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Resolving Failed Savings and Loan Institutions: Estimated Costs and Additional Funding Needs

Statement of
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Before the
Committee on Ways and Means
House of Representatives

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the Resolution Trust Corporation's (RTC) funding needs and the cost estimates for resolving failed and troubled savings institutions which were released within the last few months by RTC, its Oversight Board, and the Congressional Budget Office (CBO). In April, we testified before the Senate Committee on Banking, Housing, and Urban Affairs on the need for additional funds to resolve this crisis[1]. At that time, we stated that $325 billion would likely be needed over 43 years to pay for the Federal Savings and Loan Insurance Corporation's (FSLIC) assistance transactions, RTC resolution actions, interest on Resolution Funding Corporation (REFCORP) bonds, and establishment of the new Savings Association Insurance Fund. We also stated that costs could reach $400 billion if additional savings institutions fail or $500 billion if the economy suffers a downturn and interest rates rise.

Since that time, more institutions have been predicted to fail and the old FSLIC transactions are also expected to cost more. Our revised estimate of the total cost now ranges from $335 billion to $370 billion. These revised estimates are in line with our earlier predictions of how costs could easily reach $400 billion and $500 billion if the economy starts working against you. Also, these estimates do not include any interest for Treasury borrowing.

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[1] Resolving The Savings And Loan Crisis: Billions More and Additional Reforms Needed (GAO/T-AFMD-90-15, April 6, 1990)

We know of your interest in the total funding needs and we plan to discuss these at the end of our testimony. However, we would first like to focus on a significant piece of that total--the estimated cost for RTC resolutions.

In our April testimony, we also stated that funding provided by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) would not be sufficient for RTC to resolve known problem institutions. At that time, we estimated that RTC would need at least $100 billion, or $50 billion more than already provided by FIRREA, to cover resolution costs, administrative costs and interest on working capital. Recent RTC quarterly funding projections and resolution cost estimates independently developed by the Oversight Board, RTC and CBO also show that RTC will need substantial additional funds to resolve troubled institutions.

To address the shortfall, we recommended in our April testimony that the RTC Oversight Board and the Federal Deposit Insurance Corporation (FDIC) develop funding proposals for congressional consideration. The Administration has since proposed various general funding mechanisms, any of which will resolve RTC's immediate cash flow needs. But a funding decision, whether short term or long term, must be made soon. It is critical that RTC not run out of funds to resolve problem savings and loan institutions. While it is important that we remain vigilant as we oversee the cleanup of this unparalleled financial crisis, RTC must be given the funds to proceed expeditiously since prolonging the operations of insolvent thrifts will add significantly to the ultimate cost.

During May and June, the Oversight Board, RTC, and CBO all produced estimates of the cost for resolving failed and failing savings institutions. Although we did not audit these estimates or examine the supporting detail for all the calculations, we did discuss the individual methodologies, the various assumptions, and the financial data used with the responsible analysts at each entity. In general, we found that the Oversight Board, RTC and CBO used similar methodologies and basically the same financial data to produce present value estimates of resolution costs. The resulting independent estimates are reasonably comparable with differences due in large part to the number of institutions considered to be resolution candidates by the estimators.

Defining the size and composition of the universe requiring resolution has always been a major stumbling block to producing comparable cost estimates. The Office of Thrift Supervision (OTS) has recently developed a method by which it measures the relative health of savings institutions and categorizes private sector thrifts according to their resolution probability. Before commenting on the specific cost estimates of the Oversight Board, RTC, and CBO, I will discuss OTS's assessment of the industry's health which provides a foundation for comparing these estimates.

DEFINING THE SIZE OF

THE RESOLUTION UNIVERSE

In July, OTS released industry data for the quarter ended March 31, 1990. In an attempt to define the universe of potential resolution cases, OTS divided the 2,505 remaining private sector thrifts into four groups based upon their ability to meet capital standards, their prospects for future viability, and the results of supervisory/regulatory examinations[2]. As shown in the attachment, the various groupings are categorized as follows:

-- Category I institutions comprise half the private sector industry and hold approximately 38 percent of its assets. This group is considered healthy and well capitalized. These institutions have a composite supervisory rating of 1 or 2 and are allowed reasonable flexibility to engage in activities without excessive regulation as long as they keep their strong capital and low risk positions.

-- Category II institutions, the "near-healthy", total approximately one quarter of the industry and hold more

[2]OTS has developed a rating system that reflects its evaluation of each institution's financial condition, compliance with laws and regulations, and overall operating soundness. Each institution is assigned a uniform composite rating based on an OTS evaluation. This overall rating is expressed through use of a numerical scale of "1" through "5" in ascending order of supervisory concern; "1" indicates the highest rating and least degree of concern, while "5" is the lowest rating and therefore highest degree of concern.

than 30 percent of its assets. These institutions currently meet or are expected to meet capital requirements. Category II institutions have composite supervisory ratings of 2 or 3 and are also allowed reasonable flexibility as long as capital continues to improve and risk remains low.

-- Category III institutions, about one-eighth of the total institutions holding 14 percent of its assets, are considered "troubled" with poor earnings and low capital. Many institutions failed the new OTS capital requirements and had to submit capital plans for approval. Most institutions whose capital plans are disapproved or who fail to follow their approved plans are relegated to Category IV. The OTS composite supervisory rating is usually a 3 or 4 and, as a result, these institutions are subject to more regulation and tracked very closely to ensure compliance with approved capital plans. The future viability of Category III institutions is clearly tenuous.

-- Category IV institutions, one-eighth of the total with 18 percent of the assets, are given little or no chance of continuing in the private sector. These institutions have composite supervisory ratings of 5, the worst possible. Since OTS is virtually certain that these institutions will be transferred to RTC, its overriding regulatory concern is to reduce the eventual resolution cost.

In addition to the four OTS private sector categories, a fifth group of savings institutions are currently being operated under government control while awaiting resolution. These conservatorship institutions were transferred to RTC because they had negative capital, were consistently unprofitable, and/or were operating in an unsafe and unsound manner. While under RTC management, conservatorships are operated under strict policies regarding asset sales, high risk investments and high cost funds.

By grouping institutions according to their likelihood of becoming resolution candidates, OTS has created a useful tool for defining the size and composition of the potential resolution universe and for producing comparable estimates. In general, current estimates produced by the Oversight Board, RTC and CBO can be examined in terms of these groups. We found that when the resolution universes are composed of the same categories of institutions being resolved over the same general time period, the resulting cost estimates are similar.

It is important to remember, however, that the condition of the savings industry is not static. Institutions will, and have, moved from one to another category based on new quarterly financial data. While the situation is fluid and assumptions have to be made as to how many from any category will ultimately have to be resolved, cost estimates reported in terms of these categories will make it easier to track and compare future estimates and the progress made toward resolving this crisis.

CALCULATING THE RESOLUTION COST

From our discussions with agency analysts and our review of available supporting documentation, we determined that, in general, the Oversight Board, RTC, and CBO used similar methodologies for calculating their present value resolution cost estimates. All three relied on December 31, 1989, financial data supplied to OTS by individual savings institutions as part of their quarterly reporting requirement. All three then used this data to calculate the tangible net worth (TNW)[3] of savings institutions and to determine a "mark to market" writedown in an attempt to properly reflect the value of the institutions' assets. The asset writedown was required because, as previous experience has shown with resolved institutions, the quarterly financial reports consistently and significantly underestimate asset losses.

Although the asset valuation approach was similar, the Oversight Board, RTC and CBO stratified or grouped the assets

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[3]TNW equals tangible assets (intangibles such as goodwill are excluded) minus liabilities.

differently and applied different mark down percentages based on previous RTC experience, FDIC experience and/or the analysts' professional judgment. For example, the Oversight Board stratified assets into categories such as cash and securities, mortgage loans, and real estate owned. Based on the analysts' judgment, different loss ratios were applied to each category under three different scenarios representing low level, mid level, and high level losses on expected asset sales. RTC, on the other hand, relied on its actual resolution experience through May 1990 to calculate asset loss ratios by geographic region. The appropriate loss ratio was then applied to the unstratified asset population for that geographic region. When comparing comparable universes, much of the difference between the low and high ends of range estimates is due to the differences in asset writedowns.

Although the Oversight Board, RTC and CBO did not produce estimates for all of the categories of institutions identified by OTS, there is some overlapping among groupings which allows for comparison. As shown in the following table, the Oversight Board and RTC estimated that, at a minimum, institutions in conservatorship and in Category IV would require resolution by RTC at a cost of between $89 billion and $114 billion. If additional institutions--most of which would be in Category III--are also considered probable RTC resolutions, the Oversight Board reports costs of between $99 and $132 billion. For a similar universe, CBO present value estimates range from $90 billion to $150 billion.

The high end of CBO's estimate includes approximately $20 billion for the cost of delaying resolution and allowing failed and troubled thrifts to continue to incur losses for several years.

COMPARISON OF UNIVERSES
UNRESOLVED CASES ESTIMATES

(In Billions)	Category V*	Category IV	Category III	Category II	Category I
RTC $100	X	X			
Oversight Board (Low) $89 - $114	X	X			
Oversight Board (High) $99 - $132	X	X	X		
CBO $90 - $150	X	X	X		
CBO (High) $185	X	X	X	X	X**

* We added Category V which represents institutions in conservatorship.
** In CBO's high estimate, most of the additional institutions are from Category II, but some are from Category I.

In general, the estimates discussed above are limited to institutions in conservatorship and in the lower OTS categories expected to fail within the next 2 years and require RTC assistance. The number of these institutions ranges from about 700 to 1,000. However, CBO did not limit its loss projections to just RTC resolutions. CBO also estimated that an additional 800 institutions could be possible candidates for resolution after

1992 at a cost of $35 billion. In general, these institutions currently have tangible capital ratios greater than 3 percent of assets but, when their assets were subjected to CBO's mark-to-market writedown, they became insolvent on a tangible net worth basis. Most of these institutions are currently in OTS Category II (the "near healthy" that meet or are expected to meet capital standards) but some are from Category I (those considered healthy and well capitalized).

We caution you that all of the estimates we are discussing are subject to significant uncertainties, particularly those which consider currently healthy institutions as resolution candidates more than 3 years in the future. In general, cost estimate ranges represent the best and worst case scenarios based on currently available data using analysts' professional judgments. These scenarios reflect differences in the number of potential resolution cases, asset loss rates, and other factors. In addition to depending on highly uncertain general economic conditions that affect interest rates and real estate markets, the actual cost to ultimately resolve this crisis depends on a host of highly interrelated RTC specific factors including the manner of resolution, the order and pace of resolution, and the actual timing of asset sales. A change in any one of these factors could have a significant effect on the final numbers. In particular, a recession could dramatically increase resolution costs.

Because RTC has control of institutions in conservatorship and can perform a review and valuation of their assets, the best available information on resolution cost relates to the very near future and can be found in RTC's quarterly operating plan. However, this information is available too late and covers too short a time period to serve as the basis for major funding decisions. Given that, the next best estimates are those discussed above for the institutions in conservatorship and Category IV that will require RTC assistance within the next 1 1/2 to 2 years. While these estimates probably provide the best basis for funding decisions today, the industry's condition is not static and the composition of the OTS categories is constantly changing. New estimates will therefore have to be developed periodically for managing, budgeting and funding purposes. To facilitate this process, RTC and the Oversight Board can do some things to improve future estimates and to make them less subject to potential misinterpretation.

While having several independent estimates may be desirable, RTC and the Oversight Board need to develop an "official estimate" for funding purposes based on the OTS categories, using a consistent methodology adjusted to reflect actual experience. Also, a more structured reporting format is needed to ensure the estimates are informative and understandable. Since FIRREA already requires a semi-annual report by the Oversight Board on RTC's funding needs, this estimate could be calculated and included as part of that report. The universe, assumptions, methodology, calculations, and any supporting documentation should be available to the Congress for review and comparison. Differing independent estimates could then be discussed and evaluated in terms of changes to the "official estimate."

In addition, RTC needs to develop a method for tracking asset valuation changes from the original resolution cost estimate through the sale. Asset writedowns are a major part of any estimation methodology and more accurate information on actual market value is necessary to refine future costs estimates. RTC has informed us that such a system already exists in conservatorships and is currently being planned for receiverships.

ADDITIONAL RTC FUNDING NEEDS

As we stated in our April testimony and as the independent estimates discussed earlier support, RTC will need at least another $50 billion in resolution funding to complete its task of closing failed thrifts in an orderly and expeditious manner. RTC projections for the fourth quarter of fiscal year 1990 show that at September 30, RTC will be only $1 billion under the obligations limit imposed by FIRREA. Without additional funding, RTC will then be unable to continue resolving institutions and the ultimate cleanup costs will increase.

Due to changes made in FIRREA concerning RTC funding sources, the obligations limit formula technically allows RTC an additional $18.8 billion in borrowing authority since Treasury funding is not explicitly mentioned as part of the formula. We reported this situation in our review of RTC's quarterly report of compliance with the obligations limit[4]. Recent testimony by Chairman Seidman and the Treasury Under Secretary for Finance indicated that RTC may take advantage of that technicality rather than run out of obligating authority. While this increase would allow resolution activity to continue into the first and perhaps the second quarter of 1991, it will not buy much more time than that. The Congress needs to raise the cap on the maximum obligations limit to at least $100 billion so that RTC can plan and budget for longer than the immediate future.

In July testimony, the Treasury Under Secretary for Finance outlined three approaches which might be considered for providing RTC with additional funds to cover losses:

-- a short term funding bill to keep resolution activity going into early 1991;

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[4]Obligations Limit: Resolution Trust Corporation's Compliance as of March 31, 1990 (GAO/AFMD-90-101, July 27, 1990)

-- funding to cover estimated needs for some intermediate period; or

-- a permanent and indefinite appropriation to complete the job of resolving failed thrifts.

It is our opinion that providing short term financing through early 1991 may prove disruptive to the resolution process and be costly in time for both RTC and the Congress. Likewise, addressing the shortfall every three months or so would probably be disruptive. On the other hand, providing RTC with a permanent and indefinite appropriation would eliminate the note cap control specifically written into FIRREA to limit RTC's spending authority. It would seem important to retain FIRREA provided control mechanisms that are already in place and functioning. Therefore, we believe that the RTC should be given an additional $50 billion in resolution funding which would increase the obligations limit to $100 billion. This amount should allow RTC to operate for at least another year. RTC should continue to report on, and we will continue to review, its compliance with the limit.

In addition, we believe that all RTC funding should be on-budget. Off-budget financing has only added to the already too high costs of the crisis cleanup. Interest rates on REFCORP bonds issued since FIRREA's passage have ranged from approximately 1/4 percent to more than 1/3 percent above Treasury offerings. On borrowings of an additional $50 billion for resolutions, that rate differential translates into $125 million to $165 million a year in interest. Over 30 years, these higher interest rates would add $4 billion to $5 billion to the cost of RTC resolutions.

TOTAL FUNDING NEEDS

Up to this point, we have been talking about estimated losses or the costs for RTC to resolve failed and failing savings institutions--certainly a major component of the total cost to resolve this crisis. And thus far, the discussion has been on a present value basis--as if this were an investment decision and we could pay it off today. However, if the Congress is to make an informed decision concerning how to finance the resolution of this crisis, there are significant other costs that contribute to the total that must be considered. Because it is not possible to resolve all troubled institutions today, operating losses will continue to be incurred until the regulator closes them, the RTC will continue to incur costs as assets acquired from troubled thrifts are sold, and the regulators are continuing to pay interest and guarantee payments on FSLIC's assistance transactions. For these reasons, we have presented the total cost estimates on a cash basis.

As stated in my opening remarks, we estimated in April that the total cost was at least $325 billion, excluding general

Treasury borrowing costs. We stated then that the estimates for RTC resolution costs and for FSLIC assistance transactions were likely to change and, as previously discussed, they have. To show the effect of the Oversight Board's new low and high resolution cost estimates and to reflect new estimates for pre-1988 FSLIC assistance transactions and increased REFCORP interest expense, we now calculate that the total cost for the crisis cleanup is likely to be $335 billion to $370 billion, excluding Treasury financing costs. The Oversight Board estimates include the 700 to 1,000 institutions in conservatorship, Category IV and Category III. As you can see, we are approaching the $400 billion mark and, if the economy suffers a downturn and interest rates rise, we could easily reach $500 billion.

CONCLUSIONS

While many will want to debate the numbers and argue over whose assumptions and estimates are more accurate, we can not allow this to paralyze RTC's ability to resolve the problem institutions. Therefore, at a minimum, RTC's obligations limit should be increased and an additional $50 billion in resolution funds provided. These funds, which should be on-budget, should be sufficient for RTC to continue an aggressive resolution program for some time.

To ensure that the Congress receives the most current and complete information on which to base future funding decisions--both for RTC resolutions and for the total crisis clean-up--we have recommended that the Oversight Board and FDIC develop these estimates and report them semi-annually. Only the Oversight Board and FDIC have the necessary resources to accumulate and track the data necessary for preparing and updating such estimates.

ATTACHMENT

SAVINGS AND LOAN INDUSTRY
CATEGORIES AND CHARACTERISTICS
(Dollars in Billions)

	Number of Institutions	Assets	Income 1st Qtr. 1990	TNW at 3/31/90	Capital Level	OTS Rating[1]
Category I "healthy, well capitalized"	1264	$404	$ .7	$26	6.4%	1&2
Category II "near healthy"	620	$326	$ .2	$13	3.9%	2&3
Category III "troubled"	311	$149	$<.3>	$3	2.1%	3&4
Category IV "likely to be transferred"	310	$195	$<.9>	$<3>	<1.4>%	5
Category V[2] conservatorship	350	$164	$<3>	$<31>	<19>%	N/A

Source: Office of Thrift Supervision Analysis of the Condition of the Thrift Industry (August 30, 1990) and RTC 1st Quarter Performance Data for Conservatorships (September 9, 1990). Figures are as of March 31, 1990.

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[1]These ratings are based on the Office of Thrift Supervision's MACRO (Management, Asset quality, Capital adequacy, Risk management, and Operating results) composite rating.

[2]We added Category V which represents institutions in conservatorship.