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THRIFT RESOLUTIONS

FSLIC 1988 and 1989 Assistance Agreement Costs Subject to Continuing 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, Public Law 101-73, requires us to report to the Congress on the costs of the 1988 and 1989 assistance agreements entered into by the Federal Savings and Loan Insurance Corporation (FSLIC). These agreements, now managed by the Resolution Trust Corporation (RTC), accounted for by the Federal Deposit Insurance Corporation (FDIC), and funded by the FSLIC Resolution Fund, provide financial assistance to savings and loan institutions (thrifts) that acquired the assets of insolvent institutions.

This is the final of three annual reports required by the act. We will continue to monitor costs under the assistance agreements as part of our FSLIC Resolution Fund financial statement audits. Our first report[1] provided FDIC's March 31, 1990, estimate of total agreement payments, descriptions of typical assistance provisions, and major factors that could significantly affect these projections. Our second report[2] provided information on the reliability of FDIC's December 31, 1990, estimate of total assistance agreement payments and the status of RTC's cost-saving actions. This report provides our assessment of the reliability of FDIC's December 31, 1991, estimate of total assistance agreement payments and the status of RTC's cost-saving actions completed as of March 31, 1992.

Results in Brief

As of December 31, 1991, the total amount of payments to be made over the life of FSLIC's 1988 and 1989 assistance agreements is estimated to be about $56.1 billion.[3] Payments for these assistance agreements totaled $37.8 billion, and FDIC plans to make additional payments of $18.3 billion to meet obligations related to these agreements over their remaining terms. Total estimated payments decreased by $9.3 billion from the December 31, 1990 estimate. Of the total decrease, $9 billion resulted from eliminating

[1] Thrift Resolutions: Estimated Costs of FSLIC's 1988 and 1989 Assistance Agreements Subject to Change (September 13, 1990, GAO/AFMD-90-81).

[2] Thrift Resolutions: FSLIC 1988 and 1989 Assistance Agreement Costs Subject to Significant Uncertainties (November 18, 1991, GAO/AFMD-92-9).

[3] To arrive at total payments for the 1988 and 1989 agreements, we reduced FDIC's December 31, 1991, estimate by $2 billion. This decrease consisted of future interest payments eliminated by January 1992 note principal prepayments of $3.1 billion. Payments related to assistance agreements FSLIC entered into before 1988 are not included in this report.

future interest costs to the Fund due to RTC's note principal prepayments of $15.7 billion. While significant savings will be achieved due to these cost-saving actions, borrowing to fund these actions results in shifting future interest costs from the Fund to the Department of the Treasury. Accordingly, as of March 31, 1992, RTC estimated that savings to the government on these completed actions, after factoring in the government's cost of borrowing, will be about $1.2 billion on a present value basis.[4]

Although FDIC's estimate of total assistance agreement payments appears to be reasonable, future assistance payments remain subject to change due to continuing instabilities in local real estate markets and fluctuating interest rates. Because the acquired thrifts' covered assets were reduced by half since December 31, 1990, exposure to additional losses is significantly less.

In our November 1991 report, we made recommendations to RTC aimed at strengthening its policies and procedures over estimating future payments. RTC plans to fully implement our recommendations but had not done so as of June 17, 1992.

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, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 divided these functions among the Savings Association Insurance Fund, the Office of Thrift Supervision, and the Resolution Trust Corporation. The act 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. The Fund is provided with four funding sources to pay its liabilities: (1) income earned on Fund assets, (2) sale proceeds from assets of closed thrifts not required

[4]All amounts other than cost-savings estimates are presented in nominal dollars. Also, the RTC cost-savings estimates presented in this report do not include the potential impact on tax revenues.

by the Resolution Funding Corporation[5] or the Financing Corporation,[6] (3) Financing Corporation borrowings,[7] and (4) savings and loan insurance premiums not used for other purposes through December 31, 1992. To the extent that these funding sources and assets are insufficient to meet the Fund's obligations, the act provided for additional funds to be appropriated. Of the $35.7 billion the Fund received from all sources through December 31, 1991, about $27.6 billion came from appropriations.

The act designated FDIC as the exclusive manager of both the Fund and RTC. During 1991, FDIC turned over management responsibility for the assistance agreements to RTC staff,[8] while FDIC continues to perform the accounting function.

In 1988 and 1989, FSLIC entered into 96 assistance agreements to facilitate the merger, acquisition, or stabilization of insolvent thrifts. The number of active agreements has decreased to 87 due to the termination of 9 assistance agreements through December 31, 1991. Six of these were terminated because the assisted thrifts came under government control, one expired under the agreement's original terms, and two were terminated as a result of RTC negotiations.

The larger assistance agreements provided assisted thrifts with three main types of assistance.

- Negative net worth coverage was generally provided in the form of notes equal to the acquired thrifts' reported negative equity at the date of the assistance agreement. These notes typically carry interest rates that are tied to indexes which follow interest rate fluctuations in the marketplace.
- Capital loss coverage guarantees the recorded values (usually historical cost) of poor-quality assets taken over by the assisted thrifts. Under this

[5]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.

[6]The Financing Corporation was established by the Competitive Equality Banking Act of 1987 to fund FSLIC through the issuance of public debt offerings. To the extent amounts available from other sources are insufficient, interest and other costs related to such offerings may be funded in part from the proceeds from the sale of assets of closed thrifts.

[7]No further funding will be available through the Financing Corporation because the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 terminated its borrowing authority as of December 12, 1991.

[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 RTC staff throughout this report are to those employees of other agencies carrying out the functions of RTC.

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 the covered assets. This coverage guarantees that each 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 agreements, the Fund pays the assisted thrifts the difference.

The guaranteed book values of covered assets are used to calculate both capital loss and yield maintenance assistance. At December 31, 1991, the aggregate covered asset pool for 1988 and 1989 assistance agreements had a guaranteed value of $13.7 billion of which over 88 percent was, according to an RTC estimate, related to real estate.[9]

As of December 31, 1991, additional projected payments of $18.3 billion for the 1988 and 1989 assistance agreements consisted primarily of (1) note principal and projected note interest prepared by FDIC staff and (2) projected claim payments related to capital loss coverage, yield maintenance assistance, and certain other indemnifications estimated by RTC staff.[10] These projections are generally revised four times each year. FDIC projected future note principal and interest payments in accordance with the notes' terms. RTC estimated 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 RTC generally relied on thrift-prepared claim payment projections for the largest assistance agreements, which it reviewed for consistency with its procedures, RTC was responsible for the validity of these projections. Actual assistance payments are generally made based on the provisions of negative net worth notes and quarterly claim reports submitted by the assisted thrifts.

The 1989 act requires that RTC actively review all means by which it can reduce costs under these agreements. Based on the results of its review, RTC developed a plan to prepay notes, renegotiate large assistance agreements, buy out small agreements, write down guaranteed asset

[9]Real estate related covered assets include (1) loans and investments secured primarily by 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.

[10]These indemnifications include reimbursable goodwill on assets acquired under the agreements but not covered by capital loss and yield maintenance provisions and legal indemnifications provided for under the agreements.

values to net realizable values, and offer selected pools of covered assets to other private sector asset managers under long-term repurchase agreements. RTC's initial progress in implementing its plan was included in our November 1991 report.

Objectives, Scope, and Methodology

Our primary objective was to assess the reliability of FDIC's projections for total actual and estimated payments on FSLIC's 1988 and 1989 assistance agreements. These estimated 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 actions taken to reduce future payments.

To assess the reliability of projected claim payments, we judgmentally selected a sample of 22[11] out of the 87 total remaining 1988 and 1989 agreements and performed a detailed review on June 30, 1991, projections for compliance with RTC estimating procedures. As part of this review, we assessed compliance with capital loss projection procedures for 52 assets. We chose these assets by randomly selecting one asset from each of the asset categories applicable under 20 of the sampled agreements.[12] We did not include assets from two agreements because one agreement was in the process of termination and as such, future costs were estimated using appropriate, alternative procedures, and information on the other agreement's assets was not available in time for inclusion in our review. For the projections reported as of December 31, 1991, we performed a more limited review for the same agreements. This agreement sample, used for both reviews, represented 95 percent of future claim payments reported as of December 31, 1991.

To assess the reliability of reported actual claim payments made, we reviewed documentation for actual claim payments recorded in FDIC's records, examined a judgmental sample of 16 randomly selected claim request reviews performed by RTC staff, and reviewed FDIC Office of Inspector General compliance audit[13] reports for the selected agreements.

[11]These agreements are included in 20 separate claim payment projections because 2 of these projections included claim payments for 2 assistance agreements each.

[12]Two of these agreements did not have assets in each of the three asset categories. These asset categories are major, significant, and other. Major assets generally have guaranteed values exceeding $5 million or estimated losses exceeding $1 million. Significant assets have guaranteed values from $1 million to $5 million or estimated losses from $300,000 to $1 million. Assets that have guaranteed values of less than $1 million or estimated losses of less than $300,000 are in the "other" category.

[13]These audits are performed, in part, to ensure that assistance payments have been made in accordance with each agreement's provisions.

To assess the reliability for reported note payments, we substantiated related note balances at year-end and changes to these balances during the year by testing principal payments for 15 of the 73 notes under the 1988 and 1989 assistance agreements. These payments represented over 63 percent of note principal payments made during 1991. We also tested the reasonableness of actual interest payments and projected interest payments using analytical procedures.

To determine the status of RTC's cost-saving actions through January 31, 1992, we reviewed documentation supporting cost savings and tested calculations for accuracy on a judgmental basis. We also obtained RTC's cost-saving action reports through March 31, 1992, and have reflected these actions in this report.

We did not independently project the amount of future payments that would be made on any of the assistance agreements, nor did we independently determine if actual claim payments made were in accordance with the agreements' terms. The appropriateness of these payments is reviewed in the FDIC Office of Inspector General compliance audits. Also, we did not independently estimate the amount of cost savings achieved as a result of any RTC cost-savings activity. During our review, we relied on information from RTC and FDIC and did not review files at the assisted thrifts.

We conducted our work at FDIC and RTC offices in Washington, D.C., and RTC offices in Dallas, Texas; Houston, Texas; and Irvine, California, from September 1991 through April 1992. We conducted our review in accordance with generally accepted government auditing standards.

FDIC's Payment Projection Appears Reasonable but Remains Subject to Uncertainties

Based on the results of our financial statement audit[14] and this review, FDIC's estimate of $18.3 billion to be paid over the life of the 87 remaining assistance agreements appears to be reasonable. However, these payments remain subject to (1) instabilities in local real estate markets, (2) interest rate fluctuations, and (3) RTC's future use of appropriated funds to achieve cost savings under these agreements.

Uncertainties in Real Estate Markets

Continued uncertainties surrounding economic conditions and the over-built real estate markets affect estimated recovery values on the

[14] Financial Audit: FSLIC Resolution Fund's 1991 and 1990 Financial Statements (June 30, 1992, GAO/AFMD-92-75).

assets covered by the agreements. The aggregate covered asset pool for the 1988 and 1989 agreements was $13.7 billion as of December 31, 1991, over 88 percent of which was real estate related. Projected capital loss payments, which comprised about 32 percent of these agreements' projected December 31, 1991, payments, were generally based on appraisals of covered assets. However, appraisals, which generally estimate value based on recent sales of similar assets, might not reliably indicate future values because local real estate markets could significantly change prior to asset disposition. RTC, FDIC, and other public and private sector entities currently are holding a large portfolio of troubled assets, including large amounts of real estate related assets. Nonetheless, over the past year, local real estate markets were able to absorb over $2 billion in assisted thrifts' real estate assets covered by the agreements. In addition, RTC sold about $7 billion in similar assets from failed thrifts through December 31, 1991. As more experience is gained through sales of troubled assets and local markets stabilize, estimated capital loss payments should be more precise.

A factor that may help reduce the uncertainty in local real estate markets due to competing governmental agencies holding large amounts of real estate related assets is the adoption of RTC's discounting policy for marketing real estate assets covered by the assistance agreements. In July 1991, RTC adopted a policy that enables the real estate assets covered by assistance agreements to be marketed at the more deeply discounted prices that RTC uses to dispose of assets acquired from failed thrifts. Consequently, where this marketing strategy is used by both assisted thrifts and for sales of similar assets from failed thrifts, the assisted thrifts should be able to market these assets without a competitive disadvantage regarding sales prices, which may help reduce uncertainty in local markets.

RTC also modified its estimation procedures to reflect this discounting policy strategy. Prior estimates of capital losses were calculated based on 100 percent of the assets' appraisal values without regard to expected disposition dates. This new policy calculates capital loss for real estate assets using asset values discounted from 20 percent to 50 percent. The discounts are dependent on expected asset disposition dates. While marketing of covered assets may be facilitated by RTC's discounting policy, its implementation adds to the complexity of estimating future capital losses. However, depending on the accuracy of estimated asset disposition dates and the extent to which this policy is used, it may result in more reliable estimates.

While the Fund's future capital loss payments are subject to uncertainties, the Fund's exposure to additional capital losses beyond what it has already recognized as of December 31, 1991, has significantly decreased over the past year. Specifically, the Fund's remaining exposure to additional capital losses for the 1988 and 1989 agreements has decreased from $15.6 billion at the end of 1990 to $9.2 billion at the end of 1991.

Market conditions will also affect the amount of yield maintenance payments, which comprised about 18 percent of the agreements' total December 31, 1991, projected payments. For example, when market conditions result in increased rental income, yield maintenance payments are reduced. This is because such income offsets the amount the Fund 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.

Uncertain Impact of Future Interest Rate Fluctuations

Uncertainties in future interest rates affect the reliability of projected yield maintenance and note interest payments. These payments are calculated using interest rate indexes which vary according to market fluctuations. Even small fluctuations of from 0.5 percent to 1.0 percent in interest rates would produce changes of from $69 million to $137 million, respectively, per year in yield maintenance payments, based on the December 31, 1991, guaranteed value of the covered asset pool for these agreements. After considering projected yield maintenance and capital loss payments, the remaining total future payments are largely attributable to negative net worth and other agreement related notes.[15] These notes represent about 47 percent of future payments. About 6 percent of this total consists of projected interest payments. The material portion of projected note interest is computed on a quarterly basis using the appropriate interest rate index according to each note's provisions. RTC's projection of future assistance payments decreased over the past year in response to relevant interest rates dropping by 0.86 percent to 3.25 percent. These rates decreased steadily from January 1, 1991, through December 31, 1991. Fluctuations of from 0.5 percent to 1.0 percent in these rates would produce changes in note interest assistance of from $38 million to $75 million, respectively, per year, based on FDIC's December 31, 1991, principal balance.

[15]Projections of future capital loss coverage, yield maintenance assistance, and note principal and interest payments account for 97 percent of the total future agreement payments. The remaining 3 percent is attributable to other estimated indemnification payments under the agreements.

Effect of Cost-Saving Measures Uncertain

RTC is responsible for actively reviewing all means by which it can reduce costs under the assistance agreements. To carry out this responsibility, RTC developed a plan to prepay notes, renegotiate large assistance agreements, buy out small agreements, write down guaranteed asset values, and offer selected pools of covered assets to other private sector asset managers under long-term repurchase agreements. The successful implementation of RTC's plan would reduce assistance agreement payments.

For example, prepaying notes would save interest costs because the interest rate on federal borrowing would typically be lower than the rate on the notes over the term of the agreements. Renegotiating the agreements would result in savings if lower yield maintenance and capital loss coverage are negotiated in return for the Fund's equity interests in the assisted thrifts. Buying out assistance agreements would eliminate all future payments and would result in savings if the government's costs of borrowing the cash needed for the buyouts were less than the estimated payments that would be eliminated. Writing down covered assets to their fair market value would reduce the amount of future yield maintenance assistance since this assistance is based on the assets' guaranteed value. Offering selected pools of covered assets to other private sector asset managers would result in savings if payments under such repurchase agreements were lower than payments projected for the current assistance agreements.

As of March 31, 1992, RTC has used a total of $23.4 billion in appropriated funds to execute cost-saving actions, which RTC estimates will achieve cost savings of $1.2 billion on a present value basis. The majority of the estimated savings is attributable to interest cost savings as a result of prepaying negative net worth notes. According to RTC, total cost-saving activities included $11.5 billion in note principal prepayments; $1.7 billion for partial prepayments on a large, high-yield note that has a provision limiting its full prepayment; $4.2 billion in covered asset write-downs; $3.1 billion in payments related to renegotiations; and $2.9 billion in payments related to negotiated settlements.

In addition, RTC terminated three of its five stabilization agreements.[16] Through March 31, 1991, $3.7 billion out of the total $11.5 billion in note prepayments reported by RTC related to four of these stabilization agreements.

[16]FSLIC entered into these five assistance agreements by combining 18 insolvent thrifts into five new institutions, bringing in new management, and agreeing to provide financial assistance to stabilize their operations until permanent acquirers could be found.

As of March 31, 1992, FDIC estimated that about $10.4 billion of the Fund's fiscal year 1992 appropriation remained available. Of this amount, FDIC estimated that about $9.5 billion would be available for additional cost-saving actions after paying current obligations and administrative costs. RTC plans more renegotiations and covered asset write-downs to reduce future capital loss and yield maintenance payments. The Fund expects to receive a fiscal year 1993 appropriation of $6.8 billion, a portion of which may be available to further reduce assistance agreement costs.

Procedural and Documentation Weaknesses Continue

In the last 3 years, FDIC and RTC have made significant improvements in formalizing their policies, procedures, and systems that are used to estimate the Fund's future assistance payments. Since the end of 1989, FDIC and RTC have developed written guidelines for preparing and reviewing estimates of future assistance payments. These written guidelines, which were enhanced during 1991, help ensure consistency in this estimation process. In addition, during 1990, FDIC implemented an automated system to track assistance payments by assistance agreement and assistance payment type. This system readily provides historical information, on both actual and estimated assistance payments, for RTC to use in estimating future payments. While the uncertainties surrounding these estimates make it difficult to precisely predict actual future assistance payments, FDIC's and RTC's improvements to their estimating procedures, coupled with the experience gained over the last 3 years in preparing these estimates, increase the reliability of the projected payments for the 1988 and 1989 assistance agreements as of December 31, 1991.

Although FDIC and RTC have made these improvements, we continued to find procedural and documentation weaknesses in the preparation of projected claim payments. During our review of June 30, 1991, claim payment projections, we found instances in which asset values used in projecting payments were not in accordance with RTC's procedures, and errors in the claim payment projections were not detected by RTC staff reviews. Although these weaknesses did not appear to materially affect projected claim payments as of June 30, 1991, they nonetheless merit corrective action to avoid potentially material misstatements in future projections.

Incorrect Asset Values Used in Projecting Payments

In our detailed review of claim payment projections as of June 30, 1991, we found two weaknesses that affect the reliability of the agreements' estimated capital loss payments. This type of assistance represents nearly one third of total projected payments under the agreements. RTC estimated capital losses for major and significant covered assets for three of the agreements as a percentage of anticipated asset sales rather than on an asset-specific basis as required by RTC's guidelines. However, we verified that RTC correctly followed approved procedures by projecting capital losses for these agreements on the required asset-specific basis for projections used as of December 31, 1991. We also found in our review of the June 1991 projections that covered asset valuation data did not adequately support capital loss calculations for 3 of the 27[17] major and significant assets under agreements in which asset-specific capital losses were calculated.

Other Deficiencies Noted in Claim Payment Projections

In our detailed review of June 1991 claim payment projections, we found deficiencies on nine of the claim payment projections that were not detected by RTC staff reviews. These included inconsistent implementation of RTC guidance for calculating yield maintenance costs and errors in estimating capital loss and yield maintenance payments. In our subsequent review of the projections used as of December 31, 1991, we noted that most of the inconsistencies were corrected although errors continued to occur. The errors we found would not have resulted in a material misstatement of total future claim payments for 1988 and 1989 assistance agreements. However, because our sampling continues to find these errors, the RTC Section Chief responsible for oversight of the agreements stated that he has instructed RTC staff to perform more thorough and critical reviews and analyses of the claim payment projections. Due to the complexity of these projections, the Section Chief does not expect to eliminate all errors. However, he stated that he expects to minimize material errors through these enhanced reviews.

Little Progress Made on Previous GAO Recommendations

We believe that full implementation of our prior recommendations will enhance the reliability of RTC's claim payment projections. RTC is planning to implement our prior recommendations on the preparation of estimated claim payments. Our recommendations and their status are as follows.

- Develop and implement testing procedures to ensure that quarterly claim projections are prepared in accordance with established procedures. The

[17]Of the 52 originally selected covered assets, 33 were major and significant assets. Capital losses for 6 of these assets were computed on an aggregate basis or based on a computer model although RTC required asset-specific calculation of capital losses on these two categories of assets. RTC permitted application of historical experience in estimating capital losses on the lower-valued category, which was predominantly composed of performing loans.

RTC Section Chief responsible for monitoring the assistance agreements plans to develop written review procedures to be performed periodically on a limited number of agreements by Washington, D.C., staff beginning with the claim payment projections as of March 31, 1992.

- Compare factors used in projecting claim payments to those in approved asset management plans and identify and explain any discrepancies. The RTC Section Chief agreed to incorporate review of asset plans in the review procedures.
- Use the most current data available on asset valuations. Staff review and approval certification memorandums require use of the most current appraisal or other approved asset valuation, beginning for claim payment projections as of March 31, 1992. Where the discounted marketing policy is followed, the assumptions will be incorporated in the estimates.

We will continue to monitor the implementation status of these recommendations as part of our FSLIC Resolution Fund financial statement audits.

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 of the Resolution Trust Corporation; the President of the Thrift Depositor Protection Oversight Board; 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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