The U.S. banking system

Penn Square: the folly of Volcker's strategy

by Richard Freeman

On Friday, July 9, the Federal Reserve had to intervene and pump large masses of funds into the American banking system to prevent a generalized banking collapse. Just four days earlier, the insolvent Oklahoma Penn Square Bank had been shut down. In Europe that day, investors dumped the bonds and certificates of deposit of American banks. Simultaneously, a spokesman for the London *Financial Times* reported privately July 19, "there was a run on one of New York's largest banks."

A Federal Reserve bailout procedure continued for the entirety of the following week. The Fed's brush with catastrophe subsided, but no one knows for how long. The failure of Penn Square is termed by Federal Deposit Insurance Corporation head William Isaac an "aberration." But only two months ago, the same people were explaining away the case of Drysdale Government Securities, a firm with a mere $35 million in capital that was allowed to trade $6 billion a day in government securities. After Drysdale Government folded, and stuck Chase Manhattan with over $300 million in losses, it was said that the Drysdale case was likewise one of a kind. Perhaps the St. Valentine's Day massacre was really a series of muggings?

A decision on bailouts

"There are lots of potential bankruptcies out there, some name institutions and some surprises," said a former high-ranking Federal Reserve Board official July 19. "Many of these corporations will go, and this will mean that there are many more Penn Squares about to occur in the banking system. The decision was to let Penn Square go under, and not bail out some of the depositors, because there will be other banks in that situation and the Fed wants to get the right kind of precedent for not bailing out every failing institution."

Of the $450 million of deposits deposited at Penn Square, $190 million, or 40 percent, were not insured by the Federal Deposit Insurance Corporation (FDIC). An intense debate occurred at an emergency meeting on Saturday, July 3, at which the fate of Penn Square was decided. Fed Chairman Volcker, FDIC head William Isaac, and Controller of the Currency C. Todd Conover discussed policy for what they knew would be a wave of failing banks in the coming period. Although since the 1930s not a single American bank had been allowed to fail without action being taken to cover all its deposits—even in the case of the 1974 failure of the scandal-ridden Franklin National Bank—Volcker, Isaac, and Todd agreed to let the holders of the $190 million of uninsured deposits at Penn Square to take their lumps.

A source close to the Bank of England stated July 22, "What the Fed did at Penn Square was good. Most of the U.S. banks, with the exception of the large ones, will not be bailed out. This will cleanse the American banking system."

Thus the Fed's action in pumping emergency liquidity into the American banking system July 5-15 was not motivated by concern for the majority of the banks, but only the top 50.

Volcker may think he can let smaller banks go by the board while propping up the biggest ones through liquidity injections and book manipulations. The fact is that the largest banks are so vulnerable that if he were to bail them out it would be a matter of covering billions in assets.

Let's look again at the Penn Square case. First, while several top banks are wailing that they got "taken" by Penn Square, that is most emphatically not the case. One source noted July 18, "Continental Oil ran Penn Square. Conti wanted oil loans and used Penn Square as a funnel." It is well known that since early 1980, the Controller of the Currency had placed Penn Square on its "to be seriously watched" list.

Of course it is true that Penn Square ran a sham, profiling itself as a banker to independent Oklahoma drilling rig and exploration firms. Eighty percent of its loans were to the energy industry. As is well known, it resold $2 billion of these loans, based on inflated estimates of suspected oil reserves, to Chase Manhattan ($200 to $300 million), Continental Illinois ($1 billion), and Seafirst of Chicago ($400 million), as well as Northern Trust Bank of Chicago and Michigan National Bank of Bloomfield Hills, Michigan. All of these banks are on the list of America's 50 largest.

The energy loans brought down Penn Square. About $600 million worth of the total Penn Square energy loans the above banks took down have turned bad.

Now consider that Fed Chairman Paul Volcker has rigged the American banking system so that bank lending predominated in precisely such unsecured areas as energy lending, real estate speculation, commodity futures trading, lease-back agreements, etc. How many of these loans do large American banks have on their books? Plenty. Volcker may believe that he can quarantine the largest banks in America from disaster while letting the rest go under. While he is showing where his loyalties lie, he is also showing his incompetence, at the expense of the survival of the U.S. economy.