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ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

The RTC and the Escalating Costs of the Thrift Insurance Mess

by Christopher J. Pike and James B. Thomson

> **"The long-term challenge facing the RTC will be properly managing billions of dollars of assets that come from the resolution of failed thrifts and disposing of those assets in a timely and efficient manner."**
>
> **David C. Cooke, Executive Director of the RTC[1]**

Almost daily, the news media report on the ever-growing cost of resolving the savings and loan (thrift) insurance crisis. A year ago, the administration estimated that the present-value cost of resolving the insolvency of the now-defunct Federal Savings and Loan Insurance Corporation (FSLIC) fund was $130 billion. With the passage of time and the continued deterioration of the troubled portion of the thrift industry, current estimates of the final cost of the FSLIC bailout are half again as high. Taxpayers, who are paying a substantial portion of this bill, wonder why the cost continues to increase and why the Resolution Trust Corporation (RTC) appears to be slow in ending the thrift problem.

Although the RTC is reported to have resolved many thrifts, it has not done so quickly or completely. From its inception in August 1989 through February 1991, the RTC has disbursed $111.4 billion. Of the $98.3 billion used to resolve 366 thrifts, $64 billion has been invested in receivership assets and is potentially recoverable (see tables 1 and 2). However, the RTC has returned to the private sector less than one-third of the initial receivership assets of these institutions. In addition, there may be as many as 510 additional insolvent thrifts that will eventually have to be resolved.[2] Critics charge that the sluggishness of the RTC's salvage operation is partially responsible for the escalating costs of resolving the thrift insurance mess.

The purpose of this *Economic Commentary* is to describe briefly the structure of the RTC and the condition of its balance sheet, and then to examine the factors that may be impeding its progress in closing insolvent thrifts and returning their assets to the private sector.

Creating a Public Salvage Mechanism

In early 1989, the public began to recognize the size and scope of the insolvency of the FSLIC fund. At that time, the official estimate of the present-value cost of resolving the FSLIC's insolvency was approximately $130 billion. As noted in a previous research paper, this loss, borne largely by taxpayers, is unprecedented—there are none of even remotely comparable magnitude in American history. The combined costs of the federal bailouts of New York City, Lockheed, Chrysler, and Continental Illinois Bank did not even reach $9 billion. Thus, the FSLIC bailout is in a class by itself, a truly world-class white elephant.[3]

Handling this white elephant is a colossal and complicated undertaking that has required new legislation, a new institutional structure, and a new approach. The signing of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) on August 9, 1989 marked the first significant step toward resolving the thrift insurance mess. The primary objective of this bill, which provides the most comprehensive restructuring of

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the *thrift industry* since the Great Depression, is to resolve troubled thrifts expeditiously and with minimal detriment to the economy.

FIRREA established an entirely new regulatory structure for thrifts and created the RTC to oversee thrift resolutions from January 1, 1989 through August 9, 1992.[4] It also created the Resolution Funding Corporation (REFCORP) to provide for off-budget funding of the RTC. The RTC's initial funding consisted of $18.8 billion in direct Congressional appropriations of taxpayer money, $18 billion of taxpayer funds allocated by a drafting error in FIRREA, $1.2 billion from Federal Home Loan Banks, and $30 billion from the proceeds of REFCORP bond sales. These bonds represent an additional taxpayer liability, because although the interest on this debt is to be paid by thrifts (through higher deposit insurance premiums and assessments on Federal Home Loan Banks), the U.S. Treasury is to repay the principal and is ultimately responsible for the interest payments.

TABLE 1 SOURCES AND USES OF RTC FUNDS: INCEPTION THROUGH FEBRUARY 28, 1991

	$ Billions
SOURCES	
Treasury appropriations	18.8
Federal Home Loan Bank contributions	1.2
Resolution Funding Corporation borrowings	30.1
Federal Financing Bank borrowings	55.9
Total external sources	106.0
Repayments from conservatorships	2.0
Repayments/dividends from receiverships	11.6
TOTAL SOURCES	119.6
USES	
Resolutions and receivership funding	98.3
Advances and other disbursements to conservatorships[a]	11.3
Federal Financing Bank interest	1.8
TOTAL USES	111.4
NET FUNDS AVAILABLE	8.2

a. Net of conservatorship advances transferred to receiverships.
SOURCE: Resolution Trust Corporation, *RTC Review*, vol. 2, no. 2, February 1991.

■ The Pace of Insolvent Thrift Resolutions

Since its inception, the RTC has taken 366 failed savings and loan institutions into receivership. Unfortunately, in the majority of these cases the resolutions cannot be considered complete, because the RTC has failed to return a large percentage of the resolved thrifts' assets to the private sector. As of March 1, 1991, the corporation has been able to dispose of a mere 31 percent of the initial receivership assets of resolved thrifts, with the rest being held in its portfolio (see figure 1).

The majority of the sales have included the most marketable assets, such as cash and securities. Furthermore, some $13 billion of the reprivatized assets were sold with an option that allows buyers to return the assets to the RTC for a full refund within 90 days of the sale. The remaining assets held by the RTC, primarily real estate and junk bonds, are of lower quality and marketability. As seen in table 2, real estate and delinquent loans represent about 32 percent of the $64.0 billion currently held by the RTC in receivership assets. Junk bonds account for a smaller percentage of the assets on the RTC's balance sheet — roughly 9 percent as of April 15, 1991.

The delayed pace at which the RTC is returning assets to the private sector can increase the total resolution costs in two ways. The first is the deterioration of these assets while they remain in the government's hands. One economist contends that the RTC lacks the proper incentives to maintain and enhance the value of troubled assets on its books.[5] Another expert warns, "The problem assets in insolvent S&Ls are highly perishable commodities, particularly in the hands of inept or indifferent custodians."[6]

Second, when the RTC holds assets in lieu of returning them to the private sector, it incurs carrying costs—the costs associated with financing and managing assets. These carrying costs can be a substantial part of the total resolution costs. Irvine Sprague, former Federal Deposit Insurance Corporation chairman, argues that the costs of financing, staff time, legal fees, appraisals, and advertising are substantial and can "...eat up any profit..." and "...wipe out value more quickly than you might imagine."[7]

There are also indirect costs of the RTC's warehousing of assets. Capital that could be used to resolve additional thrift insolvencies is tied up, reducing the speed at which the RTC can execute more resolutions. Unfortunately, this delay adds to the final costs of resolving the thrift insurance mess, as operating losses and deterioration of asset quality at insolvent thrifts continue to add to the cost of resolution. This relationship is supported by a recent study from current and former Office of Thrift Supervision (OTS) economists, which finds that the most significant determinant of the total cost of resolving failed thrifts is the number of months the institutions were insolvent.[8]

The cost of delay in closing insolvent and unprofitable thrifts can also be seen by looking at the earnings performance of the thrift industry itself. In 1990, OTS-supervised thrifts (including those under RTC control) lost $13.2 billion. Although roughly 60 percent of all OTS thrifts were profitable, one report shows that the industry loss was driven by the remaining 40 percent of these thrifts, which lost $17.1 billion. Last year marked the fourth straight year that aggregate industry losses were driven by losses at a minority of thrift institutions.[9]

■ Obstacles to Efficient Asset Disposition

Critics of the RTC's performance to date point out that the corporation's operating policies have slowed the speed of thrift resolutions and have resulted in inefficient asset disposition procedures relative to a private salvage operation. In a recent study, Professor Edward J. Kane contrasts the RTC's salvage operation with that of a private salvager. He contends that while the goal of a private-sector salvager is to maximize recoveries on its assets, a public-sector salvager carries the additional burden of balancing often conflicting political objectives.[10] As a result, the RTC faces a number of restrictions on its ability to dispose of assets. In general, these constraints fall into four categories: political and legal, administrative, information, and funding.[11]

TABLE 2 RTC RECEIVERSHIP INSTITUTIONS

	Amount ($ Billions)	Percent of Gross Assets
Cash and investment securities[a]	3.1	4.8
Mortgage-backed securities	1.4	2.2
Total performing loans	32.4	50.6
1- to 4-family mortgages	14.4	22.5
Construction and land	3.1	4.8
Other mortgages	9.9	15.5
Other loans	4.9	7.7
Total delinquent loans	12.4	19.3
1- to 4-family mortgages	2.3	3.7
Construction and land	2.9	4.6
Other mortgages	4.5	7.1
Other loans	2.6	4.0
Real estate owned	8.2	12.8
Subsidiaries	2.7	4.3
Other assets	3.9	6.0
Gross assets	64.0	100.0

a. Excludes $5.1 billion in cash and cash equivalents accumulated from receivership collections.

NOTE: All data are based on preliminary information as of February 28, 1991. Number of institutions: 366.

SOURCE: Resolution Trust Corporation, *RTC Review*, vol. 2, no. 2, February 1991.

The magnitude of the current thrift problem, in terms of both the number of failed institutions and total losses, has increased the extent to which political concerns can influence asset disposition by the RTC. With taxpayers footing a substantial part of the estimated $200 billion in thrift-related losses, the operation of the RTC is subject to extensive scrutiny by Congress, the administration, and the public. One can argue, however, that the increased public scrutiny should encourage RTC managers to conduct the salvage operation in a manner that is consistent with broader political and social goals.

Unfortunately, legislators, agency officials, and analysts do not always agree on just how the RTC should resolve troubled thrifts to serve the public interest in the best way. Individuals with a short-term outlook want to minimize the near-term costs associated with taking losses. In their opinion, the RTC should spread out the recognition of losses over time by warehousing assets and financing them with working capital. Individuals with a long-term outlook are concerned primarily with total taxpayer liability and therefore want the RTC to recognize losses quickly and dispose of assets promptly, to prevent the total cost of the bailout from escalating.

Administrative constraints on the salvage operation arise from two sources. The first is the additional layer of bureaucracy that FIRREA imposed with the establishment of the RTC Oversight Board, which was instituted to ensure that the corporation conducts its operations in a manner consistent with the public interest. However, RTC Chairman L. William Seidman has stated in Congressional testimony that this board has reduced the RTC's operational flexibility and innovation and has consequently hindered the speed and efficiency with which the corporation can dispose of assets.[12]

A second source of administrative constraint is the sheer magnitude of the thrift crisis relative to the staff resources available to the RTC. The 556 thrifts that have experienced government intervention as of March 1 represent millions of individual loan contracts and investments that must be evaluated by the RTC and potential acquirers. The RTC employs more than 1,500 people, but critics contend that its pool of bank examiners and disposition experts is too small and inexperienced to keep pace with the problem.[13]

Another obstacle in the evaluation process is the lack of any secondary market in which to trade or to determine a market value for a substantial portion of the seized thrifts' assets. Further complicating the valuation process is the fact that credit risk, rather than interest-rate risk, is currently the underlying cause of losses on thrift balance sheets. Assessing the credit risk of each borrower is more complex and time-consuming than adjusting assets to account for unrealized gains and losses due to interest-rate fluctuations in a national credit market.

Uncertainty about conditions in the various regional markets also reduces the RTC's ability to value the assets in its control. Coupled with the low market value of many of the receivership assets, this uncertainty creates incentives for the

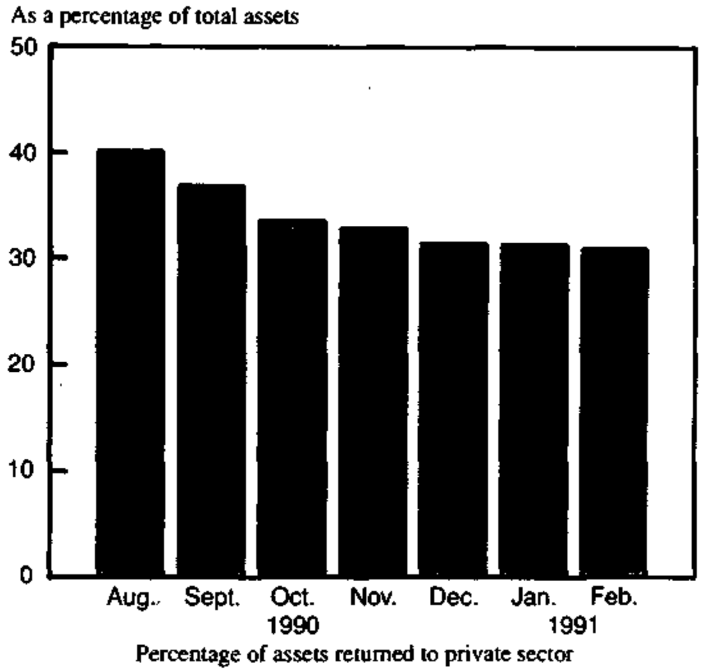
RTC to warehouse its assets. Selling these difficult-to-value assets leaves the RTC open to second-guessing by the press, taxpayers, and politicians, who may accuse the corporation of selling the assets too cheaply. Unfortunately, warehousing assets does not increase the efficiency of markets, but instead may increase the uncertainty concerning the true value of assets, such as real estate, when the market is depressed.

The lack of adequate funding may also delay thrift resolutions by the RTC. The initial $68 billion committed by FIRREA has fallen well short of what is needed to cover the losses of insolvent thrifts. The inability of the RTC to cover losses has limited the number of thrifts it has been able to resolve, and the corporation has already drained off $34.3 billion of its $50 billion of initial funding. In fact, without an additional $18 billion in funding (by way of legislative error), the RTC salvage operation would have ground to a halt last fall.[14]

Funding constraints have also reduced the working capital needed to finance the temporary holding of assets. A shortage of this capital reduces the speed at which the RTC can intervene and resolve thrift insolvencies, since it must eventually generate working capital through the liquidation of assets.

Much of the RTC's working capital to date has come from its short-term borrowings from the Federal Financing Bank. Of the total $75.3 billion in working capital that the RTC has distributed through March 1, 1991, approximately one-fourth has come from Congressional appropriation, while the remainder has come from short-term loans. These loans are to be repaid with the revenue generated from asset sales; however, the sluggish pace of these sales has reduced the amount of funds available for covering losses and providing the working capital for additional resolutions. At the end of February 1991, only $8.2 billion of cash was available from the RTC's initial Congressional appropriation and from its Federal Financing Bank borrowing authority to fund additional resolutions.

FIGURE 1 RTC RESOLUTIONS: INCEPTION THROUGH MONTH-END



SOURCE: Resolution Trust Corporation, *RTC Review*, vol. 2, no. 2, February 1991.

■ Removing Some of the Obstacles

Congress has recently passed legislation to address some of the funding problems that have threatened to paralyze the thrift salvaging operation. The new RTC recapitalization bill allocates $30 billion of taxpayer funds to absorb thrift losses and permits the RTC to borrow an additional $48 billion to use as working capital. RTC Chairman Seidman recently announced that with the newly acquired spending authority, the RTC plans to sell another 215 failed thrifts by the end of September 1991.

Although increased funding will finance the RTC through this period, it is unclear whether it will enable the corporation to resolve all insolvent thrifts. Recent statements by the U.S. General Accounting Office suggest that the RTC's additional needs to cover losses could exceed the entire $78 billion of recently appropriated funding.[15]

Seidman has also reported that the RTC will relax some rules in order to speed the sale of $65 billion in assets (particularly real estate) from those 215 insolvent thrifts. First, the corporation will increase the markdown to 40 percent for real estate assets on the market longer than six months, and to 50 percent for those held longer than 18 months.[16] In addition, the RTC also intends to offer mortgage-backed securities at the rate of $1 billion per month once registration is completed with the Securities and Exchange Commission.

Some analysts have argued that depressed real estate markets have made it more expensive for the government to hold on to some real estate than to merely give it away. Consequently, the RTC expects to give away between 2,000 and 3,000 of the single-family units that it fails to auction to nonprofit groups for use as low-income housing.

One other initiative aimed at accelerating asset sales is instituting a new bid option, whereby the RTC will include an estimate of the value of assets in its bid packages. The estimate is the price that the RTC will pay for these assets at closing and will apply to all institutions in RTC conservatorship.

Conclusion

Cleaning up the thrift mess, the goal of the RTC, is a complex and monumental undertaking. The RTC's performance to date suggests that it has not met its stated objective of resolving thrift insolvencies quickly and at the lowest cost to taxpayers. The corporation has resolved less than half of the thrifts that will ultimately be closed, and in those resolutions has failed to return nearly 70 percent of the assets to the private sector.

The pace at which the RTC has resolved insolvent thrifts reflects the sheer magnitude and nature of this unprecedented problem, as well as constraints that reduce the speed, flexibility, and efficiency of the salvage operation. Unfortunately, the resulting delay continues to add to the ultimate resolution costs. Although the recently announced procedures are a step toward streamlining operations and speeding resolutions, it is clear that the RTC must further modify its current asset disposition policies in order to resolve the thrift crisis with minimum taxpayer loss.

Footnotes

1. See David C. Cooke, "Status of the Resolution Trust Corporation: Testimony before the RTC Oversight Task Force," in *Status and Activities of the RTC and the Oversight Board, Hearings before the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance and the Resolution Trust Corporation Task Force of the Committee on Banking, Finance, and Urban Affairs of the House of Representatives.* 101 Cong. 1 Sess., October 4, 19, and November 6, 13, 1989 (Government Printing Office, 1989), pp. 290–326.

2. At the end of February 1991, 190 thrifts were operating in RTC conservatorship, and another 320 thrifts supervised by the Office of Thrift Supervision were considered marginal. We define a thrift as marginal if it is not in RTC conservatorship (as of February 28, 1991) and has a total net worth of less than 3 percent of assets on December 31, 1990.

3. See James B. Thomson and Walker F. Todd, "Rethinking and Living with the Limits of Bank Regulation," *The Cato Journal*, vol. 9, no. 3 (Winter 1990), pp. 579–600.

4. FIRREA transferred the chartering authority and supervision responsibilities of the former Federal Home Loan Bank Board to the newly created Office of Thrift Supervision. This act also transferred the responsibility of thrift deposit insurance from the now-defunct FSLIC to the Federal Deposit Insurance Corporation's Savings Association Insurance Fund (SAIF).

5. See Edward J. Kane, "Principal-Agent Problems in S&L Salvage," *Journal of Finance*, vol. 45, no. 3 (July 1990), pp. 755–64.

6. See Bert Ely, "Statement on Oversight Board's Strategic Plan to Make FIRREA and RTC Succeed," in *Status and Activities of the RTC and the Oversight Board, Hearings.* October 4, 19, and November 6, 13, 1989, pp. 92–94.

7. See Irvine Sprague, "Statement on Disposition of Assets by the Resolution Trust Corporation," *Hearings before the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance and the Resolution Trust Corporation Task Force of the Committee on Banking, Finance, and Urban Affairs of the House of Representatives*, 101 Cong. 2 Sess., May 4, 1990 (Government Printing Office, 1990), pp. 18–19.

8. See James R. Barth, Philip F. Bartholomew, and Michael G. Bradley, "Determinants of Thrift Institution Resolution Costs," *Journal of Finance*, vol. 45, no. 3 (July 1990), pp. 731–54.

9. *The S&L Quarterly Performance: Ratings and Analysis*, Austin, Texas: Sheshunoff Information Services, 1991.

10. Kane states that "... unlike a private salvor, the RTC is saddled with the additional objective of slowing down official recognition of the full size of FSLIC's losses." See Kane, "Principal-Agent Problems."

11. This follows Kane's analysis of the constraints on the ability of the Federal Deposit Insurance Corporation to resolve bank insolvencies. See Edward J. Kane, "Appearance and Reality in Deposit Insurance: The Case for Reform," *Journal of Banking and Finance*, vol. 10, no. 2 (June 1986), pp. 175–88.

12. See L. William Seidman, "Statement on Predictions and Policy Statements of the Resolution Trust Corporation," in *Oversight Hearings on the Resolution Trust Corporation, Hearings before the Committee on Banking, Finance, and Urban Affairs of the House of Representatives,* 101 Cong. 2 Sess., January 23-25, 1990 (Government Printing Office, 1990), pp. 87–93.

13. See Paul M. Horvitz, "Statement on the Strategic Plan for the RTC," in *Oversight Hearings on the Resolution Trust Corporation,* January 23-25, 1990, pp. 1165–81; and Irvine Sprague, "Statement on Disposition of Assets by the Resolution Trust Corporation," *Hearings.* May 4, 1990, pp. 18–19.

14. See "Resolution Trust Corporation Funding Act of 1990," *Congressional Record—Senate,* October 27, 1990, pp. S17722–25.

15. See John R. Cranford, "RTC Gets 'Incomplete' Grade, Urged to Improve Records," *Congressional Quarterly Weekly Report*, vol. 49, no. 8 (February 23, 1991), p. 457.

16. Under current rules, the RTC marks down property by 5 to 10 percent initially, by 15 percent after six months, and by 20 percent after nine months.

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Annual Report 1990 Now Available

Essay Examines How Banks Are Weakened by Overprotection

According to the essay in the Federal Reserve Bank of Cleveland's *Annual Report 1990*, regulation—rather than market forces—has guided the development of the U.S. banking system and has ultimately reduced its efficiency, stability, and competitiveness. "Since all industries exist in a constantly changing environment," states the essay, "this 'protection' actually creates vulnerability and increases the costs of bank failures."

The essay, entitled "The Banking Industry: Withering Under the Umbrella of Protection," indicates that U.S. banking regulations and guarantees "have been shaped by a belief that banking is 'special.' This belief is based on the fear that the economy is especially vulnerable to banking failures, panics, and other malfunctions in banking markets.

"Unfortunately," explains the essay, "the common view of bank failures, which is rooted in the financial collapse of the 1930s, is misleading. It overemphasizes the likelihood and effects of financial fragility and has been used to justify restrictions, regulations, and a safety net to protect the banking industry and the public. A closer look at the forces that led to the Great Depression and other, earlier panics seems to indicate that poor monetary policy decisions and a lack of timely, reliable information caused the crises, not an inherent weakness of banks."

The essay documents the decline in the relative importance of banks in the financial services market. Other firms, such as finance companies, insurance companies, and brokerage houses, now provide the same services as banks—without special regulations and guarantees. Consequently, treating banks as separate, unique firms is unnecessary.

Regulations could be gradually eliminated, suggests the essay, so that banks are subject to the same market forces as are unregulated, unprotected financial firms. "The result," says the essay, "would be a more efficient, competitive, and stable financial system that will not need to rely on taxpayer subsidies to compete, or even survive, in the financial marketplace."

Annual Report 1990 is available from the Public Affairs and Bank Relations Department of the Federal Reserve Bank of Cleveland at 216/579-3079.

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