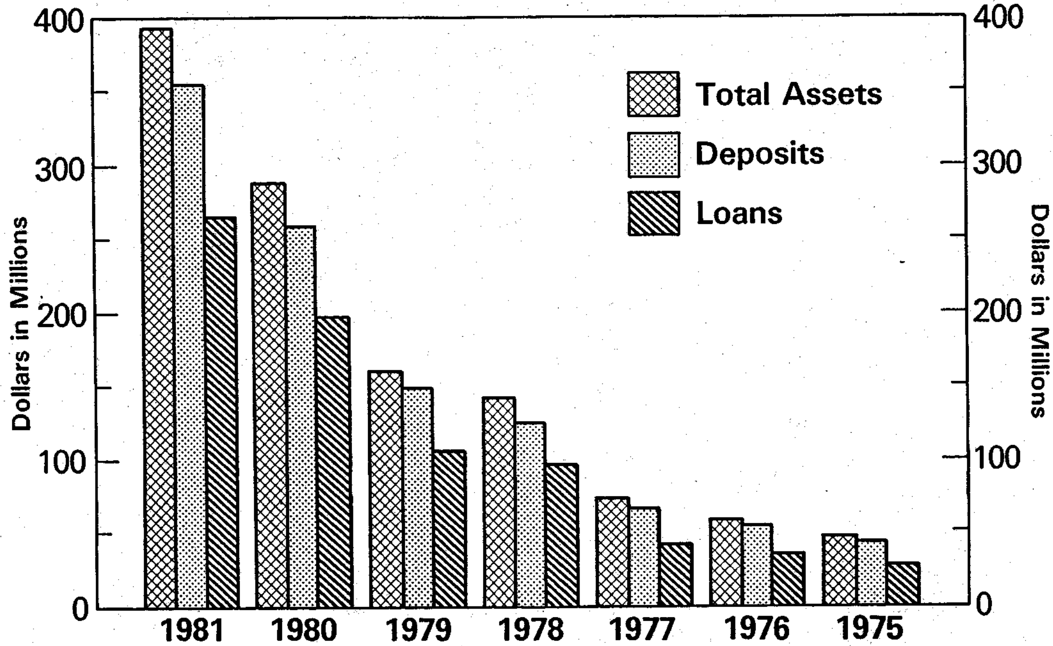
TIME DEPOSITS OVER $100M AS A PERCENT OF AVERAGE ASSETS

Penn Square Bank, N.A. Compared with Peer Group Banks



DATA Source: Comptroller of the Currency
GRAPH PREPARED BY STAFF OF THE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE

PENN SQUARE BANK, N.A.
ASSETS

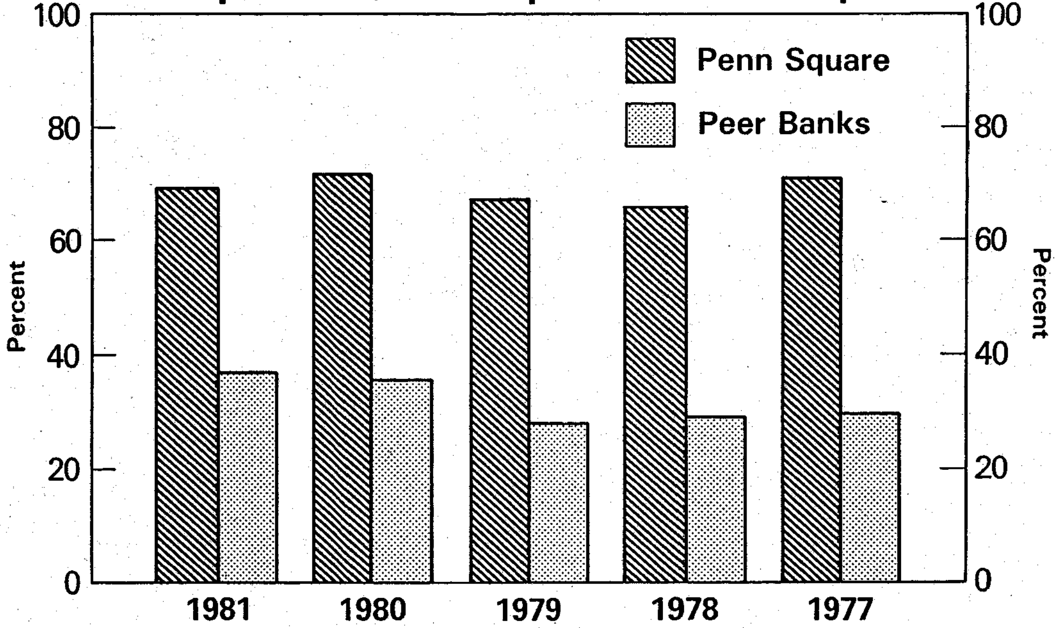


DATA Sources: Moody's Bank & Finance Manual; Polk's World Bank Directory

GRAPH PREPARED BY STAFF OF THE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE

COMMERCIAL AND INDUSTRIAL LOANS AS A PERCENT OF TOTAL LOANS

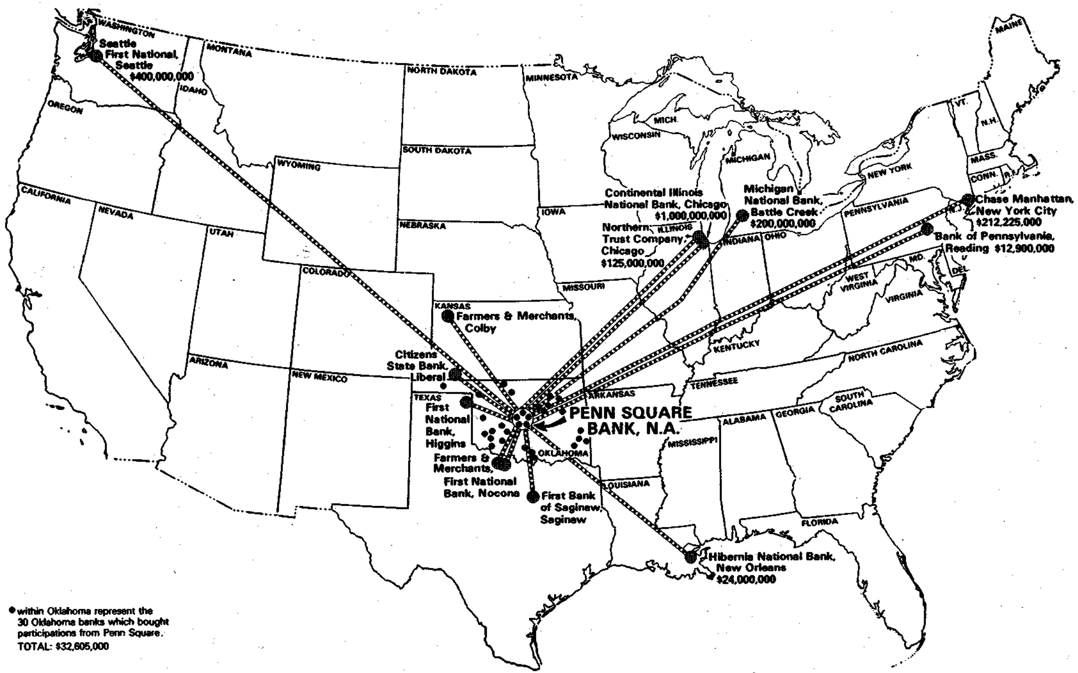
Penn Square Bank, N.A. Compared with Peer Group Banks



DATA Source: Comptroller of the Currency

GRAPH PREPARED BY STAFF OF THE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE

U.S. BANKS WHICH BOUGHT PARTICIPATIONS FROM PENN SQUARE BANK, N.A.



● within Oklahoma represent the 30 Oklahoma banks which bought participations from Penn Square. TOTAL: $32,605,000

CHART PREPARED BY STAFF OF THE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE

The CHAIRMAN. "But on the other hand these loans are comparatively new." But then we go to page 9 and $30 million of the $45.7 million in loans that were eventually classified as loss were made after September 30, 1981. Now, those got bad awful fast, didn't they?

Mr. POOLE. Yes, sir.

The CHAIRMAN. So they couldn't have been very good ab initio, from the beginning, right? How did they get that bad that fast?

Mr. POOLE. I think it was a matter of, in some cases, of the amount of lending to specific borrowers in relation to their collateral and in relation to the various comfort factors in the condition of the loans.

The CHAIRMAN. Do you know who was responsible for making these loans, $30 million of the $45.7 million in losses eventually classified as losses?

Mr. POOLE. Mr. Plunk might be able to answer that better.

Mr. PLUNK. Most of those were originated in the energy department.

The CHAIRMAN. Pardon?

Mr. PLUNK. Most of those were originated in the energy division.

The CHAIRMAN. OK. And who was the very efficient individual in the energy division who would have originated those?

Mr. PLUNK. We found in our loan review that Mr. Patterson supervised virtually all of the loans, I would say as a guess 70 percent or greater.

The CHAIRMAN. I have a little chart here that indicates, just as you've said, "The attached document provides some criticized loans of 1980, revealed that Mr. Patterson was the lending officer for over $20 million of the $34 million in such loans," right?

Then we come to 1982, and again he gets the prize, the big banana. That being the case, was that brought to your attention, Mr. Poole, that you had one particular gentleman in that institution who was a real hot-shot loan officer with a lot of bad loans?

Mr. POOLE. Yes, sir. But I have to point out that the deficiencies in loan portfolio were not that severe at previous examinations. That was basically what I meant when I was talking about quantifiable factors. And even the 1980, December 1980 examination, one of the major factors we used in judging what type of administrative action we would use was the level of classified assets.

The CHAIRMAN. Mr. Poole, your criticized loans in 1980 revealed Mr. Patterson was lending officer for over $20 million of the $34 million in such loans. OK, that's 1980. Now we come to 1982, and Mr. Plunk just stated that he was an all star again in these classified, brand-new classified loans in 1982.

I'm asking you if it was brought to your attention that you had a very, very capable gentleman here named Patterson making energy loans that had a habit of becoming classified?

Mr. POOLE. Well, it was the oil and energy department primarily, and I guess he was in charge of that if I am not mistaken.

Mr. BARTON. Yes, he was, and we were aware of it.

The CHAIRMAN. You were aware of it, Mr. Barton?

Mr. BARTON. Yes.

The CHAIRMAN. OK. You were also aware of the fact that this institution had problems?

Mr. BARTON. Yes, sir.

The CHAIRMAN. And did you give any consideration whatsoever to saying to Mr. Poole, so he could say to Mr. Conover, say, we've got a hot shot here that we can't keep up with, he's too fast for us. September of 1981 things weren't too bad at this institution. But now we come back and we've got classified loans that were made in a short period of time. This young gentleman, perhaps we should ask him to step aside.

Under the powers that you have, it doesn't have to be anything critical, just deleterious to the financial condition of the institution. Did you give that any consideration?

Mr. BARTON. We gave that consideration, but the condition of the bank, the classified assets, was not that severe during history coming up to 1982.

The CHAIRMAN. I'm talking about April and May of 1982. In May of 1982 you found, and June, you found out that there were these classified loans, comparatively new loans, correct?

Mr. BARTON. Yes.

The CHAIRMAN. And you also knew that the same gentleman who was heading up this department had a lot of classified loans in previous instances. It was the same gentleman again in May and June. The players haven't changed.

So you know you brought in Mr. Beller, you asked for all of these things to be done, and yet this area that is a rather critical one still is bad. The same individual is there. Did you give any consideration to asking for a change?

Mr. POOLE. May I answer that?

The CHAIRMAN. Yes.

Mr. POOLE. You're talking about the April 1982 examination?

The CHAIRMAN. Yes, sir. And you know, you look at a little history and you look at 1980. I read from 1980 as well, sir, the classified loans in 1980. Mr. Barton is aware. He's nodding in agreement. So I'm not isolating this so that you should have, you know, the Holy Ghost lay whole knowledge on your head in 1982. I'm saying that this has been going on for a period of time.

Mr. POOLE. I can personally assure you that had the bank survived and stayed in operation, that I feel personally very comfortable in saying that we would have recommended the removal of, or the board remove certain individuals of the bank.

But as a matter of fact, our major concern in our April examination—you have to remember, we did not complete the examination. It never was completed. The bank was closed in midexamination. We were doing our best to try to keep up with—it is very difficult to examine loans in a bank where documentation was as poor as we found in this bank and where controls are so lacking.

It is extremely difficult. You've almost got to—you've got to do everything yourself. And we sent additional staff into the bank.

It was really not a type of decision that we would have addressed during the April examination as to who we would or would not want to recommend getting out of the bank. Our major concern was determining how much of the loan portfolio was loss, so that was clearly the most critical and crucial element.

The CHAIRMAN. Weren't at the same time hoping to be able to save the institution?