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1992 THRIFT RESOLUTIONS

RTC Policies and Practices Did Not Fully Comply With Least-Cost Provisions

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Ranking Minority Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

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This report presents the results of our review of the Resolution Trust Corporation's (RTC) compliance with Section 13(c)(4) of the Federal Deposit Insurance Act, as amended by the Federal Deposit Insurance Corporation Improvement Act of 1991. This section of the act requires RTC to (1) choose the resolution method that results in the least possible cost to RTC and (2) calculate and document its evaluation of the costs of alternatives for resolving a troubled savings association. These statutory provisions contain the basic requirements that RTC must meet in making its least-cost determination.

The act requires that we annually audit RTC's compliance with the least-cost provisions. This report is intended to provide information, analysis, and recommendations to improve the RTC resolution process.

We are providing copies of this report to the RTC Deputy and Acting Chief Executive Officer and other interested parties.

This report was prepared under the direction of Mark J. Gillen, Assistant Director, Financial Institutions and Markets Issues. Other major contributors are listed in appendix V. If there are any questions about this report, please contact me on (202) 512-8678.

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Executive Summary

Purpose

During the period of 1980 through 1992, over 1,300 savings associations failed. In an effort to stem losses and to foster depositor discipline, Congress passed the least-cost resolution provisions as part of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).[1] These provisions were effective immediately upon FDICIA's enactment on December 19, 1991.

The least-cost resolution provisions of FDICIA generally require that the Resolution Trust Corporation (RTC) resolve a failed thrift at the least possible cost to RTC.[2] To that end, the provisions contain specific rules RTC must follow in calculating the cost of resolution alternatives and documenting the agency's evaluations of those costs. Finally, the statute requires GAO to annually report to Congress on RTC's compliance with FDICIA's least-cost resolution provisions.

In accordance with GAO's statutory responsibilities, GAO sought to determine the extent to which RTC's 1992 policies ensured RTC's compliance with the least-cost provisions. GAO also sought to determine the extent to which RTC's resolution decisions in 1992 complied with the least-cost provisions, specifically with requirements for calculating costs and documenting the evaluation of the costs of resolution alternatives. In addition, GAO reviewed the marketing aspects of RTC's resolution process.

Background

When a thrift fails, the Office of Thrift Supervision (OTS) or a thrift's state chartering authority usually appoints RTC as receiver or conservator. Typically, a conservatorship is established, after passing the failed thrift through a receivership, to operate the thrift pending its final resolution.

The least-cost provisions require RTC to estimate the cost of liquidating a failed thrift as one of the first steps toward resolving the institution. The cost of liquidation basically is the amount of insured deposits paid out minus the net amount recovered through asset disposition activities (or net realizable value). RTC is to compare the cost of liquidation with the costs of other alternatives once those costs have been determined. FDICIA's least-cost provisions explicitly require RTC to estimate the cost of liquidating a failed thrift in conservatorship as of the earliest of (1) the date the conservator is appointed, (2) the date the receiver is appointed, or (3) the date a determination to provide assistance to a failing or failed

[1]See Section 13(c)(4) of the Federal Deposit Insurance Act, as amended by FDICIA, Pubic Law 102-242, 105 Stat. 2236 (1991), effective December 19, 1991.

[2]Congress appropriates funds to RTC that the agency uses to assist resolutions of failed thrifts.

thrift is made. The earliest of these dates usually is the date RTC passes the failed thrift through a receivership and is appointed conservator. In addition, the least-cost provisions generally allow RTC to assume the cost of fully paying uninsured depositors only if such payments are part of a resolution alternative determined to be least costly.

The least-cost provisions also contain requirements related to the calculation of resolution costs and documentation of certain aspects of resolution decisionmaking. The cost-calculation requirements primarily apply to the adjustments RTC makes to the book value of a failed thrift's assets in estimating the net realizable value of those assets. The statute requires RTC to document its evaluation of the costs of the resolution alternatives the agency considers, including the assumptions on which the agency bases the evaluation. In addition to FDICIA's documentation requirements, GAO, in a 1992 report, developed criteria for determining whether evaluations and assumptions are adequately supported.[3]

Both before and after the enactment of FDICIA, RTC's general policy was to routinely "downsize" most failed thrifts in conservatorship, mainly by selling a portion of the thrifts' high-quality assets. RTC often pooled assets of one failed thrift with assets from other failed thrifts and sold the asset pools through RTC program activities, such as asset securitization or bulk sales. According to RTC officials, this practice enabled RTC to maximize proceeds from asset disposition activities as required by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

According to RTC's procedures, RTC was to estimate the cost of liquidating the remaining assets, deposits, and other liabilities of the failed thrift and compare that cost with the cost of other resolution alternatives. The alternatives largely resulted from RTC's efforts to market the downsized thrift. RTC was to solicit bids on the basis of a strategy reflecting then-current market conditions. The strategy was to include any one or a combination of resolution methods differing mainly in the way the remaining assets were packaged for bidding purposes. Potential acquirers could submit bids that conformed to the suggested package (conforming bids) or submit bids that deviated from the bid package (nonconforming bids). The agency was to cost out all conforming bids and those nonconforming bids that it could cost out and select the least costly resolution alternative. The agency then was to determine the portion of

[3]Failed Bank: FDIC Documentation of CrossLand Savings, FSB, Decision Was Inadequate (GAO/GGD-92-92, July 7, 1992).

any resulting losses to RTC to be shared by any remaining uninsured depositors.

GAO's review of RTC's 1992 resolution process was performed on two levels. First, GAO reviewed the adequacy of RTC's 1992 corporate policies, including the downsizing policy, to ensure compliance with the FDICIA least-cost provisions. Second, GAO reviewed a judgmental sample of 10 of the 69 resolution decisions that RTC made in 1992, most of which occurred after the failed thrifts had been downsized. GAO focused on the extent that RTC's resolutions process complied with FDICIA's least-cost provisions and provided for adequately documented resolution decisions, specifically those related to calculating and documenting costs and the underlying assumptions of resolution alternatives. GAO also reviewed the marketing aspects of RTC's resolution process as applied to the sampled decisions.

Results in Brief

During 1992, RTC resolved 69 failed thrifts. Of these thrifts, 59 were already in conservatorship before the passage of FDICIA and, consistent with RTC's corporate policies, RTC had already assumed all deposits and had downsized most of the failed thrifts by selling higher quality assets. Therefore, the opportunity had passed on these failed thrifts for RTC to assess uninsured depositors their share of estimated losses and estimate the liquidation costs as of the conservatorship date. Consequently, for these 59 resolutions, RTC could only realistically apply FDICIA's requirements at the time it resolved the downsized thrifts and made decisions about financial assistance needed for those resolutions. RTC resolved nine other thrifts through the accelerated resolution program. The remaining 1992 resolution involved a failed thrift placed into conservatorship during 1992 that RTC sold in its entirety, before any significant downsizing, at no cost to the agency.

Also during 1992, RTC assumed responsibility for another 49 failed thrifts, all of which it placed into conservatorship and most of which it downsized. RTC did not finally resolve these thrifts mainly because for much of 1992 RTC did not have appropriated funds for resolutions. Even so, RTC was responsible for complying with FDICIA's provisions aimed at ensuring the least costly resolution of these 49 failed thrifts.

From GAO's review of RTC's 1992 compliance with the FDICIA least-cost provisions, GAO found that three of RTC's corporate policies in effect in 1992 raised compliance issues. These policies did not (1) ensure that uninsured depositors would absorb their shares of thrift losses if

necessary to achieve least costly resolutions; (2) require RTC to estimate the cost of liquidating thrifts in conservatorship as of the conservatorship start date, as required by FDICIA; or (3) require RTC to evaluate other available resolution methods before downsizing.

RTC officials defended these policies by citing several factors, including the backlog of thrifts awaiting resolution in 1992 and a lack of funding for resolutions for much of that year. Whatever the merits of these factors, they are now largely moot. RTC changed its policy regarding uninsured depositors in September 1993, and the new policy, if effectively implemented, should allow RTC to better ensure compliance with that aspect of the least-cost provisions. GAO believes that RTC, with its recently appropriated funding and few additional thrifts expected to fail in 1994 or 1995, should be able to further modify its corporate policies to ensure full compliance with FDICIA.

For RTC resolution decisions made in 1992, RTC had adequate resolution procedures for calculating, evaluating, and documenting the cost of resolution alternatives. However, those procedures were not always adhered to, particularly regarding the documentation of evaluations and assumptions. GAO reviewed 10 of the 69 RTC resolution decisions that, for the most part, involved thrifts that had already been downsized before the effective date of the least-cost provisions. RTC consistently chose the least costly resolution alternatives the agency considered in resolving what remained of the failed thrifts after downsizing. However, in three of the resolutions GAO reviewed, RTC did not fully document the basis of the evaluations of the resolution alternatives considered, including the consideration given to nonconforming bids, as its procedures required.

In 7 of the 10 resolutions, RTC did not document the rationale for the marketing strategy it selected. GAO believes that RTC's marketing decisions should be thoroughly documented to give the fullest effect to the agency's statutory mandate to resolve failed thrifts in the least costly manner.

Principal Findings

RTC Corporate Policies Did Not Ensure Compliance With the Least-Cost Provisions of FDICIA

RTC's policies for the conservatorship and resolution of failed thrifts have, for the most part, not changed with the passage of FDICIA. GAO found that three of those policies raised least-cost compliance issues. These policies did not (1) ensure that uninsured depositors would share in thrift losses if necessary to achieve least costly resolutions; (2) require RTC to estimate the cost of liquidating thrifts in conservatorship as of the conservatorship start date, as required by FDICIA; or (3) require RTC to evaluate other available resolution methods before downsizing. (See pp. 25 to 30.)

RTC officials told GAO that RTC assumed all deposits, including those uninsured, into conservatorships as a policy matter to preserve the thrifts' franchise value. The officials said RTC had been considering changing this policy since the passage of FDICIA. However, the policy was not actually changed until September 1993. The new policy requires RTC to estimate the amount of uninsured deposits at the time the conservatorship is established so the uninsured depositors can absorb their share of the estimated losses. This policy, if effectively implemented, should enable RTC to comply with that aspect of FDICIA's least-cost provisions.

RTC policies did not, and still do not, require the agency to estimate the full costs of liquidation as of the conservatorship start date. Rather, RTC's policy has been to estimate insured deposits as of that date and to estimate the second component of liquidation costs—expected recoveries on assets—as of the time of final resolution. In addition, RTC's policy provides for a revision to its estimate of insured deposits when it is preparing for the final resolution of a thrift. Under FDICIA, RTC is required to hold constant its estimate of insured deposits, as of the conservatorship start date, for use in calculating the liquidation costs that it is to compare with other resolution alternatives.

RTC officials cited a different interpretation of FDICIA as the basis for its policy on liquidation cost estimates, which they believe ensures RTC's compliance. In addition, RTC officials told GAO that, because RTC did not have funding for resolutions as of April 1, 1992, liquidation cost estimates on the 49 new, but unresolved, conservatorships would be obsolete by the time the actual resolution took place after funding was restored. Also, RTC officials said that, without access to a thrift's records before it fails, RTC cannot make a liquidation estimate at the beginning of conservatorship.

While GAO agrees that early access by RTC would be helpful, RTC is not precluded from making a liquidation cost estimate as of the conservatorship start date after it assumes control of a failed thrift.

In 1992 and 1993, RTC's policy remained to "downsize" failed thrifts by routinely selling their high-quality assets out of conservatorship through securitization and bulk sales before final resolution. FDICIA's least-cost provisions contemplate that, before selling assets from a failed thrift, RTC must determine whether alternative resolution methods are potentially available. RTC officials maintain that its asset sales approach maximizes RTC's returns on assets and, as a general proposition, results in least-cost resolutions. RTC officials also told GAO that, because it lacked funding during much of 1992 and 1993, its choice of resolution methods was limited and downsizing was the only practical alternative. GAO cannot, from its review of RTC's 1992 resolution process, assess the extent that the backlog or lack of funding restricted resolution alternatives for the 49 thrifts that were placed in conservatorship but not resolved in 1992. However, GAO does not believe that RTC can continue its asset sales policy for thrifts that fail in 1994 and 1995, for which funds have been appropriated, and be assured of compliance with FDICIA's least-cost provisions.

Improvements in Documentation of Cost Evaluations Are Needed

GAO found that RTC did have adequate resolution procedures in 1992 for calculating, evaluating, and documenting the cost of resolution alternatives for those assets, deposits, and other liabilities remaining in the downsized thrifts. For example, in determining the net realizable value of the remaining assets of a failed thrift, RTC relied on the agency's Asset Valuation Review, which is an on-site analysis of a sample of asset files and records at the failed thrift. GAO's review of 10 resolutions indicated that RTC adhered to some aspects of its procedures for calculating the costs of resolution alternatives, but none of the 10 resolutions reviewed included adequate documentation of all of the assumptions underlying the cost evaluations. These included assumptions related to interest rates, holding costs, asset recovery rates, and contingent liabilities. Nor did the resolutions reviewed include adequate documentation for the consideration given to all nonconforming bids received from potential acquirers. In all 10 resolutions GAO reviewed, RTC consistently chose the resolution alternative the agency determined to be least costly in resolving what remained of the failed thrift after downsizing. However, RTC needs to better ensure adherence to its resolution procedures to effectively implement RTC's process and ensure adequate documentation of its cost

calculations and assumptions relative to all bids received from potential acquirers. (See pp. 37 to 39.)

Improvements in Documentation of Marketing Strategy Are Needed

GAO recognizes that, as a practical matter, RTC must make judgments regarding how best to offer an institution for sale. In developing marketing strategies, RTC has considerable discretion to construct bid packages by selecting from among an extensive number and type of variations within the basic resolution methods. Because the marketing strategies determine how failed thrifts are presented to potential acquirers, they can affect the range of alternatives considered by both RTC and potential acquirers. At the same time, the process by which RTC selects its marketing strategies can affect the alternatives that are later considered in least-cost calculations once bids are received.

In 7 of the 10 resolutions reviewed, GAO was unable to determine from available documentation how RTC arrived at the marketing strategy presented in bid packages. To give the fullest effect to RTC's statutory mandate to choose the least costly method for resolving a thrift, GAO believes that thoroughly documenting the marketing decisions in each case would both enhance the quality of RTC's decisionmaking and provide greater assurance to Congress and the public that resolution costs are being minimized. (See pp. 42 and 43.)

Recommendations

GAO recommends that the RTC Deputy and Acting Chief Executive Officer

- revise RTC's policies to require that the agency estimates liquidation costs as of the earliest of (1) the date a conservator is appointed, (2) the date a receiver is appointed, or (3) the date of a determination to provide assistance to a failing or failed thrift (see p. 32);
- revise RTC's policies to require that the agency evaluate the resolution methods that are potentially available before selling assets of a failed thrift (see p. 32);
- require that the consideration given all nonconforming bids received be documented (see p. 41); and
- revise RTC's policies to require that RTC documents the rationale for the agency's preferred marketing strategy for resolving a failed thrift (see p. 44).

Agency Comments

RTC provided written comments on a draft of this report. These comments are discussed following GAO's recommendations in chapters 2, 3, and 4 and, together with GAO's responses, are reprinted in appendix IV.

In general, RTC believes its policies comply with the least-cost provisions of FDICIA. However, RTC said it will initiate actions to ensure consistent adherence to its least-cost policies and procedures, including documentation of its efforts to comply with the least-cost provisions.

RTC maintained that its policies on asset sales and liquidation cost estimates are consistent with FDICIA. RTC did not respond specifically to GAO's recommendations for changes to its policies on asset sales during conservatorship and on the timing of its liquidation cost estimates.

GAO continues to believe that RTC's policies on asset sales and liquidation cost estimates should be revised to be consistent with FDICIA's least-cost requirements. GAO maintains that, to be consistent with FDICIA, RTC can sell assets from a failed thrift only if it first explores other resolution methods and determines that methods involving the sale of assets with the failed thrift's deposits and other liabilities are not likely to produce a less costly resolution. Further, FDICIA specifically requires RTC to estimate liquidation costs as of the earliest of the dates the conservator or receiver is appointed or the date that RTC determines to provide assistance to a failed thrift. Therefore, unless RTC changes its policies in these areas, neither RTC nor GAO can assure Congress that RTC is complying with FDICIA's least-cost provisions.

Contents

Executive Summary		2
Chapter 1 Introduction		12
	Thrift Failures Accelerated During the 1980s	12
	Congress Established RTC to Handle the Thrift Crisis	13
	RTC Uses Many Strategies to Resolve Thrifts	14
	FDICIA Designed to Ensure Resolutions Are Done at Least Cost	16
	RTC's Resolution Process	17
	Objective, Scope, and Methodology	22
Chapter 2 RTC Corporate Policies Did Not Ensure Full Compliance With Least-Cost Provisions		25
	RTC's Policy on Uninsured Depositors Did Not Ensure Compliance With FDICIA	25
	RTC Policy Did Not Require Liquidation Cost Estimates as of Conservatorship Start Dates	27
	RTC's Asset Sales Policy Did Not Require Review of Alternatives	29
	RTC Policy Changes Needed for Future RTC Compliance With FDICIA	30
	Conclusions	31
	Recommendations	32
	Agency Comments and Our Evaluation	33
Chapter 3 RTC Selected Alternatives It Determined Least Costly, but Consistent Conformance With Its Documentation Policies Is Needed		34
	Asset Valuations Are Key to Determinations of Least-Cost Resolutions	34
	RTC's Valuation Method Designed to Use Realistic Discount Rates in Estimating Present Value of Assets	35
	RTC Used a Valid Approach to Estimate the Value of Failed Thrift Assets	36
	In 1992, RTC Did Not Always Document the Assumptions Underlying Asset Valuations	37
	RTC Said It Considered All Bids Received, but Documentation Needs to Be Improved	39
	Final Resolution Cost Determinations Cannot Be Certain	40
	Conclusions	41
	Recommendation	41
	Agency Comments	41

Chapter 4 RTC's Marketing Strategies Need to Be Better Documented 42
Rationale for Marketing Strategies Not Documented 42
Conclusions 44
Recommendation 44
Agency Comments and Our Evaluation 44

Appendixes
Appendix I: Summary Data on GAO Sample of RTC's 1992 Resolutions 46
Appendix II: Bid Summary Data on GAO Sample of RTC's 1992 Resolutions 48
Appendix III: An Overview of RTC's Asset Valuation Review Process 49
Appendix IV: Comments From RTC 54
Appendix V: Major Contributors to This Report 66

Tables
Table 3.1: RTC Documentation Deficiencies for GAO Sampled 1992 Resolutions 37
Table 4.1: Least Costly Resolution Methods for the 10 Thrift Resolutions Reviewed 44
Table I.1: GAO Sample of RTC's 1992 Resolutions 46
Table I.2: Assets Retained by RTC in GAO Sampled 1992 Resolutions 47

Figures
Figure 1.1: RTC's Typical Resolution Process 19
Figure III.1: RTC's AVR Approach to Valuing Assets 50

Abbreviations

ARP	accelerated resolution program
AVR	Asset Valuation Review
DOR	Division of Resolutions
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FSLIC	Federal Savings & Loan Insurance Corporation
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
P&A	purchase and assumption
RTC	Resolution Trust Corporation

Introduction

Resolving failed thrifts is a primary responsibility of the Resolution Trust Corporation (RTC), which was established by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and is scheduled to cease operation by the end of 1995.[1] Under FIRREA, RTC could select any resolution alternative for a failed thrift as long as the method selected was less costly to RTC than its net cost of paying off insured depositors and selling assets.[2] As of the enactment date (Dec. 19, 1991) of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), RTC is required to select the resolution alternative it estimates to be the least costly to RTC and to follow certain specific requirements for calculating and documenting the cost of resolution alternatives. FDICIA mandates that we report to Congress on RTC's compliance with these requirements.

Thrift Failures Accelerated During the 1980s

For over 50 years, the thrift industry has promoted home ownership through home mortgage lending. The industry has been the nation's primary lender in the housing finance market. During the 1980s, the industry experienced severe financial difficulties because of high and volatile interest rates, risky investments, fraud, mismanagement, and lax supervision. As a result, the number of insolvent thrifts rose dramatically. Between 1980 and 1988, 584 thrifts failed at a cost of $42.3 billion.[3] This number was more than 3-1/2 times as many as in the previous 45 years combined.[4] From 1989 through 1992, an additional 734 thrifts failed—318 in 1989, 213 in 1990, 144 in 1991, and 59 in 1992[5]—at a cost of $78 billion to taxpayers.[6]

[1]Resolution Trust Corporation Completion Act of 1993, Pubic Law 103-204, 107 Stat. 2369 (Dec. 17, 1993).

[2]In addition, FIRREA required RTC to conduct its operations in a manner that maximizes the net present-value return on the sale of failed thrifts and their assets and minimizes losses in resolutions. RTC interprets these provisions as having required the agency to resolve thrifts in the least costly manner since RTC's inception. RTC's Strategic Plan, dated December 31, 1989, directed RTC to allow potential acquirers to bid on a variety of resolution structures and required RTC to select the least costly of all resolution methods.

[3]Resolving The Thrift Crisis (April 1993), U.S. Congressional Budget Office.

[4]Resolution Trust Corporation: Policies, Procedures, Practices, and Results (GAO Briefing Notebook, General Government Division, Job Code 247047, Sept. 30, 1991).

[5]RTC 1992 Annual Report, pages 22 and 79.

[6]RTC's Office of Research & Statistics, Resolved Conservatorship Report for the Period of August 9, 1989 to December 31, 1992.

Congress Established RTC to Handle the Thrift Crisis

Congress passed FIRREA on August 9, 1989. FIRREA sought primarily to reform and recapitalize the federal deposit insurance system for thrifts and to enhance the regulatory and enforcement powers of financial institutions' federal regulatory agencies. Its objectives were to recapitalize the federal deposit insurance system for thrifts, provide for the resolution of outstanding and anticipated failures of these institutions, and preserve a safe and stable system for financing residential housing.

FIRREA established RTC and gave it responsibility for managing and resolving all troubled savings institutions that were previously insured by the Federal Savings and Loan Insurance Corporation (FSLIC) and for which a conservator or receiver was appointed during the period of January 1, 1989, through August 9, 1989. In addition, RTC was to resolve any thrift to which the Office of Thrift Supervision (OTS) appointed RTC as conservator or receiver between August 10, 1989, and August 8, 1992. Subsequent legislation extended RTC's resolution responsibility to September 30, 1993,[7] and ultimately to not later than July 1, 1995.[8] RTC is expected to complete most of its disposition of failed thrifts assets by its sunset date of December 31, 1995.

In addition to creating RTC, FIRREA abolished the Federal Home Loan Bank Board and FSLIC and transferred their regulatory functions to a new agency, OTS, with oversight by the Secretary of the Treasury. The statute also moved FSLIC's insurance function to the Federal Deposit Insurance Corporation (FDIC) and created the Savings Association Insurance Fund to provide deposit insurance to all federally insured thrifts.

FIRREA directed RTC to (1) maximize the net present-value return from the sale or other disposition of savings institutions and their assets, (2) minimize the impact of such transactions on local real estate and financial markets, (3) minimize the amount of any loss realized in the resolution of these insolvencies, and (4) maximize the availability and affordability of residential real property for low- and moderate-income individuals.

To fund RTC's activities, FIRREA provided $50 billion, including $18.8 billion of appropriated funds. An additional $36.7 billion was appropriated for RTC to use in carrying out its mission until April 1, 1992. Congress, RTC, and we recognized this amount as insufficient for RTC to complete its mission.

[7]Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991, 12 U.S.C. § 1441a(b)(3)(A) (Supp. III 1991).

[8]Resolution Trust Corporation Completion Act of 1993, Pubic Law 103-204, 107 Stat. 2369, 2410 (1993).

From April 1, 1992, to December 17, 1993, RTC was without appropriated funds. For this reason, RTC was able to resolve only 69 thrifts during calendar year 1992: 60 out of a conservatorship inventory and 9 through the Accelerated Resolution Program (ARP). One of the resolutions involved a failed thrift that was placed into conservatorship in 1992 and was sold by RTC in its entirety at no cost to the agency. In December 1993, Congress authorized approximately $18 billion in funding to resolve RTC's remaining failed thrift inventory and any anticipated thrift failures through June 30, 1995.

RTC Uses Many Strategies to Resolve Thrifts

OTS supervises and regulates federally-insured thrifts. When OTS considers a thrift to be in serious financial difficulty, OTS may place the thrift into ARP, which is operated jointly with RTC. Arrangements made under ARP are made with the cooperation and approval of the failing thrift's management. ARP is designed to aid in the sale of the troubled thrift's assets, deposits, and other liabilities to a healthy institution before the thrift fails.

Alternatively, a thrift fails when OTS (or a thrift's state chartering authority) declares the thrift insolvent or nonviable and appoints RTC as conservator or receiver for the failed thrift. OTS can appoint RTC conservator or receiver for a thrift on grounds such as a thrift's insolvency, capital inadequacy, or unsafe and unsound practices. As conservator, RTC operates a failed thrift pending its final resolution, and as receiver, it administers the closing of an insolvent thrift and liquidates all assets not disposed of in conservatorship or at resolution. At its inception, RTC inherited responsibility for resolving 262 failed thrifts that were placed in its conservatorship program. Since RTC's inception through 1992, an additional 436 thrifts were placed into RTC's conservatorship program. In addition, 34 thrifts were resolved through ARP.

RTC can select its resolution strategies from numerous methods. Initially in 1989, RTC attempted to do "whole thrift" purchase and assumption (P&A) transactions, which had been used at FDIC to resolve failed banks. In a whole thrift P&A transaction, the acquirer purchases most if not all of the failed thrift's assets and assumes most if not all of the deposits and other liabilities. This method generally protected uninsured depositors and minimized assets requiring sale by RTC. However, RTC found that for thrifts, the market was not receptive to such transactions because of the diminished value of a thrift charter, poor quality of thrift assets, and adverse economic conditions.

RTC also offers "standard" P&A transactions in which the acquirer purchases only some assets, including many variations of asset groupings, referred to as loan pools, and assumes some or all of the deposits and other liabilities. This transaction can enable the acquirer to return (or "put back") certain assets to RTC at a specific time, for reasons such as an inability to sell the assets or secure repayment from borrowers. Assets returned in this way are called "put backs."

In early 1991, RTC began to emphasize the "branch" P&A transaction. This is similar to the standard P&A, except that it encourages bids for one or more of a failed thrift's branches. Potential acquirers can submit bids to assume some or all branch deposits and purchase some assets. Regardless of the number of separate branch acquirers, RTC policy requires that all of a thrift's depositors be treated equally. Thus, all branch transactions must result in the uniform treatment of insured and uninsured depositors.

Other resolution methods available to RTC include

- insured deposit transfers in which acquirers assume the insured deposits and may assume certain other liabilities and may purchase some of the assets and
- insured deposit payouts in which RTC pays off the insured deposits and markets the assets after all other attempts to sell the thrift's assets fail.

Under all but the last of these transactions, insured deposit payouts, the acquirer usually pays a premium for the portion of the failed thrift it acquires. The cost to RTC of the thrift failure is thus equal to the amount of deposits and other liabilities assumed by the acquirer minus any premium RTC receives for the deposits and assets and minus RTC's share of the net proceeds from disposal of the failed thrift's assets. In an insured deposit payout, RTC's cost is the amount of insured deposits paid out minus its net recoveries on asset disposition.[9]

During RTC's efforts to manage a thrift in conservatorship, the RTC markets and sells some assets of the failed thrift before the institution is resolved. These assets are primarily high-quality, easily sold assets such as marketable securities, investments, and performing loans. RTC officials

[9]RTC's net proceeds from disposing of a failed thrift's assets do not include the portion of the proceeds going to other claimants. In either an insured deposit transfer or an insured deposit payout, the uninsured depositors and the general creditors of the failed thrift share the proceeds from asset disposition with RTC. In states with depositor preference statutes, depositor claims are satisfied first. A national depositor preference provision was passed in August 1993 that now provides all depositors preference over general creditors.

may also hold all or some assets for sale as a part of a resolution transaction to make the resolution more appealing to acquirers.

From inception through December 31, 1991, RTC resolved 584 thrifts and had 91 thrifts remaining in conservatorship. By the end of 1992, RTC had resolved an additional 69 thrifts and had a total of 81 thrifts remaining in conservatorship.

FDICIA Designed to Ensure Resolutions Are Done at Least Cost

In response to concerns about the financial stability of the banking and thrift industries and the financial health of the deposit insurance funds, Congress passed FDICIA in December 1991. The purpose of this legislation was primarily to provide backup funding for federal deposit insurance and to reduce taxpayers' exposure to losses when depository institutions fail.[10]

Congress also sought to stem losses and foster depositor discipline by passing the least-cost resolution provisions of FDICIA. Most significantly, Section 141 of FDICIA requires RTC to choose the resolution method that is the least costly to RTC of all possible resolution methods.[11] To make this least-cost determination, RTC must

- evaluate available resolution alternatives by computing and comparing their costs on a present-value basis, using realistic discount rates;
- select the least costly alternative on the basis of the evaluation;
- document the evaluation and the assumptions on which it is based, including any assumptions concerning interest rates, asset recovery rates, asset holding costs, and contingent liabilities; and
- retain documentation for at least 5 years.

FDICIA also requires RTC to calculate the cost of liquidation as of the earliest of the date on which (1) a conservator is appointed, (2) a receiver is appointed, or (3) RTC makes any determination to provide assistance to the thrift. In addition, FDICIA requires us to annually audit RTC's compliance with the least-cost provisions.

[10]FDICIA applies to RTC and FDIC relative to their responsibilities for resolving failing or failed thrifts and banks, respectively. We are reporting separately on FDIC's compliance with FDICIA's least-cost provisions. See 1992 Bank Resolutions: FDIC Chose Resolutions Methods Determined Least Costly, but Needs to Further Improve Its Process (GAO/GGD-94-107, May 10, 1994).

[11]Section 13(c)(4)(G) of the Federal Deposit Insurance Act provides for a systemic risk exception to the least-cost requirement if a finding is made that compliance with the requirement would have serious adverse effects on economic conditions and that a more costly alternative would mitigate such adverse effects. To date, RTC has not relied on this exception.

In an earlier review of the resolution of CrossLand Savings Bank,[12] by FDIC, which is subject to the same least-cost provisions of FDICIA as RTC, we were critical of the quality and lack of adequate documentation of FDIC's evaluations and assumptions. In addition to applying FDICIA's documentation criteria, we established the following criteria to aid FDIC and RTC in ensuring that their evaluations and assumptions are adequately supported:

- Documentation should be clear, consistent, concise, and complete so that an outside observer can identify and understand the estimated cost of each option, including the assumptions used.
- Data sources for the cost evaluation should be clearly identified so that cost figures can be traced to their sources.
- Assumptions integral to the cost evaluation should be documented and supported. In particular, each assumption should be (1) clearly identified and (2) supported by empirical data or, in the absence of such data, by judgment on the basis of relevant experience. This support should be explicitly described in the documentation and, where appropriate, the source(s) used in making the assumptions should be identified.
- If there is uncertainty about the validity of an assumption that materially affects the cost evaluation results, some effort to gauge that uncertainty should be made and documented by showing a range of possible outcomes.

In our review of the CrossLand resolution, we stated that we would apply the criteria listed above in reviewing the FDIC's and RTC's resolution decisions.

RTC's Resolution Process

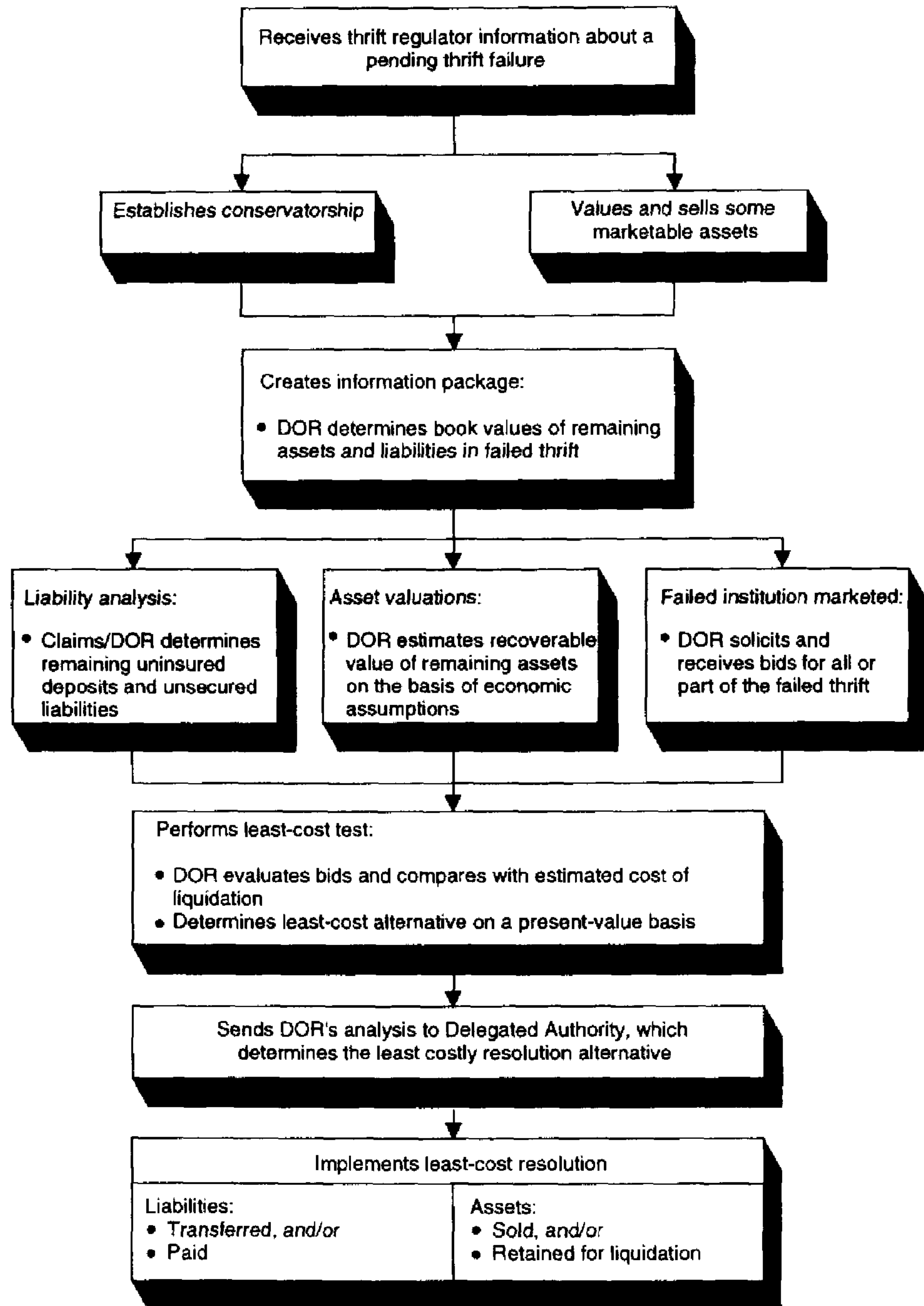
RTC's resolutions are to be carried out by its Division of Resolutions (DOR). As shown in figure 1.1, when OTS (or a state chartering authority) determines that a thrift must be liquidated or sold, OTS typically appoints RTC conservator.[13] For each failed thrift, OTS is to prepare and send to DOR a case transfer memorandum, which summarizes the thrift's problems, its ownership, the results of previous examinations, and the legal grounds for OTS to appoint RTC as conservator or receiver. At that time, RTC is to

[12] Failed Bank: FDIC Documentation of CrossLand Savings, FSB, Decision Was Inadequate (GAO/GGD-92-92, July 7, 1992).

[13] A pass-through receivership "PTR" process has been the predominant mode of passing failed savings institutions to the RTC. When OTS orders the closure of a failed thrift, it appoints RTC as receiver. RTC organizes and OTS charters a new federal mutual savings association. OTS appoints RTC as conservator of this newly chartered association. RTC as receiver passes most of the assets and liabilities to the RTC as conservator in a P&A arrangement.

assume control of the institution and continue its operations. It will then sell some of the assets, as noted earlier, and begin to develop strategies for marketing the institution.

Figure 1.1: RTC's Typical Resolution Process



(Figure notes on next page)

Note: In resolving a failed thrift, RTC often temporarily operates a failed thrift in a conservatorship before implementing and completing its resolution process. During a conservatorship, RTC typically follows its policies designed to downsize a failed thrift through asset sales and other activities.

Source: GAO review of DOR procedures.

The marketing and resolution of failed thrifts is to be done through either a regional or headquarters resolution process. The regional and headquarters processes are quite similar. Generally, regional offices are expected to handle institutions with $500 million or less in total liabilities at the date of conservatorship (nonmajor resolutions), while larger (major) resolutions are to be done in Washington, D.C.

While RTC is developing marketing strategies for the failed thrifts, it is expected to announce its intention to market the thrifts by contacting potential bidders on its regularly updated national marketing list. The list is a computerized database of about 10,000 thrifts, thrift holding companies, banks, bank holding companies, corporations, individual investors, or third-party agents that have expressed to RTC an interest in purchasing a thrift. RTC also contacts federal and state regulators to identify additional potential acquirers. Further, RTC is to publish its intention to market the thrifts in national newspapers.

DOR then is expected to prepare an information package on the institution to inform potential buyers of the composition of assets available for acquisition and liabilities for assumption. The package is to provide an in-depth description and accounting of the thrift's financial condition as well as information about RTC's marketing—including the resolution methods that acquirers should consider in their bids and instructions on bidding.

In selecting a marketing strategy, DOR is required to consider resolution methods that are potentially available.[14] Several marketing strategies may be considered—including some very complex combinations of resolution methods. RTC policy is to offer bidders the maximum number of bidding options possible within the constraints of the failed thrift's back-office capabilities, such as the capability of its data processing or accounting

[14]According to RTC officials, RTC prefers to do resolutions through ARP. RTC officials said that through mid-February 1994, RTC had completed 35 ARP transactions. The officials stated that had RTC been provided sufficient loss funding when FDICIA passed in December 1991 RTC would have pursued ARP transactions and avoided placing failed thrifts in RTC's conservatorship program.

system to separate costs relative to branches, subsidiaries, or other affiliated entities. If possible, RTC offers failed thrifts on a branch-by-branch basis.

Resolutions done in the field are to be prepared by regional officials. These officials are to prepare and submit to a DOR headquarters official a recommendation outlining resolution methods considered viable. The headquarters official is to select the marketing strategy from those methods outlined. DOR headquarters officials also are to determine and approve the marketing strategies for major transactions.

Concurrent with developing a marketing strategy, DOR staff are to contract for or prepare an on-site valuation of the failed thrift's assets. The valuation is an estimate of the amount that RTC would recover if it were to sell the assets, otherwise known as the net realizable value. The valuation process uses several computer models to value assets and inputs such as liquidating costs, recoveries when assets are sold, and marketing costs. The estimated values used depend on the valuation team's professional judgments about the value of the inputs.

Creditor analyses are also to be done at this time. The RTC Claims Section is to prepare an estimate of the amount of deposits and determine whether they are insured or uninsured. RTC's legal counsel is to estimate the amount of contingent liability from pending litigation. The asset valuation team is to value other types of contingent liabilities, such as standby letters of credit and unfunded loan commitments.

After selecting a marketing strategy, DOR officials are to hold a bidders' meeting with potential acquirers. The acquirers to be invited are those from the previously mentioned RTC national marketing list and those who responded to advertisements. Before receiving the information package or being admitted to the bid meeting, a confidentiality agreement is to be signed by potential bidders. The proposed transaction is to be discussed, and bidders with continuing interest in the institution are to secure permission to perform due diligence. Due diligence is the bidders' on-site inspections of the books and records of the institution and assessment of the value of the assets and liabilities. Due diligence enables bidders to prepare their bids.

During the bidders' meeting, DOR is to advise potential acquirers when bids should be submitted. Potential bidders are not required to attend the meeting to submit a bid. For each bid received, RTC is to evaluate its

expected cost for resolving the failed institution. RTC then is to compare these cost evaluations to each other and to RTC's estimate of the cost of liquidating the institution. FDICIA requires that RTC select the resolution option that has the lowest estimated cost to RTC.

Once bids are evaluated, the least-cost determination is to be made. A decision package is then to be prepared and submitted to the official who has been delegated the authority to approve the transaction by RTC's President and Chief Executive Officer. The decision package is also to include information about the share of the estimated resolution loss, if any, to be absorbed by uninsured depositors.

After a resolution decision is made, RTC is to dispose of any remaining assets and liabilities, which can take months or years.

Objective, Scope, and Methodology

The primary objective of our review was to determine the extent to which RTC complied with FDICIA requirements to select the least costly alternatives for resolving failed institutions. In this first report on RTC's compliance, we surveyed the RTC resolution process in place in 1992, which continues to evolve, to identify the key controls and potential vulnerabilities.

To address our overall objective during the survey, we extensively discussed the RTC resolution process with various RTC corporate, conservatorship, and resolution officials. We also reviewed pertinent RTC policies and procedures and correspondence with Congress and others relative to those policies and procedures. As shown in figure 1.1, we flowcharted the process as we understood it, and we had cognizant RTC officials verify the accuracy of the flowcharted process.

RTC policy during 1992 was to sell some marketable assets of failed thrifts held in conservatorship before applying its resolution process for marketing and considering resolution alternatives for the remaining thrift assets, deposits, and other liabilities. Since RTC lacked appropriated funds for resolving failed thrifts after April 1, 1992, RTC resolved only 69 thrifts during 1992. These 69 thrifts are composed of 59 thrifts placed into conservatorship pre-FDICIA, 1 thrift placed into conservatorship post-FDICIA and resolved at no cost to RTC, and 9 ARPs. An additional 49 thrifts were placed in conservatorship in 1992, but were not resolved due primarily to a lack of available funding. We, therefore, assessed the adequacy of RTC's

1992 corporate policies—as reflected in figure 1.1—to ensure compliance with FDICIA's least-cost provisions.

We concentrated our detailed analysis—as applied to those thrift resolution decisions made in 1992—on RTC's (1) selection of the least costly alternative, (2) asset valuation techniques and whether the assumptions used were adequately documented and supported, and (3) identification of the challenges and uncertainties inherent in implementing the law—such as determining the amount of uninsured deposits and estimating future recoveries on assets. We also considered RTC's marketing efforts to consider available resolution alternatives.

To perform our analysis of these aspects of RTC's resolution process, we judgmentally selected for review 10 of the 69 thrift resolution decisions made by RTC in calendar year 1992. The 10 thrifts had assets of $11.9 billion, and the estimated costs to RTC to resolve these thrifts was $3.4 billion. (See apps. I and II for greater detail.) The 69 thrifts had assets of $35.3 billion, with estimated resolution costs to RTC of $7.2 billion. Our selection criteria included headquarters and regional resolutions and varying attributes such as different types of resolution methods and dates resolved. Of the 10 sampled resolutions, 6 were resolved at DOR headquarters in Washington, D.C., and the remaining 4 were resolved at regional offices—2 in Atlanta and 2 in Denver. While this selection provided a cross section of 1992 RTC resolutions, the results of this judgmental sample are not generalizable to the 69 resolutions done by RTC in 1992.

We developed a data collection instrument to document and track the information collected and evaluated during our review of the resolution case files. We collected data from the inception of resolution activity through the final resolution decision. In particular, we focused on DOR's approaches to marketing the institution, asset valuations, the adequacy of documentation of the assumptions used, bids received and evaluated via application of the cost test, and the treatment of uninsured depositors.

Because asset valuations are critical to the least-cost determination, we reviewed in considerable detail the computer program models developed by RTC to value assets. We concentrated primarily on the assumptions and financial calculations used in the models to determine whether they would result in reasonable valuations. We discussed the types of assumptions and calculations used by RTC with officials from large private organizations actively involved in valuing and purchasing assets similar to those sold by

RTC. Obtaining information on their asset valuation approaches provided us a basis for assessing the adequacy of RTC's efforts. The valuation of a thrift's assets often involves thousands of assets. Consequently, time constraints precluded our reviewing the supporting documentation of a thrift's asset valuations to ensure their accuracy.

To further address our audit objective, we also examined the financial calculations DOR used to estimate the cost of resolution alternatives. However, due to the subjectivity inherent in the valuation of assets and estimation of future asset recoveries, we assessed the adequacy of RTC's resolution process to select the least costly resolution. We did not determine whether, in fact, the least costly resolution alternative was selected.

RTC provided written comments on a draft of this report. These comments are presented and evaluated in chapters 2, 3, and 4 and, together with our responses, are reprinted in appendix IV.

We did our work between August 1992 and December 1993 at RTC headquarters in Washington, D.C., and DOR regional offices in Atlanta and Denver. Our work was done in accordance with generally accepted government auditing standards.

RTC Corporate Policies Did Not Ensure Full Compliance With Least-Cost Provisions

Our review of corporate policies in effect for 1992 identified least-cost compliance issues with respect to three specific policies. First, RTC's policy on the treatment of uninsured depositors, in effect through September 1993, did not ensure that such depositors would share in losses if necessary to achieve the least costly resolution as required by FDICIA's least-cost provisions. Second, RTC's policy on liquidation cost estimates did not comply with FDICIA because it did not require RTC to estimate liquidation costs as of the date it was appointed conservator. Finally, RTC's policy on the sale of assets from conservatorships did not require RTC to consider alternative resolution methods before asset sales. On this latter point, RTC officials advised us that they were without appropriated funds for resolutions during most of 1992, and, therefore, they believed selling assets was in effect the only resolution alternative available.

RTC defended its policies in these areas by citing several factors, including the large backlog of thrifts awaiting resolution in 1992 and a lack of funding for resolutions. Whatever the merits of these factors, they are now largely moot. We believe that RTC, with restored funding and fewer expected thrift failures, should be able to modify its policies to ensure full compliance with FDICIA for the remainder of its existence.

RTC's Policy on Uninsured Depositors Did Not Ensure Compliance With FDICIA

RTC's policy on uninsured depositors throughout 1992 did not ensure that uninsured depositors would share in losses if necessary to achieve the least costly resolution. FDICIA allows RTC to assume the cost of fully paying uninsured depositors only if such payments are part of a resolution alternative determined to be least costly.[1] However, RTC's policy, until September 1993, typically was to assume all deposits into the conservatorship regardless of insurance status and without requiring uninsured depositors to share in estimated losses as of the date the conservatorship was established. Without either freezing the uninsured

[1]As FDIC noted in its regulations on the treatment of uninsured depositors, the least-cost requirements of FDICIA prohibit the passage of uninsured deposits to an acquiring institution unless that particular resolution represents the least costly resolution alternative. Further, the least-cost provisions specifically prohibit RTC from taking any action after December 31, 1994, that would have the effect of increasing losses by protecting depositors for more than the insured portion of their deposits. This provision makes clear that the agency is not prohibited from engaging in P&A transactions where uninsured deposits are acquired as long as the loss to the fund on those deposits is no greater than the loss that would have been incurred from those deposits had the institution been liquidated. Interpreting this provision in the preamble to its regulations on the treatment of uninsured depositors, FDIC stated that the provision is "subsumed in the more general least cost provisions of section 13(c)(4)(A) and has no independent operative effect." (58 Fed. Reg. 67662, Dec. 22, 1993.)

portion of deposits or haircutting uninsured depositors[2] when a thrift is initially placed in a conservatorship, RTC cannot be assured that it is complying with the least-cost provisions.[3]

RTC officials advised us that the agency established this policy because it was concerned that uninsured depositors who incurred a loss on a portion of their deposits going into conservatorship might remove their remaining deposits, which would increase the ultimate resolution costs. Additionally, RTC officials believed that such a policy change, without prior public notice, could lead to depositor runs. The officials cited the large number of weak but open thrifts operating in 1992 as potential candidates for depositor runs if RTC suddenly began imposing losses on uninsured depositors at the time a thrift failed and was put into an RTC conservatorship. They also believed that such runs could take place in marginal banks. They further contended that such runs could add unpredictably to resolution costs and could disrupt service to customers.

During 1992, RTC began evaluating whether it should change its treatment of uninsured depositors at the time a failed thrift was to be placed in conservatorship. RTC officials advised us that extensive discussions of a proposed policy change took place from 1992 through mid-1993 among RTC, its Thrift Depositor Protection Oversight Board, the Department of the Treasury, and Congress. However, RTC did not actually revise its policy until September 1993. For thrifts that fail after September 1993, RTC's revised policy requires that uninsured depositors be given access to only that portion of their uninsured deposits equal to their expected pro rata share of the proceeds from the resolution of the failed thrift. RTC is to make an insurance determination before deposits are assumed into a conservatorship. Only insured deposits are to be assumed by the conservatorship. Uninsured depositors are to receive an advanced dividend on the basis of their pro rata share of the estimated resolution proceeds, and they can submit claims for the remainder of the uninsured deposits. We believe this revised policy, if effectively implemented, should better ensure RTC compliance with that aspect of FDICIA's least-cost requirements.

[2]A "haircut" of uninsured deposits means that a depositor's access to the uninsured portion of their deposit account would be restricted to the portion of the deposit that RTC expected the uninsured depositor to eventually recover after the final resolution of the failed thrift.

[3]According to RTC officials, uninsured deposits were on average a relatively small portion (about 0.4 percent) of those thrifts' total deposits RTC resolved in 1992.

RTC Policy Did Not Require Liquidation Cost Estimates as of Conservatorship Start Dates

FDICIA requires RTC to determine the cost of liquidating a failed thrift as of the earliest of (1) the date a conservator is appointed, (2) the date a receiver is appointed, or (3) the date of a determination to provide assistance to a failing or failed thrift. For the 50 thrifts that were placed in conservatorship in 1992, the earliest of those dates was the date a conservator was appointed.

For thrifts that failed and were placed into conservatorship in 1992, RTC's policy was to make an initial estimate of the thrift's insured deposits as of the date RTC was appointed conservator. A second estimate of insured deposits was to be made nearer the time of final resolution and used in RTC's calculation of liquidation costs. RTC's policy did not require it to make any estimate of the other component of liquidation costs—expected recoveries on assets—as of the conservatorship start date. Rather, RTC's policy was to estimate expected recoveries on assets as of the time it was preparing for the final sale or dissolution of a conservatorship.

RTC officials told us that, in their view, RTC is not required to estimate the costs of liquidation as of the earliest of the three dates specified in FDICIA. RTC believes that it has the discretion to estimate expected recoveries on assets at the time of its least-cost analysis, on the basis of an FDICIA provision relating to the calculation of liquidation costs. This provision states that RTC, for purposes of comparing the costs of liquidation with the costs of other resolution alternatives, must use a liquidation cost figure equal to the sum of the insured deposits of the institution "as of the earliest of the dates described" in the statute, minus "the present value of the total net amount the Corporation reasonably expects to receive from the disposition of the assets of such institution in connection with such liquidation."[4]

In our view, the basic statutory provision requiring RTC to determine liquidation costs as of the earliest of the three specified dates means that RTC must estimate both components of those costs—the amount of insured deposits and expected recoveries on assets—as of the earliest date. Nothing in the provision cited by RTC alters this basic statutory requirement. Rather, the provision cited by RTC pertains to its calculation of liquidation costs for purposes of comparing those costs with the costs of other resolution alternatives. While that provision would allow RTC to revise its asset valuation estimate in cases where asset values have changed since the appointment of a conservator, it does not in any way negate the requirement that RTC make an estimate of liquidation

[4]Section 13(c)(4)(D) of the Federal Deposit Insurance Act, as amended by FDICIA.

costs—including expected recoveries on assets—as of the earliest of the three statutory dates.

In addition, while the provision cited by RTC would allow it to update its initial asset valuation estimate for least-cost comparison purposes, that provision does not allow RTC to revise its initial estimate of insured deposits. Rather, FDICIA specifically requires RTC to hold constant its estimate of insured deposits as of the earliest of the dates identified in the statute and to use this estimate in calculating the liquidation costs it is to compare with other resolution alternatives. For this reason, RTC's policy of making a second estimate of insured deposits for use in calculating the liquidation costs it is to compare with other resolution alternatives is inconsistent with FDICIA.

RTC officials gave us several additional reasons for RTC's policy on liquidation cost estimates. RTC officials told us that RTC did not estimate the costs of liquidation as of the conservatorship start date because it did not have appropriated funds available after April 1, 1992, for use in resolving failed thrifts. As a result, RTC maintained that making liquidation cost estimates on new conservatorships would be a waste of resources because the results would be outdated by the time the actual resolution took place after funding was restored. We agree that a liquidation cost estimate is likely to change over time if a thrift remains in a lengthy conservatorship. However, making the estimate when required by FDICIA should provide RTC a valuable baseline for comparing alternative asset disposition strategies before RTC sells high-quality assets from thrifts in conservatorship.

Further, RTC officials told us that because RTC is not authorized to enter a thrift before its failure without the thrift's approval, RTC may not have access to the data necessary for making a liquidation cost estimate at the beginning of a conservatorship. While we agree that early access to a failing thrift's books and records would be helpful, RTC is not precluded from making a liquidation cost estimate "as of" the conservatorship start date after it assumes control of a failed thrift.

In addition, we believe that it may be possible for RTC and OTS to make arrangements for RTC to obtain early access to thrift information. OTS officials told us that they were willing to consider working with RTC to explore the feasibility of early access arrangements similar to those it had made in the case of thrifts handled under ARP. Under ARP, OTS provides RTC with early access to thrift information, if the thrift consents to such access, to aid in the sale of a troubled thrift to a healthy institution before the

thrift fails. As with ARP, RTC's ability to gain early access to a thrift for the purpose of calculating liquidation costs would depend on the cooperation and approval of the failing thrift's management.

RTC's Asset Sales Policy Did Not Require Review of Alternatives

FDICIA requires RTC to resolve a failed thrift in the least costly manner. In our view, the least-cost provisions contemplate that, before selling assets from a failed thrift, RTC must evaluate those resolution methods that are potentially available to determine whether they could produce a less costly resolution. In 1992 and 1993, RTC operated under a policy that generally resulted in the sales of assets from thrifts in conservatorship through a process called "downsizing." RTC maintains that this general policy is based on their experience with many thrifts in 1989 and 1990 for which resolution proceeds were not maximized through the simultaneous offering of substantially all of the institution's assets with its deposit franchise. Moreover, according to RTC, its lack of funding during much of 1992 and 1993 limited the availability of alternative resolution methods.

According to the RTC Conservator's Operating Manual, a goal of downsizing was to reduce the institution in conservatorship to the level of core deposits; fixed assets, such as buildings and office equipment; and cash or cash equivalents. Thus, such a reduction would lower the thrift's expenses and RTC's administrative costs in the final resolution of the thrift. The assets sold in downsizing were to be primarily high-quality, easily sold assets such as marketable securities, investments, and performing loans. RTC often pooled these assets with assets from other failed thrifts and sold the pools through RTC program activities, such as asset securitization and bulk sales.[5]

RTC's policy did not require it to explore other potential resolution methods before selling assets from conservatorship. Specifically, there was no requirement that RTC explore whether methods involving the sale of assets as part of the thrift, to one or more acquirers, could produce a less costly resolution. RTC's policy required it to consider alternative methods on only an exception basis, in instances where RTC officials were aware of acquirers' interest in all or part of the failed thrift. An RTC resolutions official told us that the exception was invoked for about 15 percent of the thrifts placed in conservatorship.

[5] In March 1993, RTC revised its downsizing policy to discontinue the sale of high-quality assets from conservatorships. This revision was primarily because RTC found that high-quality assets provided the conservatorship a better return than selling them and investing the proceeds in lower yielding securities.

According to RTC officials, RTC's experience was that its asset sales approach maximized returns on asset disposition. On this basis, RTC maintained that as a general proposition the asset sales approach yields least-cost resolutions and is consistent with FDICIA. RTC officials also told us that they found through past experience that most failed thrifts RTC assumed from OTS had little or no franchise value and that acquirers had little or no interest in acquiring a whole thrift or many of the assets held by the failed thrifts.

In addition, RTC officials said that the agency's choice of resolution methods was severely limited because RTC lacked funds during much of 1992 and 1993. Specifically, the officials said that RTC, without funds to arrange assisted acquisitions, viewed downsizing as the only practical alternative for many thrifts.

We cannot, from our review of RTC's 1992 resolution process, assess the extent to which 1992 funding difficulties limited resolution methods available to RTC or made downsizing the only practical alternative for thrifts that failed in 1992. However, we do not believe that RTC can continue its downsizing policies for thrifts that fail in 1994 or 1995, for which funds have been appropriated, and be assured of its compliance with the least-cost provisions. FDICIA obligates RTC to evaluate before downsizing whether other methods of resolving the particular thrift are potentially available. In our view, RTC cannot meet this obligation under a policy that relies on a general assumption that asset sales produce least costly resolutions and requires RTC to explore market interest in a thrift on only an exception basis.

RTC Policy Changes Needed for Future RTC Compliance With FDICIA

The previous sections of this chapter showed that specific RTC policies in place in 1992 and most of 1993 did not fully ensure compliance with FDICIA's least-cost provisions. As already noted in this chapter, RTC has recently revised its policies regarding uninsured depositors. Additionally, Congress recently provided the funds necessary to complete the resolution of all current conservatorships and expected thrift failures in 1994 and 1995. We believe that with these events and with fewer thrift failures expected in the future, RTC can attain full compliance with FDICIA by making additional revisions to its current conservatorship and resolution policies.

At the beginning of 1994, RTC had 63 existing conservatorships awaiting final resolution and is now working on the final sale of each of those

institutions. Since nearly all of those thrifts have been in conservatorship for at least 6 months, much downsizing has already taken place in most of them. Therefore, the only resolution step left is the disposition of the remainder of the franchise. As we will describe in chapter 3, RTC's resolution procedures at this stage of the process are adequate to ensure compliance with FDICIA's requirements for calculating, evaluating, and documenting the cost of each resolution alternative. However, we have found areas in which RTC has failed to follow those procedures.

Legislation passed in late 1993 extended RTC's resolution authority through June 30, 1995. However, OTS and RTC expect the rate of future thrift failures to be relatively low in the near term. Therefore, with restored funding, a much smaller backlog of conservatorships, and fewer thrift failures, RTC should be well-positioned to accelerate its resolution process for thrifts that fail in 1994 and 1995. Thus, RTC now should be in position to make a liquidation cost estimate as of the earliest of the three statutory dates as established by FDICIA. RTC's policies also now require that uninsured depositors absorb their share of expected losses at the time of failure, which could be more precisely determined with this liquidation cost estimate.

Beyond those changes, for thrifts that fail in 1994 and 1995, the small RTC backlog combined with the restored funding should permit RTC (1) to move quickly to resolve the institutions in their entirety and (2) to consider marketing most or all of each thrift as a package before breaking out some or most of each thrift's assets and disposing of them separately. There should no longer be a prolonged period of downsizing separate from the disposition of the franchise. Thus, it should be both practical and desirable for RTC to ensure that all aspects of resolving any thrifts that fail during the remainder of its existence comply with FDICIA. In fact, RTC officials advised us that they anticipate that most thrifts that fail in 1994 and 1995 will be resolved through ARP. Doing so would make it even easier for RTC to meet the applicable FDICIA requirements discussed earlier in this chapter. In any event, we believe that RTC should move quickly to change those policies cited in this chapter as not ensuring full compliance with FDICIA if those policies will continue to be instrumental to future thrift resolutions.

Conclusions

RTC's policy on uninsured depositors throughout 1992 and most of 1993 did not ensure that uninsured depositors would share in losses if necessary to achieve the least costly resolution. FDICIA allows RTC to assume the cost of fully paying uninsured depositors only if such payments are part of a

resolution determined to be least costly and if the amounts received from acquirers are sufficient to cover losses that could have been imposed on uninsured depositors. RTC's policy was to avoid imposing losses on uninsured depositors at the time conservatorships were established because RTC was concerned about the adverse impact such losses may have had both on depositors in the failed thrift and on the thrift industry. This policy was replaced in September 1993 by one requiring uninsured depositors to share in estimated losses on thrifts being placed into conservatorship.

While FDICIA clearly requires RTC to estimate the cost of liquidating a failed thrift as of the earliest of three dates specified in the statute, RTC's policy was to estimate only insured deposits as of the conservatorship start date. RTC's policy was to estimate the second component of liquidation costs, expected recoveries on assets, as of the time of final resolution. This policy, as well as RTC's policy of revising insured deposit estimates for purposes of calculating liquidation costs in its least-cost analysis, was inconsistent with FDICIA.

RTC's policy of selling assets from thrifts in conservatorship did not require RTC to first evaluate whether alternative, potentially less costly resolution methods were available. According to RTC officials, its lack of funding during much of 1992 and 1993 made downsizing the only practical alternative available.

The statements of RTC officials reported in this chapter are helpful to understand the difficulties that they faced in implementing the least-cost provisions. However, whatever the merits of the reasons RTC offered for its policies, those reasons are largely moot. For the remainder of 1994 and 1995, we believe that RTC can and should change its policies to ensure full compliance with FDICIA.

Recommendations

We recommend that the RTC Deputy and Acting Chief Executive Officer

- revise RTC's policies to require that the agency estimates liquidation costs as of the earliest of (1) the date a conservator is appointed, (2) the date a receiver is appointed, or (3) the date of a determination to provide assistance to a failing or failed thrift and
- revise RTC's policies to require that the agency evaluate the resolution methods that are potentially available before selling assets of a failed thrift.

Agency Comments and Our Evaluation

RTC provided written comments on a draft of this report, which together with our detailed response appears in appendix IV. RTC did not respond specifically to these recommendations, but said that it believes its policies are consistent with the requirements under the FDICIA least-cost provisions.

We continue to believe that RTC's policies on liquidation costs and asset sales need to be revised to be consistent with the least-cost provisions. In the case of RTC conservatorships, we believe these provisions require that the liquidation cost estimates—including estimates of insured deposits and recoveries on assets—be calculated as of the conservatorship start date. We believe it imperative that RTC estimates liquidation costs at the time of conservatorship, not just to comply with FDICIA requirements, but to engage in a sound business practice that establishes a meaningful baseline to aid in making cost-effective asset disposition decisions as well as for comparing resolution alternatives. Additionally, in our view, RTC can sell assets from a failed thrift consistent with FDICIA only if RTC first explores other resolution methods and determines that methods involving the sale of assets with the thrift are not likely to produce a less costly resolution.

We do not believe RTC can meet this requirement by applying a general assumption, on the basis of its past experience, that acquirers are not interested in purchasing assets with the deposit franchise. Without a policy requiring RTC to evaluate the potential availability of other, less costly resolution methods for the particular thrift before assets are sold, neither RTC nor GAO can assure Congress that RTC is complying with FDICIA's least-cost provisions.

RTC Selected Alternatives It Determined Least Costly, but Consistent Conformance With Its Documentation Policies Is Needed

During a conservatorship, RTC is to manage a failed thrift until it is scheduled for resolution. The conservatorship period provides RTC an extended "hands on" period to learn about a failed thrift's operations and its asset portfolio and deposit structure. Many of a failed thrift's high-quality assets, such as performing home mortgage loans, were often sold during the conservatorship.[1] As the conservatorship is prepared for closure and the resolution process begins, the remaining assets that RTC prepares to market as part of the resolution transaction include primarily cash and a relatively small amount of any remaining high-quality assets. This occurs in part because of the conservatorship asset sales activities and in part because RTC at resolution generally retains certain problem assets, such as nonperforming loans and owned real estate, for liquidation after the resolution transaction. Resolutions also typically include acquirers assuming responsibility for the remaining deposits or at least the insured deposits.

RTC's written process provides for compliance with FDICIA's requirements and our criteria (discussed in ch. 1) for documentation, assumptions, and cost calculations necessary to ensure least-cost resolution determinations for those assets and deposits and other liabilities included in the resolution transaction. However, in the 10 resolutions we sampled,[2] we found that not all aspects of the process were consistently implemented in making the 1992 least-cost determinations. RTC officials consistently selected the resolution alternative determined by DOR staff to be least costly. However, RTC needs to better ensure adequate documentation of its assumptions, cost calculations and underlying assumptions, and adherence to its own procedures.

Asset Valuations Are Key to Determinations of Least-Cost Resolutions

RTC is to prepare an information package that summarizes a failed thrift's assets as well as deposits and other liabilities on the basis of the thrift conservatorship's financial records. This provides potential acquirers and RTC with a common base of information to estimate (1) the amount that potential acquirers may bid for the institution's assets and deposits and (2) the net realizable value of the thrift's assets, less the cost to pay off

[1]In March 1993, RTC revised its downsizing policy to discontinue the sale of high-quality assets from conservatorships, primarily because it found that these assets provided the conservatorship a better return than selling them and investing the proceeds in lower yielding securities.

[2]As discussed in chapter 1, RTC makes its resolution decisions and least-cost determinations at the end of conservatorship. RTC applied its resolution procedures to the 69 thrifts it resolved in 1992. We judgmentally sampled 10 of those 1992 resolutions to determine whether those procedures were effectively implemented and provided for compliance with documentation, assumption, and cost-calculation requirements for those thrift assets, deposits, and other liabilities remaining at the end of the conservatorships.

insured depositors and other secured creditors. Basically, RTC is to estimate liquidation costs by calculating the difference between the result of its asset valuation and the amount to be paid to insured depositors. To determine the least costly resolution alternative, RTC is to compare the estimated liquidation cost with the bids received from potential acquirers.

FDICIA requires RTC to calculate the cost of each resolution alternative on a present-value basis using "realistic discount rates." FDICIA further requires that RTC document its evaluation including assumptions upon which the evaluation is based.

Some types of assets can be fairly precisely valued, while other types are judgmentally valued on the basis of a number of often uncertain factors. The value of cash and marketable securities can be determined precisely from reconciling cash balances to books and readily available financial sources such as The Wall Street Journal, respectively. However, the values of loans—which typically comprise the bulk of thrifts' assets—are more difficult to determine. Loans such as mortgages and consumer loans must be valued with consideration to the risk associated with repayment as well as interest rates, the value of any underlying collateral, and other factors. Even more imprecise are the valuations of assets such as loans in default or real estate owned, involving borrower defaults and foreclosures. Generally, RTC has found these types of assets particularly difficult to sell with resolution transactions.

RTC's Valuation Method Designed to Use Realistic Discount Rates in Estimating Present Value of Assets

We determined that the asset valuation method RTC used in 1992 complied with the FDICIA calculation rules. We also determined that the basis of the RTC asset valuation method—its calculation of present value and its basis for determining realistic discount rates—was consistent with those generally used in private sector firms experienced in valuing and acquiring thrift and bank assets as well as by academicians who have studied such valuations. RTC's selection of discount rates varied according to a variety of factors—market rates at the time of the resolution and risks associated with the assets, such as credit risk, for example. Our review of the Asset Valuation Review (AVR) process is discussed in further detail in appendix III.

To determine if RTC's valuations of assets were calculated on the basis of present value with realistic discount rates, or market-based rates, we reviewed RTC's asset valuation method and RTC's documentation of determining "realistic" discount rates in estimating the present value of the

failed thrifts' assets. Also, to better understand the selection of discount rates and the use of present-value analysis, we reviewed the academic literature on asset valuation and interviewed officials of five private sector firms, including banks and securities and investment firms involved with valuing asset portfolios similar in type to those of many thrifts and banks.

Private sector officials said that present-value analysis required assets to be judged in terms of a variety of aspects and market conditions. The analysis often requires estimating the timing and amount of cash flows from an asset to an investor. The cash flows generally represent an investor's returns (yield) from the asset purchased. If the investor's yield differs from current market rates for similar assets, the asset value—or selling price—is adjusted or discounted by an amount to essentially provide an investor with a yield comparable to the current market.

The officials said that they used discount rates that were based on a variety of factors. Some of the factors they mentioned included the firms' investment objectives, the relative quality of the asset to be acquired, the term the asset would be held, and how the quality of the asset might change during the period held.

RTC has established a process designed to identify realistic discount rates in a manner consistent with approaches used in the private sector. However, we could not always determine the basis for discount rates RTC used in valuing certain assets held by our sampled resolutions.

RTC Used a Valid Approach to Estimate the Value of Failed Thrift Assets

During 1992, RTC used one approach to estimate the present value of assets expected to be held by a failed thrift at the end of its conservatorship.[3] RTC relied on its AVR, which was based on an on-site review of a sample of asset files and records at the thrift.

RTC used the AVR results in estimating the difference between the book value of assets about the time of a thrift's resolution and the net present value that RTC could recover through liquidating the assets itself. A failed thrift's records generally reflect asset values that were based on historical cost. RTC has found that these values generally overstate the value that can be recovered through the agency's liquidation of the assets.

[3]As discussed in chapter 2, a failed thrift's assets may be sold during conservatorship through various RTC asset sales programs. A thrift's assets selected for such a sales program are usually sold in advance of the resolution decision, and even if not, they are not revalued as part of AVR. At the time of the resolution decision, the failed thrift's records will reflect the actual or estimated proceeds, i.e., cash expected to be realized from such sales.

In 1992, RTC Did Not Always Document the Assumptions Underlying Asset Valuations

FDICIA requires RTC to document the agency's evaluation of the costs of resolution alternatives considered, including the assumptions upon which the evaluations are based. FDICIA specifically requires documentation of any assumptions made relating to interest rates, asset recovery rates, asset holding costs, and payments of contingent liabilities. It also requires such documentation to be retained for at least 5 years. In addition, as discussed in chapter 1, we developed documentation criteria during our 1992 review of the CrossLand Savings Bank resolution that were designed to aid RTC and FDIC in supporting their evaluations and assumptions.[4] Among other things, key assumptions should be clearly identified and supported by empirical data or, in the absence of such data, by judgment that is based on relevant experience.

In reviewing our 10 sample resolutions, 5 of which had asset valuations that were performed (between January and August 1992) after the passage of FDICIA, we attempted to identify the underlying assumptions of asset valuations, focusing first on the types of assumptions described in the least-cost decision package. We were not always able to identify the underlying assumptions affecting asset valuations.[5]

We found that RTC did not adequately document the basis for its asset valuations. As a result, we could not identify the bases for all the underlying assumptions affecting the valuation process for our sample resolutions as shown in table 3.1.

Table 3.1: RTC Documentation Deficiencies for GAO Sampled 1992 Resolutions

	Documentation	
Assumption	**Adequate**	**Inadequate**
Interest rates	2	8
Holding costs	0	10
Asset recovery rates	8	2
Contingent liabilities[a]	1	7

[a]Two of the 10 sampled thrifts had no contingent liabilities on their books.

Source: GAO analysis of the final AVR report for each of the sampled resolutions.

We found that the underlying assumptions often were based on RTC's asset disposition experience, and on surveys of local firms dealing with the

[4]GAO/GGD-92-92, July 7, 1992.

[5]RTC's AVR methodology, as described in its August 1991 Methodology Description for Asset Valuation Reviews, requires the narrative section of the final AVR report to summarize the methods, assumptions, and conclusions used in calculating the net realizable values of a thrift's assets.

same types of assets being valued. However, RTC did not always document how it used this information to value specific types of assets held by a failed thrift. To provide an assessment of the effect of a failed thrift's letters of credit, and unfunded loan commitments, the AVR team estimated the recovery value. Legal contingent liabilities—lawsuits filed against and on behalf of the failed thrift—are to be done through a separate legal analysis by RTC's legal counsel, and the results are to be incorporated into the AVR report. The records for seven of the eight sampled resolutions that had legal contingent liabilities, however, did not include the legal analyses of the legal contingent liabilities nor could RTC officials provide us with copies of the completed analyses. Like recoveries on assets, the outcome of lawsuits and other contingent liabilities may not be known for several years after the resolution of a failed thrift.

FDICIA requires RTC to use realistic discount rates in valuing alternatives that RTC primarily applies to its valuation of assets. We found that RTC had relied on a standard discount rate of 15 percent to adjust the values of assets to reflect RTC's cost of funds or opportunity costs and its indirect expenses associated with asset recoveries. An RTC senior official said that this rate reflected RTC's pre-FDICIA experience for these cost elements and a midpoint of the actual range of cost rates reported by the RTC regions. Geographic location, in part, could have caused the regions to report different cost experiences.

The RTC senior official said that RTC adopted the standard 15-percent discount rate in July 1991 as a method to ensure each of the RTC regions consistently accounted for these costs. However, RTC did not document what portion of the discount rate reflected either the RTC's cost of funds or its indirect asset expenses for our sampled resolutions. Nor did RTC document its determination that the standard discount rate would be appropriate in calculating costs for thrifts resolved since FDICIA was enacted.

Both the RTC Office of Inspector General (OIG) and we reported earlier on problems with RTC's adherence to its procedures for documenting the basis for its AVRS.[6]

In April 1993, we reported that RTC completed AVRS (between June 1991 and January 1992) in a manner inconsistent with its procedures. Specifically, we reported that the AVRS lacked the required discussion

[6]Resolution Trust Corporation: Controls Over Asset Valuations Do Not Ensure Reasonable Estimates (GAO/GGD-93-80, Apr. 8, 1993). Asset Valuation Methods and the Appraisal Review Process, RTC Office of Inspector General (Audit Report A92-016, Apr. 28, 1992).

summarizing the methods, assumptions, and conclusions used to calculate asset values and that problems existed with the documentation for assumptions used when assets were valued. In April 1992, the RTC OIG also reported that it was unable to tell whether RTC had properly valued its assets according to policies and procedures. For AVRs completed between July 1990 and May 1991, the RTC OIG found a lack of sufficient documentation to support the AVR conclusions and asset recovery calculations as well as inadequate evidence of oversight of the asset valuation process.

The RTC Vice President of Resolutions said that efforts were made during the period of our audit to improve documentation of AVRs done at failed thrifts. The RTC official also said that AVRs for our sampled resolutions were done before the improvements were initiated and anticipated that future AVRs would better comply with the FDICIA documentation requirements and RTC's AVR requirements. Since the improvements were implemented in 1993, we did not assess the adequacy of these improvements in this review.

RTC Said It Considered All Bids Received, but Documentation Needs to Be Improved

In the 10 resolutions we reviewed, RTC approving officials selected the resolution method they determined to be the least costly from among those alternatives considered. We were also assured by the officials that they considered all bids received in determining the least costly resolution alternative, but did not estimate costs for all nonconforming bids. Also, the documentation of the reasons why bids were nonconforming and/or were not costed out needs to be improved.

To determine the least costly resolution alternative, RTC should estimate the cost of each bid it receives and compare those estimates to the cost of liquidation. More specifically, RTC should evaluate both conforming and nonconforming bids to the extent possible. In cases where RTC concludes that it is unable to evaluate a nonconforming bid, RTC should document its rationale for reaching its conclusion.

RTC's resolutions officials are to present their estimates and recommendation of the least costly resolution alternative to the deciding official who can vary on the basis of the size of the thrift to be resolved. The deciding official may accept the estimates and decide the resolution alternative on the basis of these estimates, or the official may raise questions and call for further analysis of costs before any decision is

made. In any event, the deciding official is responsible for ensuring the adequate documentation of the basis for the resolution decision.

In all 10 resolutions we reviewed, the deciding officials selected the resolution alternative recommended by DOR. RTC used its asset valuations and deposit estimates to document the estimated costs of the available alternatives within each of the 10 resolutions we reviewed, and compared the cost of liquidation to the potential acquirers' bids to determine the least costly alternative for resolution. However, RTC did not always document why it decided not to fully evaluate all nonconforming bids received. RTC officials advised us that as a matter of policy certain bids are considered nonconforming and generally are not costed out. For example, as a matter of policy, RTC does not cost out bids requiring RTC to issue a funding note to an acquirer. However, RTC resolution files did not always document the basis for such nonconformance. The Vice President of Resolutions advised us that he plans to issue a memo requiring his staff to provide better documentation of nonconforming bid evaluations.

Final Resolution Cost Determinations Cannot Be Certain

RTC's calculations of losses on assets complied with FDICIA requirements and the resolution alternatives selected were those RTC determined to be least costly. However, final resolution costs cannot be certain. Resolution cost determinations are uncertain in part because of the possibility of events occurring both before and after the resolution decision. Such events include

- fluctuations in the amount of uninsured deposits between the date of the RTC cost evaluation and the date the thrift is closed, which can affect the amount of losses RTC may impose on uninsured depositors as part of a resolution decision and
- unanticipated gains or losses from (1) conservatorship and receivership asset sales or (2) lawsuits filed against or on behalf of the failed thrift could affect recoveries on assets estimated at the time of the resolution decision.

While many of a failed thrift's assets, retained by RTC after conservatorships are dissolved and resolution decisions are made, are placed in receivership in anticipation of being sold as quickly as possible, it may take many months or years until such asset sales are completed and the receivership is terminated.[7] Asset recoveries are subject to

[7]From its inception in August 1989 through December 1993, RTC has resolved 680 thrifts. In July 1992, RTC set up its Receivership Termination Program and, through December 1993, has terminated 77 receiverships, or about 11 percent of the resolved thrifts.

uncertainties because of changing market and economic conditions affecting asset values. Such changes could reduce or increase actual recoveries from the level estimated at the time of the resolution decision. RTC intends to use information about such recoveries in future asset valuations and loss estimations. Additionally, RTC officials told us that to implement RTC's September 1993 policy on the treatment of uninsured depositors, they have started using such information as a basis to estimate the amount of initial losses to impose on uninsured depositors at the time a thrift is placed into conservatorship.

Conclusions

RTC calculated its cost to resolve a failed thrift using a present-value analysis method as prescribed by FDICIA. RTC established and followed a reasonable process to identify realistic discount rates, based on market conditions and risk factors, which it used in its cost calculations. During 1992, RTC did not adequately document the underlying assumptions affecting its cost calculations and it failed to consistently follow its own AVR procedures.

For our 10 sampled resolutions, we could trace RTC's analyses of resolution alternatives to the source documents providing the bases for the analyses. On the basis of our analyses, RTC selected the resolution alternative it identified as being the least costly.

Actual resolution results cannot be known until essentially all of a failed thrift's assets have been sold and the receivership has been terminated. Resolution results are subject to uncertainty since estimated asset recoveries can be affected by future economic events.

Recommendation

The RTC Deputy and Acting Chief Executive Officer should direct the Division of Resolutions to require that the consideration given all nonconforming bids received be documented.

Agency Comments

Although RTC said it believes its documentation is adequate, it agreed to initiate action to better document its consideration of conforming and nonconforming bids.

RTC's Marketing Strategies Need to Be Better Documented

After RTC becomes a failed thrift's conservator, it sells some of the assets, as discussed in chapter 2, and begins to develop marketing strategies for resolving the remaining assets, deposits, and other liabilities. While FDICIA requires RTC to resolve failed thrifts in the least costly manner, the statute does not prescribe the way in which RTC must consider the realm of all possible resolution alternatives. Thus, RTC has considerable discretion to construct a strategy from among a large number of variations within the basic resolution methods in any given resolution.

RTC's marketing decisions, which determine how failed thrifts are presented to potential acquirers, can affect the range of alternatives considered by potential acquirers and ultimately by RTC in evaluating bids in its least-cost test. Because the marketing of failed thrifts is central to RTC's consideration of possible resolution methods, we reviewed the marketing strategies RTC used in 10 resolutions to determine the agency's rationale for those strategies and the process used to implement these strategies. In most cases, we found the agency's rationale for judgments made in selecting marketing strategies were not documented. Without such documentation, RTC cannot demonstrate with great assurance that it is giving the fullest effect to its statutory mandate to choose the least costly resolution method.

Rationale for Marketing Strategies Not Documented

DOR is to determine strategies for marketing a failed thrift primarily by making in-depth analyses of available financial information, such as the balance sheet and income statement, and discussing with RTC-appointed managing agents the thrift's operations, staff, and branch structure. Additionally, DOR is to consider the extent and level of competition and the economic condition of the thrift's geographic area. This information enables DOR staff to decide which assets and branch structures to offer potential acquirers.

The resulting marketing strategies consist of (1) certain assets that bidders must accept; (2) other assets that bidders may accept; and (3) still other assets, such as nonperforming multifamily loans and real estate owned, that, on the basis of RTC corporate policy, are generally to be excluded from transactions offered to potential acquirers at resolution. The transaction structure may be a whole, standard, or branch P&A or an insured deposit transfer, as discussed in chapter 1.

For nonmajor thrift resolutions, those having liabilities at or under $500 million at the date of conservatorship, DOR's regional staff is to

develop and submit recommended marketing strategies to an RTC headquarters official for review and approval. The RTC official is to review the recommended strategies to ensure they are reasonable and that all appropriate alternatives have been considered. The marketing strategies for major thrift resolutions, those having liabilities over $500 million at the date of conservatorship, are to be developed by DOR staff in RTC headquarters with input from regional staff. The files for major thrift resolutions do not contain written and approved strategies. However, according to RTC officials, the recommended marketing strategies are to be reviewed and approved by a senior DOR official before being presented to potential acquirers.

In 7 of the 10 failed thrift resolutions we reviewed, we found that DOR did not document the judgments made in arriving at its preferred marketing strategies. Without such documentation, RTC cannot demonstrate, with great assurance, that it gave the fullest effect to its statutory mandate to choose the least costly resolution method.

Once marketing strategies are developed, the information package is to be completed and potential acquirers are to be contacted and invited to a bidders' meeting. Also, RTC generally announces a prospective thrift for sale by placing an advertisement in The Wall Street Journal and the American Banker. Any interested party can respond to these announcements and be invited to attend the bidders' meeting. In our review of the 10 resolution cases, we found that RTC adequately documented these activities.

At the bidders' meeting, RTC is to provide written instructions to bidders and discuss in detail its marketing strategies. RTC also is to provide guidance on submitting bids and inform bidders that RTC reserves the right to reject any bids submitted. After the meeting, those acquirers interested in purchasing the thrift, who have regulatory approval to do so, may perform a due diligence examination of the thrift's assets and liabilities. While due diligence is encouraged by RTC, performing it is not a prerequisite for submitting a bid. We found during our review of the 10 resolution cases that, once RTC selected its marketing strategies, RTC adequately documented the steps taken to implement the strategies.

Table 4.1 shows the resolution method selected by RTC as the least costly for the 10 thrift resolutions we reviewed.

Table 4.1: Least Costly Resolution Methods for the 10 Thrift Resolutions Reviewed

Resolution method determined least costly	Nonmajor cases		Major cases
	Denver	Atlanta	
Whole thrift P&A	1	0	0
Standard or branch P&A	0	1	6
Insured deposit transfer	1	0	0
Liquidation	0	1	0

Source: GAO analysis of sampled resolution cases.

Conclusions

We were unable to determine from available documentation how RTC arrived at the marketing strategy for most of the 10 resolutions reviewed. As a practical matter, RTC must make judgments regarding how best to offer an institution for sale. However, to give the fullest effect to RTC's statutory mandate to choose the least costly method, we believe that marketing decisions should be thoroughly documented.

Recommendation

The RTC Deputy and Acting Chief Executive Officer should direct the Division of Resolutions to revise RTC's policies to require that RTC document the rationale for the agency's preferred marketing strategy for resolving a failed thrift.

Agency Comments and Our Evaluation

RTC agreed to adopt procedures to implement our recommendation. However, RTC also noted that we did not identify any marketing strategies that it overlooked or did not use that would have resulted in a less costly resolution method than that chosen by RTC. We concur with this observation and note that the absence of our recommended documentation precluded RTC from demonstrating—or us confirming—that the marketing strategies RTC pursued resulted in the least costly resolution.

We believe that judgments regarding how best to offer an institution for sale are an important part of each resolution. Further, we believe that documenting the bases for such judgments would make RTC's resolution documentation more comprehensive and may enable RTC to better demonstrate its efforts to meet its least-cost mandate. In our view, this documentation would enhance the quality of the decisionmaking process including any review of that process.

Summary Data on GAO Sample of RTC's 1992 Resolutions

This appendix includes profile information on the DOR resolutions included in our sample. Table I.1 shows data from our analysis of the 10 sampled resolutions, and table I.2 reflects the assets retained by RTC in the sampled resolutions.

Table I.1: GAO Sample of RTC's 1992 Resolutions

Dollars in millions

DOR office/Failed thrift	Date resolved (1992)	Total assets[a]	Total deposits[a]	Uninsured deposits[a]	Estimated loss[b]	Loss to uninsured deposits (Yes/No)
Atlanta						
New Metropolitan FSB	February 28	$10	$35	$[c]	$27	N/A
Sentry FSA	March 20	33	35	[c]	11	N/A
Denver						
Home SB, FSB	February 28	7	9	[c]	3	Yes
Republic FSB	November 6	234	217	[c]	0	No
Washington						
AmeriFirst FSB	March 20	2,327	1,980	19	807	No
FarWest S&LA, FA	March 20	1,743	1,903	3	831	Yes
Home FSA of K.C.	March 27	2,499	2,222	7	607	Yes
Investors FSB	July 10	1,395	1,018	7	487	Yes
Perpetual SB	January 10	3,419	2,606	22	419	No
Professional FSB	March 13	293	437	[c]	269	Yes
Total	**N/A**	**$11,960**	**$10,462**	**$58**	**$3,461**	**N/A**

[a]Values as noted by DOR in its cost analysis.

[b]Loss reflects DOR's estimated cost of resolution as reflected in its cost analysis.

[c]Indicates values less than $1 million. (Uninsured deposits at these five thrifts totaled $929,000: New Metropolitan, $0; Sentry, $0; Home, $4,000; Republic, $394,000; and Professional, $531,000.)

Source: GAO analysis of 10 sampled resolutions.

Table I.2: Assets Retained by RTC in GAO Sampled 1992 Resolutions

Dollars in millions

DOR office/Failed thrift	Total assets[a]	Assets retained by RTC[a]	Resolution method	Percentage of assets retained by RTC
Atlanta				
New Metropolitan FSA	$10	$6	P&A	60%[b]
Sentry FSA	33	33	Payoff	100
Denver				
Home SB, FSB	7	3	Insured deposit transfer w/assets	43[b]
Republic FSB	234	0	Whole P&A	0
Washington				
AmeriFirst FSB	2,327	2,228	P&A	96
FarWest S&LA, FA	1,743	1,478	Branch P&A	85
Home FSA of K.C.	2,499	2,386	Branch P&A	95
Investors FSB	1,395	332	P&A	24
Perpetual SB	3,419	1,867	P&A	55
Professional FSB	293	255	Branch P&A	87
Total	**$11,960**	**$8,588**	**N/A**	**72%**

[a]Asset values as noted by DOR in its cost analysis.

[b]Percentage does not match RTC records due to rounding.

Source: GAO analysis of 10 sampled resolutions.

Bid Summary Data on GAO Sample of RTC's 1992 Resolutions

DOR office/Failed thrift	Least costly resolution method	Winning bid nonconforming (Yes/No)	Total bidders[a]	Total bids[a]	Total nonconforming bids
Atlanta					
New Metropolitan FSA	P&A (ID)	N/A	3	5	0
Sentry FSA	Payoff	N/A	0	0	N/A
Denver					
Home SB, FSB	Insured deposit transfer (ID)	N/A	1	1	0
Republic FSB	Whole P&A (AD)	N/A	1	1	0
Washington					
AmeriFirst FSB	P&A (AD)	No	6	8	2
FarWest S&LA, FA	Branch P&A (ID/PO)	No	6	25	16
Home FSA of K.C.	Branch P&A (ID/PO)	Yes-2 bids	57	97	17
Investors FSB	P&A (ID)	No	52	81	10
Perpetual SB	P&A (AD)	N/A	11	120	0
Professional FSB	Branch P&A (ID)	N/A	11	26	0
Total	**N/A**	**N/A**	**148**	**364**	**45**

Legend

AD = all deposits assumed
ID = insured deposits assumed
ID/PO = insured deposits assumed in some branches & RTC paid off insured deposits in remaining branches

[a]Includes franchise and asset bidders/bids.

Source: GAO analysis of 10 sampled resolutions.

An Overview of RTC's Asset Valuation Review Process

RTC uses the Asset Valuation Review (AVR) results in the least-cost analysis of proposed transactions for resolving a failing or failed thrift. The AVR process starts with the book value of a failed thrift's assets remaining in the institution and determines the estimated loss on the disposal of the assets—the difference between the book value and net realizable value of the assets. The AVR process uses present-value analysis to estimate the net realizable value of a failed thrift's assets on the basis of RTC liquidating the assets itself. The present-value analysis is based on RTC's anticipated cash recoveries from the assets and takes into account RTC's costs associated with holding and selling the assets.

An AVR can be done by a team composed of RTC staff or by contractors. AVR procedures require an overall summary valuation report that identifies the methodologies and assumptions used during the valuation review and require documentation of the completed asset valuations done within the review of a thrift's assets.

The AVR Process

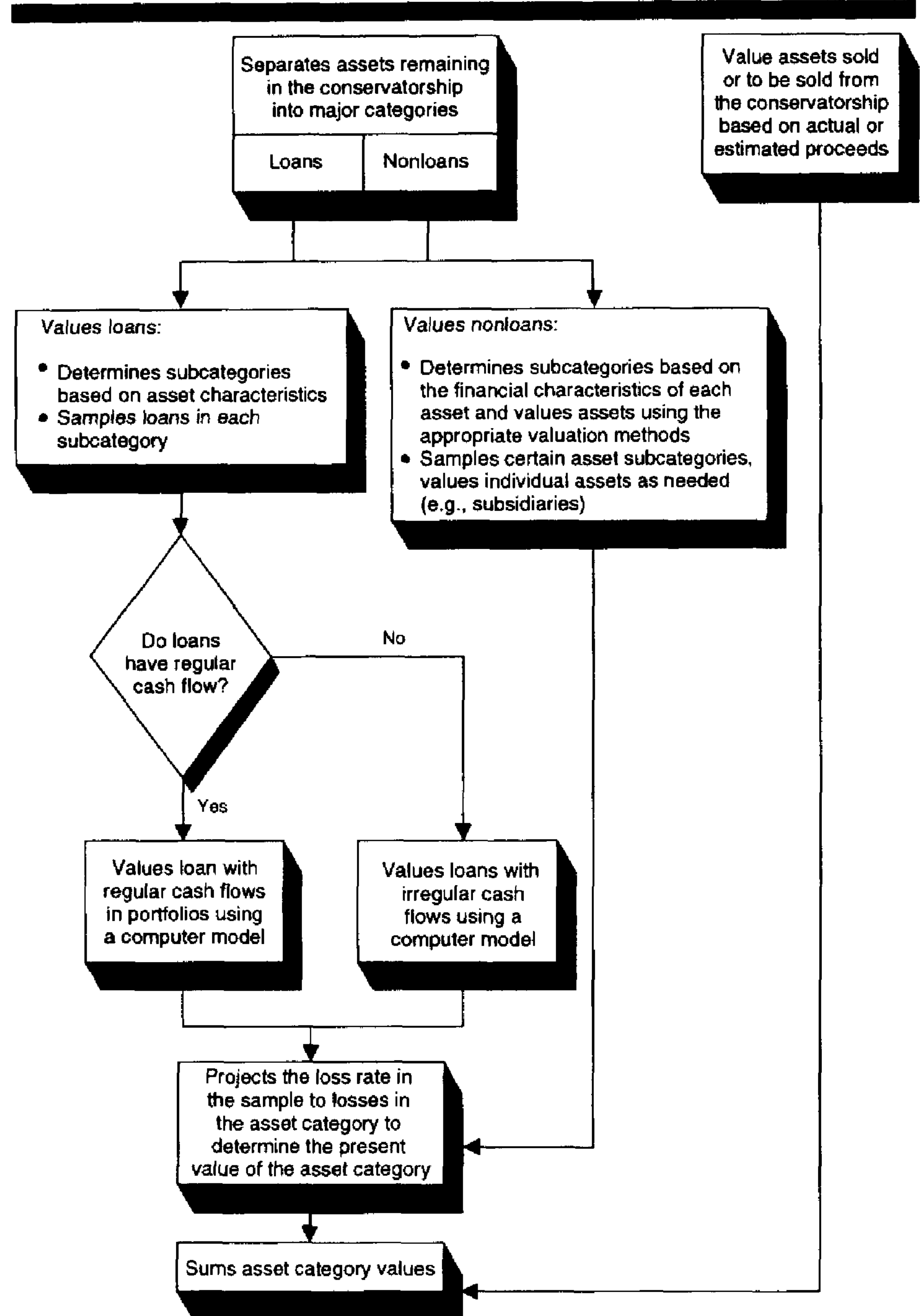
RTC's AVR uses several valuation approaches to estimate the net realizable value of assets held by a failed thrift. Certain assets, such as cash and federal funds sold, are valued through a reconciliation of the thrift's records. Securities are marked to market by contacting brokers or using publications such as The Wall Street Journal to obtain current securities price quotes. These activities are done as part of the AVR process and determine the current values of those assets, usually as of the date of the financial data used to perform the asset valuations.

To estimate the present value of other assets, such as loans, real estate owned, and subsidiaries,[1] the AVR relies on selecting samples of assets on the basis of such attributes as the type, value, and performance status of loans and other characteristics. On the basis of analysis results for each sample of assets, the AVR projects the value for all similar assets not included in the sample. The difference between the asset's book value and calculated value represents the estimated loss on the asset.

As shown in figure III.1, AVR uses one of two approaches to value assets, depending on how RTC anticipates the assets will be sold.

[1]The AVR process may also incorporate results from asset valuations done outside of the AVR process. These would include valuations done for assets scheduled to be sold outside of RTC's resolution process, such as assets scheduled to be sold while a thrift is in conservatorship. Additionally, AVR is to incorporate legal contingent liability data on the basis of a separate analysis to be done by RTC's legal counsel.

Figure III.1: RTC's AVR Approach to Valuing Assets



Source: GAO analysis of RTC's AVR procedures.

One valuation method involves selling groups of homogeneous assets, such as one-to-four family residential mortgages, by securitizing the loans and selling them in secondary markets. RTC usually uses this sales method for one-to-four family residential mortgages that meet industry standards for documentation. AVR computes the present value of such assets using a discount rate built on the secondary market's required yield—essentially market rates at the time of the valuations—adjusted for risk-related factors, i.e., problems with loan documentation, underwriting standards, or the remaining maturity of the loans. As discussed in the next section of this appendix in more detail, the model then estimates the present value of the proceeds of the sales of the securitized loans, on the basis of when the sales are expected to occur, plus proceeds RTC realized while it held the loans until they were sold, using a discount rate reflecting RTC's cost of funds and overhead expenses.

The second valuation method assumes RTC's recoveries come from any payments a borrower continues to make until a loan is paid off, or, ultimately, the sale of the underlying collateral. AVR estimates the present value of the cash recoveries expected to be realized from managing and eventually selling such assets as nonperforming loans, real estate owned, fixed assets, and subsidiaries on a liquidation basis.

AVR Discounting Methodology

The AVR team takes a two-step approach in applying discount rates to determine the present value of an asset.

The AVR team first estimates the price at which RTC could sell an asset. The AVR team does this by estimating the amount and timing of any net income, or yield, the property may provide to the asset purchaser. Using a private-sector discount rate based on current market rates adjusted for credit risks or other risks associated with the asset, the AVR team adjusts the value of the asset to determine a selling price that would provide an investor a rate of return similar to rates on comparable assets.

The AVR team then determines the present value of the asset sale. This determination involves accounting for the asset's value as discounted in the first step, the asset's estimated selling price, and any net income RTC may earn while holding the asset until it is sold. The AVR team is to use a standard 15-percent discount rate in its calculation to determine its present value or net realizable value of the asset. This rate includes both a pure interest rate, reflecting RTC's cost of funds, and some adjustments reflecting RTC overhead costs.

This two-step calculation estimates the asset's present value on the basis of RTC's liquidation of the asset.

Data Sources Used by AVR

The AVR team is to obtain data from several sources for inputs such as current market rates and interest rate risk adjustments, asset recovery rates, holding period costs, and contingent liabilities.

The AVR team is to determine a reasonable discount rate or interest rate to be used in a present-value calculation by adding risk adjustments to a base market rate for the assets being valued. The base rate is obtained by surveys of current market participants. The risk adjustments are based on a review of the thrift's files and current market conditions and assessments of risks associated with the type of asset being valued. As market conditions, the condition of thrift records, and asset conditions change, so will the risk adjustments. RTC's process for selecting and using discount rates overall appears reasonable.

Interest rate risk adjustments are based on several factors. These factors include the condition of thrift records, national and local market conditions that affect selling prices, and local and national interest rates. Such information may be obtained from RTC sales records and from surveys of financial institutions, securities dealers and brokers, real estate brokers and agents, and other local market participants.

Asset recovery rates may come from several sources, including RTC asset liquidation results or asset recovery rates reported by private sector liquidators. Real estate property values needed to determine the final sales prices of such assets may be obtained from local real estate appraisers or may be based on recent sales by RTC. Also, values for personal property assets, such as cars, needed to determine final sales prices can be obtained from industry reference material.

Holding period costs can be based on RTC's actual liquidation costs and can be adjusted for any added costs that the AVR team expects for holding and selling assets that are being valued.

RTC does not use the AVR team to estimate costs associated with contingent liability from pending lawsuits filed against or on behalf of the failed or failing thrift, but does for other contingent liabilities such as standby letters of credit and unfunded loan commitments. A separate team composed of RTC's legal counsel analyzes the pending lawsuits and

estimates RTC's potential returns and costs associated with those lawsuits. These results are incorporated into the AVR report.

Comments From RTC

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

March 18, 1994

James L. Bothwell
Director
Financial Institutions and Market Issues
United States General Accounting Office
Washington, D.C. 20548

Re: GAO Draft Report on 1992 RTC Compliance with Least Cost Test, GAO Code 233406

Dear Mr. Bothwell:

This is in response to your request for comments on the General Accounting Office ("GAO") Draft Report entitled: "1992 THRIFT RESOLUTIONS: RTC Policies and Practices Did Not Fully Comply with Least Cost Provisions," dated March 1994 (the "Draft Report"). The Draft Report focuses on (1) RTC compliance with the "Least Cost" provisions of 12 U.S.C. 1823(c)(4) in the 69 resolutions completed by the RTC in 1992, and (2) the adequacy of the least cost test policies and procedures which the RTC had in place in 1992. We appreciate the opportunity to provide comments on the Draft Report.

I. General Comments

As you know, the RTC has been conducting resolutions on a "least cost" basis since the RTC was created in 1989, which was approximately two and a half years prior to the December 1991 enactment of the "least cost" provisions of 12 U.S.C. 1823(c)(4). In fact, the term "Least Cost" was coined in the resolution provisions of the 1989 Strategic Plan for the RTC which implemented the provisions of 12 U.S.C. 1441a(b)(3) that require the RTC to conduct its operations in a manner which "maximizes the net present value return from the sale or other disposition of institutions," and "minimizes the amount of any loss realized in the resolution of cases." See pages 36 - 37 of the RTC Oversight Board's 1989 RTC Strategic Plan.

See comment 1.
Now on pp. 4, 5, and 7.

The Draft Report acknowledges that the RTC is in substantial compliance with the least cost provisions. For example, the report indicates that the RTC complied with the least cost test for all of the 69 resolutions done in 1992. See pages 5, 6 and 9. The GAO statement that ". . RTC consistently chose the resolution alternative the agency determined to be least costly in resolving what remained of a failed thrift after downsizing. ." is fully

justified in our view. See page 9.

See comment 2.

Now on p. 7.

Now on p. 35.

With regard to the adequacy of the RTC's practices and procedures which were in place in 1992, the Draft Report acknowledges that RTC resolution procedures for calculating, evaluating and documenting the cost of resolution alternatives complied with the least cost provision. See page 9. In addition, the Draft Report indicates that the RTC's asset valuation methods used in 1992 complied with the least cost provisions as to present value and realistic discount rates. See Chapter 3, page 3-4.

See p. 6.
See comment 3.

See comment 4.

While we disagree with the Draft Report's characterization of our previous position on uninsured depositors and with GAO's legal analysis, we note that the Draft Report concludes that the RTC's current policy on uninsured depositors ensures compliance with the least-cost test. See page 7. The report identifies certain items that might need some improvement by the RTC, such as better documentation. We believe that the Draft Report would be more balanced if its major conclusion that the RTC is in substantial compliance with the least cost test was more clearly stated and given greater emphasis. For example, the Draft Report would be more accurately titled "The RTC Policies and Procedures are in Substantial Compliance with the Least Cost Provisions."

As noted below, in response to suggestions in the Draft Report the RTC will be taking steps in the near future to ensure consistent adherence to RTC least cost procedures and consistent documentation of our compliance with the least cost provisions.

II. Specific Comments

A. Draft Report Recommendations

Now on p. 8.

The Draft Report contains four recommended changes by the RTC in its policies and procedures in resolving institutions under the least cost provisions. See pages 10 and 11 of the Draft Report. The recommendations are that the RTC should change its policies to: (1) document the consideration given all bids; (2) document the rationale for RTC's preferred marketing strategy for resolving a failed thrift; (3) require an evaluation of the resolution methods that are potentially available before selling assets of a failed thrift; and (4) require an estimate of liquidation costs as of the earliest of the date the conservator or receiver is appointed or the date the RTC determines to provide assistance.

1. Documentation Recommendations

See comment 5.

The Draft Report states that the RTC currently considers all bids which it receives, both conforming and nonconforming, but notes that our documentation of such consideration could be improved. Although we believe RTC documentation to be adequate, the RTC will be taking steps in the near future to improve our documentation of RTC's consideration of all bids (conforming and nonconforming).

See comment 6.

A documentation improvement is also recommended for the RTC's preferred resolution marketing strategies. The GAO has not indicated that they have discovered or are aware of any marketing

strategies which the RTC overlooked or did not utilize which would have produced a transaction which would have resulted in a less costly resolution method than the method chosen by the RTC. Nevertheless, the RTC will adopt procedures which will implement the recommendation.

See comment 7.

The Draft Report also cites the RTC's failure to document fully the assumptions used for identifying realistic discount rates and present values of assets in Asset Valuation Reviews ("AVRs"). The Draft Report seems to rely primarily on previous GAO and IG reports issued in 1992 and 1993 regarding AVRs completed between June 1991 and January 1992 (only one month after the enactment of the least cost provisions). The RTC has previously implemented procedures to cure such problems.

2. Evaluation Recommendations

See comment 8.

Despite our agreement with the Draft Report on the above noted matters, there are several factual and legal statements/conclusions in the Draft Report with regard to, among other things, the recommendations for changes to RTC evaluation methods on asset sales during conservatorship and on timing of liquidation cost estimates with which the RTC disagrees. Rather than cover all the factual and legal statements and conclusions with which we disagree, this letter addresses only the most important areas of concern.

a. RTC Evaluation Methods on Conservatorship Assets Sales

At the direction of the RTC Oversight Board, in 1990 the RTC established a general policy of selling assets out of conservatorship prior to resolution, unless resolution personnel determine that an exception for a specific institution was justified. See page 33 of the RTC Oversight Board Strategic Plan for the RTC, dated December 31, 1989. That policy was based on many unsuccessful attempts both in 1989 and early 1990 to sell assets as part of the resolution of the institution, experience with accelerated resolution program ("ARP") transactions and experience with subsequent conservatorship resolutions in which assets were also made available. In addition, sales out of conservatorship were further necessitated under the least cost provisions in 1992 and 1993, since the RTC lacked funding for resolutions.

See comment 9.

The early attempts to sell assets as part of conservatorship resolutions in 1989 and 1990 resulted in approximately 50% of the assets being put back to the RTC, with a resulting delay in their disposition. Moreover, in approximately 33 of the 35 ARP transactions completed to date the franchise bidders either put back most of the assets or the winning deposit franchise bidders did not submit winning bids for the assets. Those attempts indicated that resolution premiums are not generally maximized through the simultaneous offering of substantial amounts of an institution's assets with the resolution of its deposits franchise.

The RTC has continued to test the validity of this general approach to asset sales out of conservatorship prior to resolution.

For example, in the summer of 1992 the RTC marketed the assets and deposits of Investors Federal Savings Bank in Richmond, Virginia at the same time, but the highest bids on the assets were received by bidders who did not bid on the deposits. The RTC will continually reassess this assumption in the future.

See comment 10.

Therefore, the Draft Report is not accurate to the extent it suggests that the RTC does not evaluate whether it would be less costly to sell assets before or at resolution. However, in terms of documentation of that evaluation, the RTC will in the future document not only the approval of an exception to that general policy, as is currently done, but also, with respect to each institution, document the staff consideration of whether or not to seek such an exception. However, the issue may be relatively moot for institutions transferred to the RTC for resolution in the future. With the availability of funding and the relative health of most of the institutions on the Office of Thrift Supervision ("OTS") watch list, the RTC intends, with OTS cooperation, to resolve institutions primarily through ARPs which avoids a conservatorship and by its very nature preserves the institution's assets for sale at resolution.

b. RTC Evaluation of Liquidation Costs

See comment 11.

The Draft Report also recommends that the RTC change its policies to require an estimate of liquidation costs as of the earliest of the date the conservator or receiver is appointed or the date the RTC determines to provide assistance. On this point the report is also inaccurate to the extent it suggests that the RTC currently does not comply with the least cost test in this regard.

(i) ARP Resolutions

See comment 12.

The RTC has always done a liquidation cost estimate as of the earliest statutory trigger date (i.e., the date the receiver is appointed) with respect to all 35 ARP transactions which the RTC has done, including the 9 ARPs done in 1992. Although both RTC and GAO Staff agreed on this point, this fact seems to have been omitted from the Draft Report.

(ii) Conservatorship Resolutions

See comment 13.

In addition, the RTC believes that it complies with the least cost test for purposes of liquidation cost estimates for conservatorship resolutions. The Draft Report acknowledges that the RTC complied with this provision for all of the 1992 resolutions since the earliest date for a liquidation cost estimate in those cases was made when a determination was made to grant assistance. The conservatorship date was not applicable since those institutions were already in conservatorship prior to the date the least cost provisions became law. However, as to resolutions of institutions placed into conservatorship after the enactment of those provisions GAO has indicated that the RTC should have a liquidation cost estimate of asset values at conservatorship and as a fall back position should have asset values determined as of the

conservatorship date. We believe these positions are not consistent with either the statutory language or Congressional intent.

The statute provides that the determination of the costs of liquidation shall be made "as of" the earliest of the date of conservatorship, receivership or the RTC's determination to provide assistance. 12 U.S.C. 1823(c)(4)(C). However, the statute indicates that the liquidation costs may not exceed the amount which is equal to the sum of the insured deposits of the institution as of the earliest of those dates minus the present value of the total net amount the RTC reasonably expects to receive from the sale of the assets of the institution. 12 U.S.C. 1823(c)(4)(D).

See comment 14.

From a technical standpoint the least cost provisions arguably do not apply to RTC conservatorships since the determination to provide assistance under section 13(c) of the FDIA, which is the event that triggers the application of the least cost provisions, is made by the RTC only at resolution, and then only if a payout under section 11 of the FDIA can be avoided.[1]

The least cost provisions requiring a liquidation cost estimate "as of" the earliest of conservatorship, receivership or the determination to provide assistance do not seem to raise significant problems when applied to FDIC resolutions. The FDIC, in its supervisory and examination role, has complete access to detailed information about the institution and its assets and liabilities, and thus the ability to market the institution, prior to its appointment as a conservator or receiver. In addition, the FDIC has had funds available for immediate resolutions without the need for conservatorships.

See comment 15.

However, the RTC has no legal authority to force an operating institution to give the RTC access to its detailed operational and financial information which would enable the RTC to market an operating institution and avoid conservatorship or make a liquidation cost estimate as of the date of conservatorship. More importantly, the RTC did not have the funding during 1992 and 1993 to immediately resolve institutions through an ARP transaction and thereby avoid accepting institutions as conservatorships. Therefore, without available funding or necessary information the use of a conservatorship mechanism by the RTC as part of the RTC resolution process was the only viable alternative available.

See comment 16.

In addition, the RTC's interpretation of the liquidation cost estimate provisions differs from that contained in the Draft Report. Statutorily, the liquidation cost estimate has two components -- insured deposits and reasonably expected return from the liquidation of the assets. The statute requires the first component, insured

[1] Unlike the FDIC funding of the prior losses of the Crossland Savings, FSB during conservatorship under section 13(c) of the FDIA in 1992, it is RTC policy not to fund (i.e., provide assistance under section 13(c) of the FDIA) any of a failed institution's prior losses during the conservatorship.

deposits, to be determined as of the earliest of conservatorship, receivership or the date the RTC determines to provide assistance. The Draft Report acknowledges that the RTC has compiled with this provision.[2]

See comment 16.

However, in our view the statute does not require a determination of the asset values as of the earliest of conservatorship, receivership or the determination to provide assistance, as the Draft Report seems to suggest. The RTC estimates the asset values after performing an asset valuation review ("AVR"), but does not attempt to fix the value of such assets as if they had been sold at the earliest of those events.

See comment 16.

The RTC could not and, more importantly, was not legally required to have assets valued as of its appointment as conservator. As noted above, if the RTC had access to the books and records as well as the assets of the failing savings association prior to conservatorship, as in an ARP, the RTC could have valued the assets prior to conservatorship. However, in order to make any meaningful accurate least cost determination for conservatorship resolutions the liquidation cost estimates can not be based on data fixed as of a significantly different point in time than the date bids are received since the composition of assets and liabilities and their values constantly change. To calculate the liquidation cost as suggested in the Draft Report could easily cause the RTC to conduct a resolution that was not the least cost resolution. In fact, the RTC could under such a construction of the statute rely on "stale" data and end up conducting a resolution that would have exceeded the actual cost of liquidation.

See comment 17.

Even if we had an estimate of asset values at the time of the appointment of the conservator, the RTC would have to update the asset valuations as we get closer to resolution to maintain the comparative value of that data for purposes of the least cost provisions. RTC loss funding ran out April 1, 1992. The lack of loss funding meant that the RTC had no idea when it would be able to market and resolve conservatorships established in 1992. The Draft Report's position on this matter would require the RTC to expend taxpayer money to produce "stale" AVRs for these new conservatorships and subsequent updates when the RTC eventually received loss funding.[3] Such a result does not appear to be consistent with obtaining a least cost resolution.

See comment 16.

In conducting its resolutions, the RTC is responsible for

See comment 16.

[2] Shortly before resolution, the RTC updates this estimate of insured deposits to ensure that the least cost resolution alternative is chosen.

See comment 17.

[3] The GAO made it clear in its 1992 report on the FDIC compliance with the least cost provisions in the funding of the conservatorship of Crossland Savings, FSB that the use of stale AVR's would be totally improper. See pages 9 and 10 of the GAO Crossland Savings Report dated July 7, 1992.

administering and interpreting the least cost provisions. The RTC believes that its interpretation of the least cost provisions of the statute is reasonable and consistent with the intended purpose of the statute.

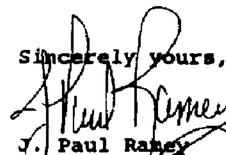
CONCLUSION:

See comment 1.

To summarize, the RTC is extremely pleased with many of the major conclusions in the Draft Report. The fact that the Draft Report concludes that the RTC complied with the least cost test for all 69 resolutions done in 1992 is very important. With respect to the RTC's policies and procedures, we are also very pleased that GAO believes the RTC is in substantial compliance with the least cost provisions. We recommend that the GAO revise the Draft Report to make sure that these key conclusions are clearly articulated and given their proper emphasis. The RTC agrees that our documentation of compliance can, and will, be improved.

If you have any questions regarding this letter, please contact me at (202) 416-7577.

Sincerely yours,



J. Paul Ramey
Vice President
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cc: John E. Ryan
Ellen B. Kulka
Gregory B. Smith

The following are GAO's comments on the RTC letter dated March 18, 1994.

GAO Comments

1. RTC misstated our position on compliance with FDICIA requirements regarding the 69 resolutions RTC completed in 1992. This report does not conclude that RTC was in substantial compliance with the least-cost provisions nor does it indicate that RTC had complied with the least-cost provisions for all 69 thrifts resolved in 1992. Since 59 of the 69 resolved thrifts were already in conservatorship when FDICIA's least-cost provisions became effective, our position is that the opportunity had passed for RTC to assess uninsured depositors their share of the estimated losses and estimate liquidation cost as of the conservatorship start date for these thrifts. However, RTC policies required it to estimate liquidation costs at the earliest date required by FDICIA for thrifts resolved through the Accelerated Resolution Program (ARP), of which there were nine in 1992, and this was done in the one ARP resolution we reviewed. Also, another thrift was placed in conservatorship and resolved in 1992 at no cost to RTC. Nonetheless, RTC's corporate policies relating to when RTC completes its estimate of the cost to liquidate a failed thrift and its sale of assets of a failed thrift in conservatorship raised least-cost compliance issues for the remaining 49 thrifts that failed and were placed in conservatorship in 1992.

2. RTC appropriately reflected our view that the procedures it had in place during 1992, if effectively implemented, would ensure adequate documentation of its evaluations and assumptions. However, we found in the 10 resolutions we reviewed that RTC did not always adhere to its documentation procedures, particularly as these procedures related to RTC's cost evaluations of resolution alternatives.

3. Before September 1993, RTC's policy was to transfer all of a failed thrift's deposits to the conservatorship without taking action to ensure that the uninsured depositors would share in losses if necessary to achieve the least costly resolution. In September 1993, RTC revised its policy on its treatment of uninsured depositors. The revised policy now requires an estimate of the amount of uninsured deposits at the time the conservatorship is established so that the uninsured depositors can absorb their share of any estimated losses. Uninsured depositors are to be given access to a portion of their uninsured deposits that does not exceed their expected pro rata share of the proceeds estimated to be realized from the resolution of a failed thrift. This new policy, if effectively implemented, should enable RTC to comply with that aspect of FDICIA's least-cost provisions.

4. RTC misstated our conclusion—we did not conclude that the RTC is in substantial compliance with the least-cost test. For example, as discussed in detail in chapter 2, we found that certain RTC corporate policies in place during 1992 did not ensure that RTC complied with the least-cost provisions of FDICIA.

5. As discussed in chapter 3, we could not independently determine from reviewing available resolution documentation the consideration RTC may have given to all nonconforming bids received in certain resolutions we reviewed. Rather, we had to rely on assurances from senior resolutions officials that RTC generally considers nonconforming bids when evaluating resolution alternatives. A senior RTC official also provided us explanations as to why RTC did not cost out or evaluate all nonconforming bids on the resolutions that we found to be lacking adequate documentation after he reviewed the full contents of the case files. The RTC official said that resolution case files did not summarize the basis for not costing out certain types of nonconforming bids, but he agreed that such information should be included in resolution case file summaries.

6. As discussed in chapter 4, we recognize that as a practical matter RTC must make judgments on how best to offer an institution for sale. We believe such judgments are an important part of each resolution, and documenting the bases for such judgments would make RTC's resolution documentation more comprehensive and could enable RTC to better demonstrate its efforts to meet its mandate to choose the least costly alternative for resolving a failed institution.

7. As discussed in chapter 3, the 10 resolutions we reviewed included 5 resolutions with asset valuations done since the passage of FDICIA. We found instances where RTC did not adequately document the basis for its asset valuations for all 10 resolutions we reviewed, which includes the 5 asset valuations done since the passage of FDICIA. We also discussed in chapter 3 that both the RTC Office of Inspector General and GAO had reported on problems with RTC's documentation of asset valuations that were mostly done before the passage of FDICIA. This report notes that during 1993 RTC implemented improvements to correct those documentation problems with the asset valuations, but that we did not assess the adequacy of the improvements as a part of our review of 1992 resolutions.

8. RTC officials subsequently provided us additional information on the agency's current procedures and practices for resolving failed thrifts, which we incorporated into the report where appropriate.

9. We believe RTC's assumption, on the basis of its past experience, that acquirers are not interested in purchasing assets with the deposit franchise does not constitute the type of least-cost analysis FDICIA requires. In our view, RTC can sell assets from a failed thrift consistent with FDICIA only if it first explores other resolution methods and determines that methods involving the sale of assets with the thrift are not likely to produce a less costly resolution. While this does not mean that RTC has to market alternative structures before it sells assets, it does mean that RTC must do an evaluation relating to the particular thrift assessing whether other, less costly methods may be available. In our view, RTC cannot meet this analytical requirement by relying on its past experience that asset sales produce least costly resolutions.

10. RTC needs to analyze alternative resolution methods for each thrift and document its analysis to be able to demonstrate that it is selecting the least costly resolution method. As described in comment 9 above, we do not believe that documentation of a decision concerning selling a failed thrift's assets during its conservatorship alone will ensure RTC's compliance with FDICIA.

11. RTC policies do not require an estimate of liquidation costs as of the conservatorship start date in accordance with FDICIA requirements for thrifts taken into conservatorship. It is our understanding that these policies are still in effect.

12. We agree that RTC policy regarding the ARP resolution transaction requires a liquidation cost estimate as of the earliest statutory trigger date, the date the receiver is appointed for a thrift resolved through an ARP transaction, and that such an estimate was performed on the 1 ARP transaction we reviewed in our sample of 10 RTC resolutions.

13. We do not take the position that RTC is required to estimate liquidation costs "at conservatorship." Rather, FDICIA requires RTC to estimate liquidation costs as of the earliest of the following occurrences: (1) the date a conservator is appointed, (2) the date a receiver is appointed, or (3) the date of a determination to provide assistance to a failed thrift. In estimating these costs, RTC must consider both components

of liquidation costs—the amount of insured deposits and the expected recoveries on assets—as of the earliest of the specified dates.

14. We do not agree with RTC's interpretation of the least-cost provisions. Section 13(c)(4)(C)(i) of the Federal Deposit Insurance Act provides that the determination of the costs of providing assistance is to be made as of the date RTC makes the determination to provide assistance. Section 13(c)(4)(C)(ii) of that act specifically requires that RTC estimate liquidation costs as of the earliest of the three dates specified in comment 13. In RTC conservatorships, these provisions require that the liquidation cost estimates be calculated as of the conservatorship start date. This date precedes the date on which RTC makes the determination to provide assistance.

15. As we note on page 28 of this report, while we agree that early access to a failing thrift's books and records would be helpful, RTC is not precluded from making a liquidation cost estimate "as of" the conservatorship start date after it assumes control of a failed thrift. RTC has provided no explanation of why it would be unable to estimate liquidation costs as of the conservatorship start date on the basis of the information it acquires after assuming control of a failed thrift. In addition, as we state on page 28 of this report, we believe that it may be possible for RTC to make arrangements with the Office of Thrift Supervision to obtain early access to thrift information.

16. We do not agree that RTC's policy of only estimating a failed thrift's insured deposits as of the conservatorship start date fully complies with FDICIA. FDICIA requires RTC to estimate both components of liquidation costs, the amount of insured deposits and expected recoveries on assets, as of the earliest of the specified dates. Since RTC does not calculate expected recoveries on assets as of the conservatorship start date, it is not making the liquidation cost estimate required by FDICIA.

In addition, RTC acknowledges that it is revising its initial estimate of insured deposits shortly before the time of final resolution and is using this second estimate in calculating the liquidation costs it compares with other resolution alternatives. As we point out in chapter 2 of this report, FDICIA specifically requires RTC to hold constant its estimate of insured deposits as of the earliest of the dates identified in the statute and to use this estimate in calculating the liquidation costs it is to compare with other resolution alternatives. For this reason, RTC's policy of making a second estimate of insured deposits, for use in calculating the liquidation costs it

is to compare with other resolution alternatives, is inconsistent with FDICIA.

17. As stated on pages 27 and 28 of this report, FDICIA requires RTC to estimate liquidation costs, both insured deposits and expected recoveries on assets, as of the earliest of the three specified dates. The fact that asset values may change before the final resolution of a thrift does not affect RTC's statutory obligation to make an initial estimate of asset values as of the earliest of the three statutory dates.

Further, as discussed in chapter 2 of this report, FDICIA contains a separate provision pertaining to RTC's calculation of liquidation costs for purposes of comparing those costs to other resolution alternatives. While that provision specifically requires RTC to hold constant its initial estimate of insured deposits as of the earliest of the three statutory dates, it would allow RTC to revise its asset valuation estimates at the time of its least-cost analysis. Therefore, we do not agree that our interpretation of FDICIA requires RTC to rely on outdated asset valuation reviews, as alleged by RTC in footnote 3 of its comment letter.

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