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Penn Square Bank:
The School for Scandal

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TEXT OF SPEECH BY PHILLIP L. ZWEIG TO OCU CONFERENCE ON "PENN SQUARE BANK—20 YEARS LATER"

"PENN SQUARE BANK: THE SCHOOL FOR SCANDAL"

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When Penn Square failed, I knew that I was witnessing a major event in American financial history. But Penn Square has aged much better than I ever expected. It may have faded into history, but it has also blossomed in historical significance. It has taken its rightful place among the great booms and busts and business scandals of all time, from tulip bulbs to Teapot Dome, from the Great Depression to the S&L crisis, from the insider trading and junk bond scandals of the 1980s to the dot com crash of 2000 and Enron, Worldcom, Tyco, Global Crossing, Imclone and the rest.

Indeed, the passage of 20 years and the current wave of corporate scandals casts Penn Square in a wholly new and even more significant light. In an ironic twist, Penn Square was the straw that broke the back of interest rates in the summer of 1982, which in turn unleashed the longest bull market in American history. Now Enron has helped undo what Penn Square wrought, turning that once raging bull into a rampaging bear.

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Which brings me to three points I would like to make this afternoon. First, Penn Square contains in one sordid package all the lessons and warning signs you will ever need to understand, and anticipate, in virtually every business and banking scandal. As I wrote in a February 2002 op-ed piece in *The New York Times,* the parallels and connections between Penn Square and Enron are many, and they are uncanny. Penn Square is the ultimate playbook, the School for Scandal, if you will. Study, analyze, dissect and digest the lessons of Penn Square and you will have all the material you need to recognize any market bubble or corporate scandal that will ever come down the pike.

Second, it is unlikely that the reforms that have been proposed or enacted will head off future scandals. One reason, as Walter Wriston, former chairman of Citicorp, used to say, is that trouble always comes through the window you are not watching. Another reason is that the investigative resources of our nation, both governmental and media are stretched perilously thin. In turn, one reason for that is September 11. Understandably, because of the terrorist attacks, the top three priorities of government investigators are terrorism, terrorism, and terrorism, in that order. In my current work, I am involved in exposing corruption in the health care system, and I know for a fact that, after September 11, agents working on important health care fraud cases were reassigned to counter-terrorism.

That takes me to my third and final point, which is actually a question: What are we to do? Do we shrug our shoulders and accept the occasional financial debacle as the unavoidable cost of capitalism? Over the last year, the op-ed pages of our leading newspapers have been crammed with all kinds of proposed solutions, many of them intriguing. I do not presume to have any quick fixes. But I feel strongly that it is time for corporate Americans to take the truth into their own hands. An examination of financial scandals from Penn Square to Enron shows how one person can bring down a company, even the banking system. At the same time, they also suggest that at various junctures one stand-up person might have saved them.

Let me elaborate on point number one. Much of the discussion at this conference will obviously focus on the lessons of Penn Square. Everyone who lived through this episode and has thought about it since has his own list, so I will try not to exhaust you by being exhaustive.

To be sure, there is something here for everyone. There are the soft lessons and hard lessons. General and specific lessons. There are lessons for bankers, consumers, and investors. More lessons for lawyers, regulators, accountants, CEOs, and government policymakers. On July 6,

1982, big city bankers realized that they needed to return to the basics. Like avoiding the temptation to dabble in areas outside their expertise. That rapid, unchecked asset growth and portfolio concentrations can be hazardous to a bank's health. That in making loans, character counts. Consumers who had invested more than $100,000 in high-yielding Penn Square CDs sold by Newport Beach money brokers discovered to their chagrin that if something seems too good to be true, it probably is. Some of these have a cliché quality, but they are true and important nonetheless, and relevant to the blizzard of scandals we are witnessing now.

For my part, some of the lessons of Penn Square began emerging while I was working on my first story for the *American Banker*, which ran April 26, 1982. It was called "Oklahoma's Penn Square Bank, Maverick Oil Patch Lender: Some Say It's Bet Too Heavily on Energy." At that time, I had been working for less than two years as a full-time staff reporter. Sometime after that first story ran, I was talking to a source in Oklahoma City whom I had code-named "Deep Vault." He dropped a little bombshell on me. He told me that Bill Patterson, whom I had interviewed for my first story, liked to entertain other bankers by drinking liquor out of his shoes. Huh? This could not be. A pin-striped banker drinking liquor out of his shoes? This tidbit flew in the face of everything I had been brought up to believe about bankers. I even began to question the reliability of my source. But I was able to confirm that a senior officer of Manufacturers Hanover had witnessed this at the Cowboys, and said, "There's no way we're going to do business with that guy." That was all he needed to know.

To give Bill Patterson the benefit of the doubt, I called some people I knew down here and asked if that was a common practice in Oklahoma. When I was informed that it was not, I included this vignette in a story that I filed the week after the bank failed. A heated debate ensued at the *American Banker* over whether to include this material. Sandy Rose, the veteran columnist for the *Banker*, argued that printing this was inappropriate. He wanted to say that Patterson exhibited "unbankerlike" behavior. I said that hardly did justice to the incident. Ultimately, I prevailed, and the rest, as they say, is history.

Perhaps more than anything, that drove home the importance of the smell test in sizing up a business or banking institution. In reviewing bank financial data, Penn Square jumped off the page. But Penn Square also drove home to me the importance of considering non-financial indicators of change. One investor I interviewed for the book had compiled a long list of such indicators. He became alarmed, for

example, when a company replaced the linoleum with thick pile carpet. Or installed a hot tub in the office or bought that second jet.

Twenty years later, apparently no one thought anything was amiss when Tyco ex-CEO Dennis Kozlowski used company funds to buy a $6,000 shower curtain and throw a $2 million birthday party for his second wife.

When I was holed up at a cheap motel that July 4 weekend, I called a friend who was a mid-level official at a bank regulatory agency and a student of bank failures. I asked him what I should be looking for outside the bank lobby. He said potted plants. The first indication, he said, that a bank is about to fail is they remove the potted plants from the lobby.

Another lesson that emerged early on was the hazards of relying on experts and their predictions. In reporting my first article, I flew to Oklahoma City and spent several hours with Beep Jennings, Eldon Beller, and Bill Patterson.

I had never been to Oklahoma before, and knew very little about the oil and gas business or even geology. I thought oil was found in huge caverns. When I first heard the term frac job, I thought that was something you did not talk about in mixed company. But I was not afraid of asking dumb questions. And I always remembered my sixth grade teacher's definition of an expert as a drip under pressure. I asked Beep Jennings how his loans would be repaid. He replied that oil was going to rise to $104 a barrel. How did he know that? Because the oil and gas experts at Chase Manhattan said so.

Penn Square and its upstream bankers exuded arrogance. They liked to believe they had mastered this rocket science called oil and gas lending and that they had discovered the brass ring. The oil and gas business has its own jargon that in the wrong hands can be used to confound and bamboozle. By the time the national bank examiners figured out this was a smokescreen, it was, of course, too late.

Later, as a finance editor at *Business Week*, I observed the same kind of "We're smarter than you are" arrogance among the so-called Wall Street rocket scientists who concocted and traded in derivative financial instruments. I never understood these things, and apparently their purveyors did not understand them either. At the time, the temple of the derivatives business was Bankers Trust, which had decided to bet its future on derivatives and trading. For a while, they looked like heroes, until some of their customers decided they were getting the short end of the stick. Court transcripts of the so-called Bankers Trust tapes, in which traders talked openly about how they were shafting clients, were leaked to *Business Week*, and Bankers Trust wound up being acquired by

Deutsche Bank. To my knowledge, no one has ever reported this, but I am told by an impeccable source that Enron considered Bankers Trust as its role model, and sought its advice on how to transform itself from an old-fashioned pipeline company into a trading shop. The derivatives episode confirmed for me what I had learned back at Penn Square. That most legitimate ways of making money are relatively simple. Of course, some illegitimate ways of making money are pretty simple too, but that is beside the point. The bottom line is: if you do not understand it, stay away from it.

Another fascinating discovery for me was how the financial world operates at the margin. It does not always take an event of the magnitude of, say, the 1973 Arab Oil Embargo, to change the world. The failure of a $500 million shopping center bank can do it too. After Penn Square failed, I was preoccupied with writing about the impact of the failure on banking industry practices and getting a book contract. When it came to the larger, macroeconomic picture, I had my head partially buried in the sand.

A year later, after I had gone on leave to write the book, I began to understand the big picture and my own role in it. A senior official of the FDIC suggested that I interview Bob Weintraub, the late chief economist of the Joint Economic Committee of Congress.

Over coffee in the Capitol cafeteria, he informed me that my stories in the *American Banker* were part of the chain of events that prompted the Fed to lower interest rates in the summer of 1982. Rates declined by five percentage points after Penn Square failed, and in August the great bull market began in earnest. As I mentioned earlier, Enron had the opposite effect nearly twenty years later. Incidentally, if you would like more evidence of the impact of Penn Square on monetary policy, check out Bill Greider's book, "Secrets of the Temple," or Paul Volcker's "Changing Fortunes." Volcker did not grant me an interview for "Belly Up" because he was still worried about Continental Illinois and the survival of the banking system. But in his book he acknowledged Penn Square's role in his decision to cut interest rates.

As the Enron saga unfolded, I was continuously struck by the uncanny connections between these two events and concluded that Enron was Penn Square all over again. As I wrote in the *Times* op-ed piece earlier this year, the only true lesson is no one learns the lessons of history. Ken Lay apparently did not drink Amaretto out of his Gucci loafers. But both scandals involved corporate boards, corrupt auditors, a shell game with off balance sheet debt, and fund-raisers for politicians named George Bush. In both instances, there were inquisitions,

Congressional hearings, litigation, and calls for reform.

In fact, many of the same players show up in both scandals. It was also fascinating to me that Jeff Skilling, the arrogant former CEO of Enron, was an alumnus of McKinsey and Co., which had set the stage for the debacle by advising three of Penn Square's big bank partners, Continental Illinois, Chase Manhattan, and Seattle-First. McKinsey sold a deal called "decentralization by market segment." That really meant letting nitwits give away big money. In fact, Andrew Fastow, Enron's chief financial officer, turned out to have learned the banking business at, where else? Continental Illinois. And who should show up as one of Enron's lead bankers but J. P. Morgan Chase, successor to Chase Manhattan, the bank of David Rockefeller.

Another common thread linking Penn Square to Enron is the misuse of the holding company. Bill Patterson used Penn Square's holding company, the First Penn Corporation, to remove bad loans from the books, and many of Penn Square's borrowers used a myriad of corporate entities to play a game of three-card monte with their balance sheets.

All of these scandals represented an abysmal failure of due diligence. I remember going to the SEC library in Washington and discovering a book that contained an index of everyone who was ever sued by the agency since it was created in the mid-1930s. In it was the name of Ken Tureaud, a veteran scamster to whom Penn Square and Chase Manhattan had lent, and lost, something north of $30 million. I thought, "Gee, all they would have had to do was check this book." Twenty years later, we have a wonderful tool called the Internet, but some huge companies still do not do even cursory due diligence. About a year ago, *The New York Times* ran a front page story about how Becton Dickinson had hired a vice president for medical affairs, Dr. Seymour Schlager, only to discover that he had spent three and a half years in the Illinois correctional facility for attempting to smother his wife with a pillow. The story was headline news in all the Chicago papers and would have showed up simply by plugging his name into Yahoo. He had chutzpah, though. The business address on his resume was the post office box for inmate mail. He even got a law degree from the William Howard Taft University School of Law while in prison.

So as I said at the outset, I am not optimistic that we are going to see sweeping reforms in corporate governance, or that any of the proposals for reform, if implemented, are going to do much to prevent future Penn Squares or Enrons. It certainly cannot hurt, of course, for CEOs to be required to sign off personally on their company's financial statements. And I am certainly in favor of hard time for corporate wrongdoers. But

the laws that should deter these crimes are already on the books. In fact, I recently spoke about this with one of your distinguished alumni, Steve Korotash, OCU Law Class of 1978, a senior enforcement attorney with the SEC in Ft. Worth. While stressing that he was not speaking for the SEC, Steve pointed out that existing wire and mail fraud statutes already cover a multitude of corporate sins. "They're broad and all encompassing," he said.

Knowing Steve, who is one of the most dedicated and hardworking prosecutors I know, has certainly given me a good feeling about his alma mater. There is much to be said for small, local law schools, like this one, that provide a legal education to people who decide in later life that the law is their true calling.

Another concern for me is that the chances that investigators will catch these crimes in time to prevent a complete meltdown are dwindling with every passing day. The FBI is understandably focused on counter-terrorism, and investigators at agencies like the SEC are overwhelmed and underpaid.

And it is becoming less and less likely that journalists will uncover such scandals before they implode. I was able to spend two months working on my first Penn Square story because the *American Banker* was owned at the time by a family trust administered by one Derick Otis Steinmann. Derick was a psychologist who did not have to answer to public shareholders. My understanding was that his family made a lot of money in elevators, so he also understood better than anyone that what goes up must come down. He simply enjoyed watching reporters go out and find good stories. So I was given enough rope to hang myself with. Since then, the family-owned newspaper has gone the way of the family farm. Media organizations are owned by huge conglomerates like AOL Time Warner and Viacom.

American media organizations have no interest in investigative journalism, which to me simply means getting ahead of the story. Letting people like me run wild for two months on a story that might not pan out is expensive. It is also risky. You can get sued for doing tough, critical stories.

Big time journalism is also mired in politics and turf battles. I got my first real taste of this when I was recruited to join the *Wall Street Journal* after I completed "Belly Up." I was hired to cover banking out of New York. While working here on "Belly Up" in 1983 and 1984, I began to hear stories about widespread fraud at S&Ls and HUD. But I had a book contract to meet, so I could not stop everything and investigate that. But when I reported to work at the *Journal* in April 1985, I handed my new

boss a memo on what I had found. To my shock and chagrin, he told me "That's not your beat or your bureau. Your job is to tell me who's quitting Citicorp." They sent my memo to the reporter in Washington who covered HUD. She called the PR person at HUD, who said there was no problem. End of story.

So it was no wonder that this summer, in the midst of a war against terrorism and the worst spate of corporate scandals since the Great Depression, *Time* magazine ran back-to-back cover stories on the Lewis and Clark expedition and vegetarianism. If I had to write the Penn Square story today, I would probably have gotten a week to do it. And the headline would likely have read "Oklahoma Bank Finds Brass Ring in Energy Lending." American journalism has become a wasteland of regurgitated and reactionary stories. The name of the game is to fill the book, as we say.

The real journalism is being practiced, honestly, in Third World countries. I got a taste of that some years ago after I was sued by a bankrupt Houston oil and gas operator named Jack Stanley who had issues with a cover article I wrote on him. In a nutshell, the point of the article was that no one wanted to finance him out of bankruptcy because he was so litigious. One of the benefits of being represented by my friend Bruce Sanford of Baker & Hostetler was that I got invited to the annual dinner of the Committee to Protect Journalists. It is one of the toniest social events in journalism. Dan Rather, Peter Jennings, Tom Brokaw, and all the media elite are there. Dressed in their tuxes, they give out awards to journalists in places like Colombia and Nigeria who have put their lives on the line to expose drug dealers and government corruption. Some of the awards are given posthumously. In this country, I am afraid that if the present trend continues, a certain Oklahoma newspaper may eventually become the gold standard for excellence in journalism.

All this is unfortunate, because I think that more and more people are starting to realize what Walter Wriston, the subject of my second and last book, knew all along. As you may be aware, he and his institution led the global banking community into the Third World debt crisis with the assurance that "countries don't go bankrupt." Of course, as we discovered later, companies that lend to them can. In one interview, I asked Wriston why he lent all those billions to corrupt countries like Brazil, Argentina, and Mexico? He said, "Let me tell you something. This country is just as corrupt as any of those countries. It's on a different level, so it's not as obvious." Unlike Mexicans, Americans don't have to bribe a cop to get through the day. We're now discovering

how right he was.

But we obviously have to do more than wring our hands. If I may throw in my two cents, I think a partial answer lies in empowering corporate Americans. Companies need to do more than give lip service to the fact that their most important asset is their reputation. In most all of these debacles, beginning with Penn Square, there has always been at least one person who witnessed wrongdoing and took some action to try to stop it. For example, at Continental Illinois, a woman named Kathy Kenefick yelled and screamed about Penn Square but was ignored and derided.

Some writers have proposed more courses in business law and ethics as a solution, but I doubt these whistleblowers ever read a book on business ethics. They just knew the difference between right and wrong. If our economic system is not to be threatened periodically by these episodes, we must enable right-minded corporate citizens to take the truth into their own hands. This summer, I started reading Caroline Kennedy's sequel to her father's Pulitzer Prize-winning "Profiles in Courage." Perhaps now it is time for a "Profiles in Corporate Courage." Twenty years ago, and again over the last year, we learned that a couple of misguided people can kill a company, nearly bring down the banking system, and wreak havoc with the global economy. Likewise, one right-minded person can save it. Corporate America must now do whatever it takes to enable that to happen.