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THRIFT RESOLUTIONS

FSLIC 1988 and 1989 Assistance Agreement Costs Subject to Significant Uncertainties

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To the President of the Senate and
the Speaker of the House of Representatives

Section 501(f) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Public Law 101-73, requires us to report to the Congress on the costs of the assistance agreements entered into by the Federal Savings and Loan Insurance Corporation (FSLIC) from January 1, 1988, through August 9, 1989. These agreements, now managed by the Resolution Trust Corporation (RTC) and accounted for by the Federal Deposit Insurance Corporation (FDIC), provide financial assistance to savings and loan institutions (thrifts) that acquired the assets of insolvent institutions.

This is the second of three annual reports required by the act. Our first report, Thrift Resolutions: Estimated Costs of FSLIC's 1988 and 1989 Assistance Agreements Subject to Change (GAO/AFMD-90-81, September 13, 1990), provided FDIC's March 31, 1990, total projected payments for these agreements; described typical contractual provisions; and discussed some of the major factors that may cause actual payments to be different from those projected. This report provides information on the reliability of FDIC's December 31, 1990, total projected payments and the status of RTC's plans through the end of July 1991 for using fiscal year 1991 appropriated funds to prepay notes and renegotiate or buy out the assistance agreements.

Results in Brief

As of December 31, 1990, FDIC projected that payments for FSLIC's 1988 and 1989 financial assistance agreements would exceed $65.4 billion. FDIC had paid about $14.6 billion to meet obligations related to these assistance agreements and projected that an additional $50.8 billion would be paid over the remaining terms, typically 8 years for the largest agreements.

However, this projection, like the March 31, 1990, projection, is subject to significant uncertainties, largely outside of FDIC's control, that may result in material changes in actual payments. Future payments under the agreements are liabilities of the FSLIC Resolution Fund. In a recent audit,[1] we disclaimed an opinion on the Fund's financial statements

[1] Financial Audit: FSLIC Resolution Fund's 1989 Financial Statements (GAO/AFMD-91-69, August 2, 1991).

because of these uncertainties, which relate principally to the continuing instabilities in local real estate markets, future interest rate fluctuations, and the ultimate results of RTC's asset disposition strategies. The reliability of FDIC's December 31, 1990, projection is further diminished because the effects of paying off notes and exercising other potential cost-saving options through use of about $16 billion in fiscal year 1991 appropriated funds could not be reliably estimated.

Instances in which FDIC did not comply with certain procedural and documentation requirements, primarily those related to valuing the acquired assets, also undermined the reliability of the payment projections. We identified two ways that FDIC could strengthen these requirements.

Background

Until August 1989, FSLIC and its operating head, the Federal Home Loan Bank Board, were responsible for insuring and regulating federally insured thrifts and resolving insolvent institutions. On August 9, 1989, FIRREA transferred these functions as follows:

- the Office of Thrift Supervision became the thrift industry's federal regulator;
- the Savings Association Insurance Fund (SAIF) became the thrift industry's insurance fund; and
- the Resolution Trust Corporation assumed responsibility for thrifts on which resolution actions were begun from January 1, 1989, through August 8, 1992.[2]

FIRREA established RTC's Oversight Board to oversee and be accountable for RTC.

FIRREA also established the FSLIC Resolution Fund to pay the obligations resulting from thrift resolution and other assistance actions initiated by FSLIC and reflected in its assets and liabilities as of August 8, 1989, except for certain 1989 resolution liabilities transferred to RTC. FIRREA provided the Fund with four funding sources to pay its liabilities: income earned on Fund assets, sale proceeds from assets of closed thrifts not required by the Resolution Funding Corporation or the

[2]The thrifts do not include the three that were resolved in two assistance agreements during early 1989. The cost of resolving thrifts chartered after August 8, 1989, and all troubled thrifts after August 8, 1992, will be borne by SAIF.

Financing Corporation,[3] Financing Corporation borrowings,[4] and savings and loan insurance premiums not used for other purposes through December 31, 1991. To the extent that these funding sources and assets transferred from FSLIC are insufficient to meet the Fund's obligations, FIRREA provided for appropriations. Of the $11.6 billion the Fund received from all sources through December 31, 1990, about $7.1 billion came from appropriation acts dated November 9, 1989 (Public Law 101-144), and November 5, 1990 (Public Law 101-507). FIRREA also designated FDIC as the exclusive manager of both the Fund and RTC. FDIC administered the assistance agreements until January 1991 and projected the amount of assistance agreement payments as of December 31, 1990. FDIC then transferred management responsibility for the assistance agreements to RTC in January 1991. FDIC continues to perform the accounting function for these agreements.

FSLIC entered into the 1988 and 1989 assistance agreements to facilitate the merger, acquisition, or stabilization of insolvent thrifts. During this period, FSLIC entered into 96 assistance agreements to resolve 199 insolvent thrifts. Prior to December 31, 1990, one of these assistance agreements was terminated because RTC intended to close the assisted thrift.

The larger 1988 and 1989 assistance agreements generally provided assisted thrifts with notes equal to the acquired institution's reported negative net worth. These notes typically provide for variable interest rates. In addition, most large assistance agreements provide capital loss and yield maintenance coverage on poor-quality assets which are known individually as covered assets and collectively as the covered asset pool. Capital loss coverage guarantees the recorded value (usually historical cost) of poor-quality assets held by the failed thrifts and taken over by the assisted thrifts. Under this coverage, assisted thrifts are compensated when they sell a covered asset for less than its guaranteed value. Yield maintenance coverage guarantees the financial performance of these assets. This coverage guarantees that each assistance agreement's covered assets will collectively yield a specified rate which varies in accordance with the terms of the agreement and with market conditions. If covered assets do not generate the amount of income specified by the

[3]The act established the Resolution Funding Corporation to raise funds, primarily through bond sales, for thrift resolution activities. Interest on these bonds may be partially funded by the net proceeds from the sale of any assets transferred to the FSLIC Resolution Fund to the extent that amounts available from other sources are insufficient.

[4]The Financing Corporation was established by the Competitive Equality Banking Act of 1987 to fund FSLIC through the issuance of public debt offerings, which are limited to $10.8 billion.

agreements, the Fund pays the assisted thrifts the difference. The aggregate covered asset pool for 1988 and 1989 assistance agreements had a guaranteed value of $28.7 billion at December 31, 1990, over 84 percent of which was, according to an FDIC estimate, related to real estate.[5]

As of December 31, 1990, additional projected payments of $50.8 billion for the 1988 and 1989 assistance agreements consisted primarily of (1) note principal and projected note interest and (2) projected claim payments related to capital loss and yield maintenance assistance and certain other indemnifications.[6] These projections are generally revised four times each year. While FDIC projected future note principal and interest payments in accordance with the notes' terms, it had to estimate future claim payments using assumptions related primarily to losses resulting from covered asset dispositions, the timing of these asset dispositions, and future interest rates. Although FDIC generally relied on thrift-prepared claim payment projections for the largest assistance agreements, which it reviewed for consistency with its procedures, FDIC was responsible for the validity of these projections.

As required by FIRREA, RTC reviewed the 1988 and 1989 assistance agreements to identify cost-saving opportunities. RTC's September 18, 1990, study estimated that if the Fund was provided with $18 billion to $20 billion in fiscal year 1991, the government could achieve savings with a present value of about $2 billion (net of borrowing costs and adjustments for potential tax benefits) from prepaying notes and writing down assets to estimated fair market value. Both of these actions require current payments from the Fund to achieve savings by reducing either related note interest or yield maintenance payments. In the case of a write-down, the payment reflects a portion of the assisted institution's estimated losses on covered assets.

RTC's study also recommended renegotiating the agreements to reduce projected payments and improve asset disposition incentives. The study anticipated that some assisted thrifts would be willing to reduce or restructure yield maintenance coverage if the Fund was willing to give

[5]Real estate related covered assets include (1) loans and investments secured by primarily commercial properties, (2) foreclosed commercial or residential properties, and (3) subsidiaries which hold these types of assets, when the acquired institutions' investment in the subsidiary became a covered asset. This definition considers undeveloped land to be commercial property.

[6]The most common indemnifications were for legal costs and liabilities due to the actions of prior management or resulting from any challenges to FSLIC's actions in closing the insolvent institutions whose assets were acquired under these agreements.

up its equity interests.[7] It estimated that the government could realize additional present value savings of $1 billion to $2 billion from renegotiations, purchasing covered assets, buying out smaller assistance agreements, and eliminating tax benefits related to capital loss payments. Subsequently, Public Law 101-507, dated November 5, 1990, provided the Fund a total fiscal year 1991 appropriation of $22 billion. FDIC officials estimated that about $6 billion would be used to meet current obligations and administrative expenses of the Fund and the remaining $16 billion would be available for cost-saving measures.

Objectives, Scope, and Methodology

Our primary objective was to assess the reliability of FDIC's projections for payments to be made after December 31, 1990, on FSLIC's 1988 and 1989 financial assistance agreements. These projected payments constitute all of the Fund's future costs for these assistance agreements except for administrative costs. In addition, we determined the status of RTC's plans to reduce future payments by using fiscal year 1991 appropriated funds.

To assess the reliability of projected claim payments, we judgmentally selected 13 claim payment projections and performed a detailed review of compliance with recently revised FDIC procedures on the manner in which such projections were to be calculated and supported. These 13 claim payment projections represented 15 of the 95 remaining 1988 and 1989 assistance agreements because 2 of these projections included claim payments for 2 assistance agreements each. Our sample represented 68 percent of the total amount of claim payments projected for all of the 1988 and 1989 assistance agreements. As part of our review, we assessed compliance with yield maintenance and capital loss projection procedures for 59 assets judgmentally selected from those covered by the 15 assistance agreements represented in our sample. These assets had the highest guaranteed values among the assets covered by these agreements and, as of December 31, 1990, represented 7 percent of the covered asset pool's guaranteed value.

To assess the reliability of the projected note payments, we tested interest payment projections and note principal balances in accordance with the terms of each of the 40 notes FSLIC entered into under the 15 assistance agreements represented in our sample.

[7] The Fund's equity interests consist of options FSLIC acquired under the assistance contracts to purchase stock in the assisted thrifts, or their owners, at specified prices in the future.

To determine the status of RTC's plans for using the fiscal year 1991 appropriated funds, we obtained the plans and discussed them with RTC officials.[8] In addition, we discussed progress on the plans with RTC staff and obtained documentation regarding actions taken through July 1991.

We did not independently project the amount of future payments that would be made on any of the assistance agreements or determine if actual claim payments through December 31, 1990, complied with the agreements' terms.

We conducted the majority of our review at FDIC offices in Washington, D.C., and Dallas and Houston, Texas, from October 1990 to May 1991. However, we updated information regarding the status of RTC's (1) oversight system through July 1991 and (2) cost-savings measures through September 1991. We conducted our review in accordance with generally accepted government auditing standards. Responsible RTC officials provided comments on our preliminary findings, conclusions, and recommendations and generally agreed with them. Their comments are incorporated where appropriate.

FDIC's Payment Projection Is Subject to Significant Uncertainties

FDIC's estimate that $50.8 billion will be paid after December 31, 1990, over the life of the 95 remaining assistance agreements is not a reliable indicator of future payment requirements. This projection is subject to material revisions because of significant uncertainties regarding (1) continuing instabilities in local real estate markets, (2) future interest rate fluctuations, (3) the effectiveness of RTC oversight of assisted thrifts' asset management strategies, and (4) the impact of potential cost-saving options exercised by RTC.

Real Estate Markets Are Unstable

Uncertainties in local real estate markets affect asset recovery values, which are used to project capital losses. Capital loss assistance comprised over 25 percent of FDIC's total December 31, 1990, payment projection. These uncertainties are significant, outside of FDIC's control, and include the continuing weakness in the economy and the seriously overbuilt real estate market. RTC, FDIC, and other public and private sector financial institutions have a growing portfolio of troubled assets, including vast amounts of real estate related assets. Until the real estate

[8] RTC is prohibited from having employees but is authorized to use the personnel of FDIC and other agencies on a reimbursable basis to conduct its functions. The references to "officials" and "staff" of RTC throughout this report are to those employees of other agencies carrying out the functions of RTC.

markets stabilize, capital loss payments could be significantly different than projected. For example, a decrease of only 5 percent in the disposition values used in FDIC's December 31, 1990, projections would increase capital loss estimates by over $777 million.

Market conditions will also affect the amount of yield maintenance payments to the assisted thrifts. For example, when market conditions result in increased rental income, yield maintenance payments are reduced. This is because such income offsets the amount FDIC must pay to meet the assisted thrifts' guaranteed yield. Similarly, real estate market conditions that decrease rental income would increase the level of assistance payments.

Future Interest Rates May Fluctuate

Uncertainties in future interest rates affect the reliability of projected yield maintenance assistance and note interest assistance, which comprised 37 percent of total projected payments. Even small fluctuations of 0.5 percent to 1.0 percent in interest rates would produce a change of from $143 million to $287 million, respectively, per year in yield maintenance payments, based on FDIC's December 31, 1990, valuation of the covered asset pool. The same interest rate fluctuations would produce a change in note interest assistance of from $88 million to $175 million, respectively, per year, based on FDIC's December 31, 1990, principal balance.

Effectiveness of RTC Oversight Is Unknown

The success of RTC's oversight and monitoring of the assisted thrifts' asset management and disposition strategies will also affect the amount of projected claim payments. In January 1991, RTC took over responsibility for reviewing and approving assisted thrifts' asset management plans. These plans typically provide the assets' estimated disposition dates and values. Successful use of RTC's broad oversight authority should help ensure that covered assets are managed in a manner which maximizes their financial performance and disposition value and, therefore, minimizes future claim payments.

RTC officials told us they believe their day-to-day oversight of the agreements should not contribute to material changes to assistance agreement payment projections. We agree that exercising their oversight of the agreements in the normal course of business should not produce material changes to assistance agreement payments. However, RTC's broad authority to write down assets, pay off notes, and renegotiate assistance agreements can have a material impact on the ultimate payments. To facilitate its oversight, RTC has developed a system to help ensure that assisted thrifts submit and obtain approval of their asset management plans. However, RTC had not reviewed the validity of plan submission and approval data at the end of July 1991. When the system becomes fully operational, it should provide aggregate data that will help develop a historical record against which the overall success of approved plans can be measured. Such data can be useful when used with sales data on individual assets.

Fiscal Year 1991 Cost-Saving Measures Not Fully Considered in Future Payment Projections

As of December 31, 1990, FDIC could not project the full impact of savings resulting from use of the Fund's fiscal year 1991 appropriation[9] because the RTC Oversight Board did not approve strategies for using these appropriated funds until January 1991. As of July 31, 1991, RTC had not reported an estimate for total cost savings in its monthly status report to the Congress.

Renegotiations and prepayments of notes are part of RTC's five-step plan to reduce future assistance agreement payments. The first step consisted of prepaying $5.3 billion in note principal. RTC estimated that the government would save about $356 million[10] on a present value basis because the interest rate on federal borrowing would be lower than the rate on the notes over the term of the agreements.

Under the second step, RTC plans to renegotiate 26 of the largest assistance agreements to reduce costs and improve asset disposition incentives. For example, savings could be achieved if lower yield maintenance and capital loss coverage are negotiated in return for giving up the Fund's equity interests in the assisted thrifts. Renegotiations had begun but were not completed for any of the assistance agreements at the end of July 1991. If renegotiations fail, RTC plans to undertake the third step, which is to offer selected pools of covered assets to other private sector asset managers under long-term repurchase agreements. Savings could be achieved if payments under such repurchase agreements were lower than payments projected for the current assistance agreements.

[9]The December 31, 1990, estimate of future assistance agreement payments included the impact of asset write-downs totaling $1.4 billion, for which RTC planned to use fiscal year 1991 appropriated funds.

[10]The estimates presented in this report take into account the government's borrowing costs; however, they do not include the potential impact on tax revenues.

The fourth step is to buy out the 51 smallest assistance agreements, thus eliminating all future payments on them. For example, buying out an assistance agreement containing guaranteed yield maintenance would result in savings if the government's costs for borrowing the needed cash were less than the projected payments that would be eliminated. According to RTC's July 1991 monthly status report to the Congress, 2 of these smaller agreements had been bought out and the terms of 2 others had expired.

The fifth and final step is to evaluate further note prepayments and covered asset write-downs or repurchases to determine if additional savings are possible. RTC paid about $2 billion to write down covered assets during the fourth quarter of fiscal year 1991. Because yield maintenance is based on the assets' guaranteed value, RTC estimated that this write-down of assets will reduce the amount of future yield maintenance paid to assisted thrifts by $112 million.

In addition to the five-step plan, RTC plans to terminate or restructure 5 assistance agreements, referred to as stabilizations, prior to the sale of the related thrifts. FSLIC entered into these 5 assistance agreements by combining 18 insolvent thrifts into 5 new institutions, bringing in new management, and agreeing to provide financial assistance to stabilize their operations until permanent acquirers could be found. Through July 1991, FDIC had prepaid $2.2 billion for notes related to 2 of the 5 stabilizations.

According to an RTC official involved in overseeing the cost-saving efforts, RTC paid about $6.9 billion during the final quarter of fiscal year 1991 to complete additional cost-saving actions that it estimates will save $177 million. These actions included note prepayments of about $4.5 billion and a cash settlement of $2.3 billion to terminate one of the 26 largest assistance agreements. During fiscal year 1991, RTC did not complete renegotiating any of the largest assistance agreements, however, the RTC official involved with these actions said that renegotiation efforts would continue in fiscal year 1992.

Projected Payment Reliability Diminished by Procedural and Documentation Weaknesses

Several procedural and documentation problems that we found diminished our confidence that the payment projections had been consistently prepared in accordance with FDIC's procedures. During 1990, FDIC developed its first comprehensive set of procedures for preparing these estimates to improve the consistency and documentation of its payment projections. These procedures revised and consolidated prior guidance supplied to FDIC staff and were officially completed and implemented at the same time that the December 31, 1990, projections were being prepared. FDIC staff told us that the short time frame for implementing these procedures contributed to procedural and documentation problems for these projections. We believe that problems in implementing these procedures also reflect FDIC case managers' lack of review experience. Prior to the December 31, 1990, projection period, case managers were not required to perform a detailed review of thrift-prepared projections.

For the 13 claim payment projections and documentation for 59 covered assets that we reviewed, we identified problems with 10 claim payment projections and 11 covered assets. Most of these problems involved asset valuations. In addition, we identified two ways in which FDIC procedures for preparing claim payment projections could be strengthened.

According to responsible RTC officials, both RTC staff and assisted thrifts have improved their preparation of these projections during the 1991 quarterly estimates, largely because staff have become more familiar with the written procedures FDIC implemented in December 1990. RTC officials also stated that testing these projections for compliance with the written procedures should improve consistency.

Asset Values Used in Projecting Payments

FDIC's procedures required that projected capital loss payments be based on current formal appraisals of individual assets classified as major or significant.[11] If assets had not been formally appraised within the previous 12 months, then projections were to be based on the assisted thrift's own internal valuations. However, for 5 of the 13 claim payment projections we reviewed, projected payments were not individually identified to specific assets for the full period that the assistance agreements were expected to be in force. Therefore, we could not determine whether capital loss was projected in accordance with FDIC's procedures for these agreements.

[11] Major assets generally have guaranteed values exceeding $5 million or estimated losses exceeding $1 million. Corresponding amounts for significant assets are guaranteed values from $1 million to $5 million or estimated losses from $300,000 to $1 million.

Also, for 7 of the 59 assets we reviewed, capital losses were not based on either (1) the current appraisals or (2) the appropriate values contained in these appraisals. For example, FDIC projected the capital loss on one asset using an appraisal value that was contingent on obtaining a U.S. Corps of Engineers permit. According to an RTC official, a significantly lower appraisal value should have been used because of the conditional nature of the higher appraisal value.

Documentation for 10 of the 59 covered assets reviewed, which include the 7 covered assets noted above, supported capital losses significantly different from those included in the payment projections. For example, no capital loss was projected for one of these assets even though the thrift-prepared payment projection anticipated foreclosure by a primary lien holder and that after satisfying that lien, there would be no residual proceeds to cover the RTC-backed loan. For another asset, RTC officials stated that the most recent appraisal was not used because it had not yet been approved by the assisted thrift.

In addition, for an asset that was not included in our sample, we found that FDIC used two conflicting values to project capital loss. As a result, FDIC included both a capital gain of $30 million and a capital loss of $4 million for this asset in one claim payment projection, resulting in a net capital gain of $26 million. The capital gain was based on the assumption that the asset would be broken down and sold piecemeal over an extended number of years, while the capital loss reflected FDIC's anticipated write-down of the asset's guaranteed value to about its currently estimated market value as an undivided parcel. According to FDIC officials, the piecemeal sale strategy was consistent with the approved asset management plan and no write-down should have been applied to the asset.

Other Deficiencies Noted in Claim Payment Projections

For 3 claim payment projections, we found that the same holding period was used to calculate projected income and expense for all types of covered assets. For example, FDIC assumed the same holding periods for income-generating real estate as well as for unsecured, delinquent loans. According to FDIC's written procedures, different average holding periods should be determined for each category of assets.

In addition, 9 of FDIC's December 31, 1990, claim payment projections, including the 3 projections cited above, included significant errors. Seven of the 9 projections double counted losses on covered assets, overstating projected claim payments by at least $621 million. In each instance, some portion of the assets' losses had been included under both asset write-downs for specific assets and as part of capital loss on the covered asset pool. Two other claim payment projections omitted projected payments for one period, understating future claim payments by at least $117 million.

FDIC Projection Procedures Can Be Strengthened

We did not perform a detailed review of FDIC's revised and formalized claim payment projection procedures. However, we identified two areas in which procedures over asset valuation could be strengthened.

First, the revised procedures did not require FDIC staff to identify and resolve any inconsistencies between currently approved asset management plans and information used in preparing the payment projections. Such comparisons could have helped FDIC staff identify and correct outdated or inappropriate asset valuations. This would have improved the quality of payment projections and enhanced oversight of the approved plans. In addition, comparing actual asset sale prices and dates with those anticipated in approved plans would be useful in assessing the reliability of plan assumptions, which ultimately affects the reliability of RTC's claim payment projections.

Second, FDIC's revised procedures did not provide for any modification to existing valuations when either new appraisals had been prepared but not formally approved or the requirement for a new appraisal had been waived. FDIC waived its requirement for current appraisals when the assets were not being actively marketed because (1) the approved asset management plan called for a holding period[12] or (2) there was a problem affecting the asset, such as litigation, title dispute, contamination of the site, or other environmental issues related to the asset.

According to RTC officials, FDIC sometimes used internal evaluations rather than formal appraisals when it determined that the appraisals no longer reflected the asset's current value. However, this practice was neither required by nor reflected in FDIC's written procedures. Given the unstable real estate market discussed earlier, it is important that payment projections be based on the most current information available. Old or outdated valuations can result in significantly misstated capital loss projections.

[12]According to an FDIC official, holding periods were used to increase the values of assets but not to speculate. For example, a holding period may have been approved to increase the occupancy rate for commercial property prior to marketing.

Conclusions

FDIC's December 31, 1990, projection of $50.8 billion in future assistance agreement payments is not reliable. The reliability of these projections is affected by continuing instabilities in local real estate markets and future interest rate fluctuations, factors which are outside of FDIC's control. Reliability of the December 31, 1990, projected payments is also diminished because the ultimate results of RTC oversight of assisted thrifts' asset management strategies are unknown and the full impact of cost-saving measures related to the use of the Fund's fiscal year 1991 appropriation was not estimable. In addition, deficiencies in payment projections, primarily related to asset valuations, and weaknesses in FDIC's written procedures diminished the reliability of projected claim payments.

Recommendations

To improve the reliability of claim payment projections and strengthen RTC oversight of assistance agreements, we recommend that the President and Chief Executive Officer of the Resolution Trust Corporation develop and implement testing procedures to ensure that quarterly claim projections are prepared in accordance with established procedures. We also recommend that the RTC President strengthen and modify the claim payment projection procedures by requiring RTC staff

- to compare factors used in projecting claim payments to those in approved asset management plans and to identify and explain any discrepancies and
- to use the most current data available on asset valuations.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Banking, Finance and Urban Affairs; the Secretary of the Treasury; the Chairman of the Federal Deposit Insurance Corporation; the President and Chief Executive Officer of the Resolution Trust Corporation and the President of the Oversight Board, Resolution Trust Corporation; and other interested parties.

This report was prepared under the direction of Robert W. Gramling, Director, Corporate Financial Audits, who can be reached on (202) 275-9406. Major contributors are listed in appendix I.

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