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GAO

United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-247628

April 1, 1992

The Honorable Bruce F. Vento
House of Representatives

Dear Mr. Vento:

In our February 25, 1992, briefing report to you entitled Resolution Trust Corporation: Assessing Portfolio Sales Using Participating Cash Flow Mortgages (GAO/GGD-92-33BR, Feb. 25, 1992) we concluded that, in concept, portfolio sales using participating cash flow mortgages could be an important disposition strategy for RTC's least marketable real estate assets. However, we recommended that further RTC actions were necessary to improve the pilot portfolio sales and any future transactions.

On March 4, 1992, you asked that we provide certain supplemental information about participating cash flow mortgages. Our responses to your questions are enclosed. If you have any further questions, please call me at (202) 736-0479.

Sincerely yours,

Gaston L. Gianni

Gaston L. Gianni, Jr.
Associate Director,
Federal Management Issues

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Enclosure

Responses to Questions on
Resolution Trust Corporation: Assessing Portfolio Sales Using Participating Cash Flow Mortgages
GAO/GGD-92-33BR

1) **The report references the Staff Study of the Patriot American transactions, but does not discuss any of the problems cited in that study. Mr. Fogel's testimony[1] last week indicated that the Resolution Trust Corporation (RTC) ought to "address" the issues raised by that study.**

GAO Response

Our report did not specifically address the implementation of the Patriot transaction. Rather, our report assessed the overall strengths and weaknesses of the concept of portfolio sales using participating cash flow mortgages.

As indicated on page 7 of our report, the staff study prepared by the House Committee on Banking, Finance and Urban Affairs raised policy and implementation issues specific to the Patriot transaction. We believe it is important that RTC respond to those issues concerning the Patriot transaction. In addition, the RTC Oversight Board[2] asked the RTC Inspector General to look at the implementation of the Patriot transaction. That review could also yield information to improve future transactions.

2) **Should the RTC designate pools of assets to be sold by bulk sale and then advertise?**

GAO Response

We believe advertising pools of assets for bulk sale is an appropriate strategy when sufficient investor interest exists. RTC's current policy provides for this approach.

As discussed on page 15 of our report, in September 1991, the RTC Board of Directors approved a policy statement entitled "Marketing of Asset Portfolios," which highlights two new marketing programs--competitive solicitation and widely marketed. Under the competitive solicitation program, using market preferences, RTC assembles a portfolio

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[1] Resolution Trust Corporation: Performance Assessment for 1991 (GAO/T-GGD-92-14, Feb. 26, 1992)

[2] This board was succeeded by the Thrift Depositor Protection Oversight Board.

of assets and solicits investors' purchase offers from the widest practicable target markets. It then selects the most attractive proposals and negotiates the final contract terms.

Under the widely marketed portfolio program, RTC considers purchase offers for portfolios of assets that have already been widely marketed for at least 6 months and then selected by the investor. These portfolios must be sold at prices that exceed the sum of the minimum acceptable sales prices for each of the individual assets in the portfolio. RTC negotiates the final contract terms. The Patriot transaction was structured under the widely marketed portfolio program.

At the time the pilot transactions were developed, the widely marketed approach was used because there was limited interest in RTC's commercial real estate assets. According to RTC officials, buyers have since expressed greater interest in RTC properties. Because of this additional interest, RTC has placed greater emphasis on competitive solicitation and competitive bidding for future portfolio sales of commercial and other hard-to-sell assets.

3) **Should the size of bulk sale portfolios be substantially smaller than the size of those in the pilot program so as to greatly increase the number of bidders?**

GAO Response

We believe RTC's objective should be to structure transactions that are responsive to investors' interest in order to maximize the sale of its assets. As of December 31, 1991, RTC held $42 billion of hard-to-sell assets including delinquent loans and real estate. Given this large inventory, RTC needs to use multiple disposition methods and assorted transaction sizes targeted to a wide range of investors to enhance its ability to dispose of assets.

RTC now uses portfolio sales of various sizes to dispose of its inventory of hard-to-sell assets. The National Sales Center has structured portfolio sales ranging from about $70 million to $1.2 billion. RTC's regional and consolidated offices also structure portfolio sales of various sizes.

4) **Should the RTC competitively bid bulk asset pools, including price-determining variables such as the discount rate and the terminal capitalization rate?**

GAO Response

Available data shows that RTC currently awards most bulk asset pools through competitive bidding. During calendar year 1991, the National Sales Center reported selling about $3.1 billion of performing loans, nonperforming loans, and real estate through competitive bidding. This is about 82 percent of the total assets sold by the National Sales Center in 1991.

Price-determining variables, such as the discount rate and the terminal capitalization rate, are components of the valuation method that the buyer and seller agree to under the widely marketed portfolio program, described in our response to question 2. Furthermore, these variables are considered by potential investors in determining their individual bids on competitively bid bulk asset pools. Therefore, they do not need to be evaluated separately by RTC in the competitive bidding process.

5) **Since the price of specific properties is generally from 30% to 50% less than appraised values, should the RTC widely advertise the assets as a group?**

GAO Response

We believe it is appropriate for RTC to advertise some assets individually and other assets in groups. RTC needs to use multiple disposition methods targeted to a wide range of investors.

As we discussed in our response to question 2, RTC has placed greater emphasis on competitive solicitation and competitive bidding for future portfolio sales of commercial and other hard-to-sell assets. Under these approaches, the portfolio sales are widely advertised. Although advertising may enhance RTC's ability to sell assets, it will not necessarily affect asset values, which are related to market conditions and other factors.

6) **Should the RTC be required to advertise the assets individually with the same financing terms as the cash/flow mortgages?**

GAO Response

RTC should not be required to advertise all assets individually with participating cash flow mortgages. As discussed on page 37 of our report, we believe it is reasonable for RTC to offer participating cash flow financing as an option for portfolios of hard-to-sell assets. It could also be appropriate to use this type of financing on certain individual, large, hard-to-sell assets. However, this decision should be made on a case-by-case basis.

RTC is currently offering portfolios of hard-to-sell assets with seller financing options, including participating cash flow financing. RTC has also used participating cash flow financing on one large single-asset sale.

7) **Should the RTC take additional actions to assure that its field, consolidated, and regional offices are in meaningful contact with the National Sales Office?**

GAO Response

Yes. We believe that communication is important and that RTC should continue to improve communications between its offices.

Issues were raised in the Patriot transaction relating to the coordination between the National Sales Center and RTC's regional and consolidated offices. To address this concern, RTC has named one person in each regional office as the regional coordinator for the Patriot transaction. RTC officials believe that communications between its offices have improved as a result of this action.

8) **Should the RTC increase penalties for default on properties by adding terms to the sales agreements that (1) specify additional cash forfeitures and (2) impose cross default provisions?**

GAO Response

Given the distressed nature of these assets and the terms and conditions of these transactions, we believe that investors may find additional cash forfeitures unacceptable. Patriot American and other investors purchased assets from RTC with non-recourse loans. The Patriot transaction documents provide for usual and customary events of default and remedies for RTC, but they do not provide for additional cash forfeitures.

Generally, we are not convinced that a cross-default provision would enhance RTC's position. Such a provision could cause an entire portfolio to default because of the poor performance of a single asset. However, theoretically, it could also discourage a buyer from defaulting on a single asset. Furthermore, if RTC subsequently decided to sell the loans arising from these transactions, cross-default provisions could impair the marketability of individual loans.

9) **Should the RTC insist upon a single blanket mortgage so that the sale is more like a bulk sale than simultaneous sales of individual assets?**

GAO Response

We do not believe that a single blanket mortgage is an appropriate option for these pilot transactions. Such a mortgage is not commonly used in the financing of real estate assets. A single blanket mortgage could also impair the marketability of individual loans.

Furthermore, a single blanket mortgage could lower RTC's return on these portfolios. This type of mortgage would require aggregation of income from individual assets. Under the Patriot transaction, RTC receives a share of the positive cash flow from individual assets but is not required to fund a share of operating deficits on negative cash flow properties. With aggregation, positive cash flow from performing properties would be reduced by operating deficits of negative cash flow properties. Therefore, aggregation could lower RTC's cash flow payments and its overall return on the portfolio, unless other terms or conditions of the transactions are changed.

10) **Should the RTC take actions to assure that there are no organizational conflicts of interest (or the appearance of conflicts and self-dealing) amongst the private contractors involved in bulk sale transactions?**

GAO Response

Yes. RTC should take actions when conflict-of-interest issues are raised including those among the private contractors involved in bulk sale transactions. RTC has issued regulations and established policies and procedures that are designed to prevent contractors who provide asset-related services to RTC from attempting to purchase those assets or assisting others to purchase those assets. When a conflict-of-interest issue is raised, RTC's Inspector General or Ethics Office is to investigate the potential conflict. We support this approach.

11) **Should the RTC restructure these transactions to assure that its position could be taken/sold to private investors?**

GAO Response

We are not aware of any modifications that would assure RTC's ability to sell its position. If modifications were made, it could still be difficult to sell RTC's interest in the resulting loan assets because of the cash flow structure and complexity of the transactions. However, RTC may be able to sell its interest in individual assets depending on asset performance, market interest, and other factors.

12) **Should the RTC obtain a ruling from the Internal Revenue Service (IRS) that its cash flow financing will not be viewed as a partnership, thus subjecting the RTC to continuing risk of ownership, as well as other liabilities on account of its partner status?**

13) **Should the RTC take other action to change the format of the transactions to make them more like sales and less like joint ventures?**

GAO Response

Questions 12 and 13 both relate to potential tax and liability implications related to a recharacterization of the loan transactions as joint ventures.

In any participating cash flow transaction, such as the one with Patriot, we believe the purchaser would be the appropriate party to request an IRS ruling because of the negative tax consequences that it could sustain if IRS recharacterized the participating mortgage loans as equity investments. If such a recharacterization occurred, Patriot might not be entitled to fully depreciate the properties or deduct the interest under the notes. Any IRS ruling concerning whether the Patriot transaction is debt or equity would be for tax purposes. For liability purposes, state law would determine whether a partnership exists between RTC and Patriot.

RTC was advised by its outside counsel that a typical participating mortgage loan contains elements of equity as well as elements of debt. The outside counsel recommended various ways to restructure the Patriot note to improve the likelihood that it would be viewed as debt. On the basis of this advice, RTC made changes to the transaction terms to lessen the risk of the transactions being recharacterized as joint ventures. For example, the transaction was originally structured using a 7-year loan term with no fixed interest, plus a 5-year extension. The note now includes a 12-year loan term with a fixed accrued interest rate of 9 percent in the last 5 years of the transaction. After reviewing these changes, RTC's outside counsel has concluded that, taking into account all aspects of the transaction structure, it is probable that the transaction contemplated by the Patriot loan documents would be respected as a loan.

Additionally, Patriot is required, as a condition of closing under the master sales agreement, to obtain an opinion from Kenneth Leventhal & Company or another accountant acceptable to RTC that generally accepted accounting principles (GAAP) or accounting standards do not require the transactions to be reported as partnerships or joint ventures. The buyer's counsel is also to provide a legal opinion that it does not believe the transactions will result in RTC being deemed a partner or joint venturer with Patriot for contract or liability purposes.

14) **Does the report's general conclusion regarding the strengths of the large portfolio/cash flow mortgage program in general, mean that the GAO also draws this conclusion with respect to the three transactions that are regarded as pilot efforts?**

GAO Response

Our general conclusion was that, in concept, portfolio sales using participating cash flow mortgages could be an important disposition strategy for hard-to-sell assets, especially RTC's least marketable real estate assets. Our conclusion regarding the pilot transactions was similarly based on this overall concept. We believe that, overall, the strengths of the pilot portfolio sales using participating cash flow mortgages outweigh the weaknesses. However, we recommended that RTC develop detailed oversight procedures for loan monitoring and administration, centralize oversight responsibility, and implement an oversight process in a timely manner.

As can be expected with any new program, RTC has experienced a number of implementation problems. RTC should take additional actions to improve the implementation of the pilot transactions and any future similar transactions.

15) **Do you agree that the likelihood of being paid for a mortgage that has no interest due or accumulated for seven years, and no principal payable except out of cash flow, and no recourse against the borrower, comes down to whether the economy recovers? Doesn't that put the RTC in the position of speculating on economic futures?**

GAO Response

RTC's present value return on the participating cash flow mortgages will be affected by several factors including general economic conditions, real estate market trends and individual asset performance. These factors will determine when the payments are received and the amount of the payments, including RTC's share of proceeds when the loan matures or an asset is sold or refinanced.

In the pilot transactions, repayment of RTC's loan is to be accomplished in two ways. First, its principal is to be repaid through sharing in the operating cash flow on a predetermined basis. Second, any remaining principal balance or accrued interest is to be paid off when the loan matures or an asset is sold or refinanced. RTC holds a first lien against each asset in the amount of its loan. RTC's mortgage must be repaid when any property is sold or refinanced, or at loan maturity.

16) **Do you agree that other analysts of the cash flow mortgage program could have just as reasonably concluded that the RTC should make substantial changes in their approach prior to going forward with these pilot transactions?**

GAO Response

We cannot predict how other analysts might view these transactions. However, as discussed on page 23 of our report, RTC received the opinion of an independent financial advisor on the reasonableness and appropriateness of each transaction. The advisor independently reached conclusions similar to ours.

17) **Is it GAO's recommendation that the RTC not close the pilot sales until a method of monitoring is in place? Is it fair to conclude that the RTC should not close any of the pilot transactions at this time?**

18) **In view of the fact that the RTC has failed to develop a thorough and accurate management information system with an accurate and complete data base for the assets under its control, does the GAO conclude that the RTC has or will develop a "diligent post-closing monitoring and administration" system for assets of which they hope they have transferred the risk of ownership?**

19) **In view of Mr. Fogel's testimony[3] here last week assessing the RTC's performance last year which noted a serious lack of oversight of their contractors, does the GAO believe that the RTC will in the near future be able to oversee these tremendously complicated cash flow mortgage arrangements?**

GAO Response

Questions 17, 18, and 19 all relate to RTC's development of oversight policies and procedures, their implementation, and RTC's oversight of contractors retained to service the transactions.

As discussed on page 41 of our report, RTC should develop detailed oversight procedures for loan monitoring and administration, centralize oversight responsibility, and implement an oversight process in a timely manner. The oversight process should be implemented prior to the completion of the pilot transactions. These actions should enable RTC to closely monitor completed portfolio sales using participating cash flow mortgages in order to protect RTC's long-term interests.

RTC is currently developing servicing procedures and oversight guidelines. In addition, RTC plans to have a national servicer in place for these loans by late summer 1992. RTC officials told us that they will hire an interim servicer, to be overseen by RTC personnel, if the Patriot transaction closes before the national servicer is in place.

Until we review RTC's final oversight policies and procedures, as well as their implementation, it would be premature to comment further on the adequacy of the oversight program. We will continue to monitor RTC's contractor oversight efforts.

20) **Does the GAO believe that the RTC's inability to know precisely the rate of occupancy on commercial real estate under its control is consistent with obtaining the best prices for these assets?**

GAO Response

RTC is obtaining occupancy rate information as part of the due diligence process for the Patriot transaction. The independent advisor hired by RTC to do asset valuations is

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[3]Resolution Trust Corporation: Performance Assessment for 1991 (GAO/T-GGD-92-14, Feb. 26, 1992)

required to perform due diligence on individual assets. The due diligence procedures require, among other things, that an asset's current occupancy rate and its income and expense levels be determined. Therefore, an asset's price is determined by its current occupancy rate and its income and expense levels, among other factors.

21) **In view of the GAO's testimony[4] last year which indicated that field and consolidated offices were unable to monitor properties for which they had responsibility because the properties were located in distant places, do you expect the RTC to do better in monitoring the bulk sale/cash flow mortgage transactions, which also contain widely scattered properties?**

GAO Response

As we stated in our response to questions 17, 18, and 19, implementation of our recommendations should enable RTC to closely monitor completed portfolio sales using participating cash flow mortgages in order to protect RTC's long-term interests. RTC is currently developing its oversight process for the pilot transactions and taking actions to improve contractor oversight. These actions have the potential to help RTC monitor the pilot transactions using participating cash flow mortgages. However, until we review RTC's final oversight policies and procedures, as well as their implementation, it would be premature to comment further on the adequacy of the oversight program.

22) **Does the GAO have confidence that the RTC is presently able to accurately identify its "widely marketed" assets?**

GAO Response

Our past work has shown that RTC has not developed an accurate inventory system and that this situation has impaired RTC's ability to routinely identify widely marketed assets.

However, for the Patriot transaction, RTC hired an independent advisor to gather information on properties selected by Patriot and RTC. Using this information, RTC is to determine if the properties are qualified for the transaction, including whether they meet the widely marketed requirement. Also, the RTC Inspector General has been asked

[4]Resolution Trust Corporation: Performance Assessment to Date (GAO/T-GGD-91-7, Feb. 20, 1991)

to review implementation issues of the Patriot transaction, including asset selection and qualification.

23) **What is GAO's view of the consequences of allowing the buyer/RTC to preempt other sales activity for these same assets?**

GAO Response

Preexisting contracts and bona fide purchase offers should not be preempted by portfolio sales to provide fair treatment to potential purchasers who have executed contracts or submitted bona fide offers. In response to issues raised in the Patriot transaction, RTC has made modifications to its procedures for identifying and reserving assets for portfolio sales.

Under current policies, RTC officials report that if an asset is selected for a portfolio sale, a regional or consolidated field office has 30 days to accept a contract for any asset for which it has received a bona fide purchase offer. If after 30 days the purchase offer is not accepted, the asset will be available for the portfolio sale. We believe this is a reasonable procedure which should reduce potential conflicts between preexisting purchase offers and portfolio sales.

24) **Did the GAO attempt to estimate the potential cost impact of the arrangement that allows asset by asset default (so that bad assets can be defaulted and good ones kept) along with the adverse impact on the price paid for so-called good assets?**

GAO Response

It is not feasible to predict individual asset defaults or the potential costs associated with such defaults. In loan transactions, the lender usually attempts to build protections into the transaction documents to minimize the risk of asset default and provide remedies if an event of default occurs. The Patriot transaction documents provide for usual and customary events of default and remedies for RTC.

As with any real estate loan, RTC faces the risk of asset default. However, the cash flow structure of the pilot transactions should lessen this risk because the buyer is not obligated to pay fixed debt service. Rather, payments are dependent upon the availability of cash flow.

Individual asset values for the pilot transactions are determined by a two step process. First, RTC and the buyer agree on a standard valuation method. Second, an independent advisor implements this valuation method to determine individual asset values. Under this valuation method, the values of performing assets should not be affected by nonperforming assets.

25) **The selection of assets to place in the portfolio is the critical variable in these transactions. What confidence does the GAO have that the RTC is presently able to review buyers' selections and evaluate associated prices? If this task is to be accomplished through private contractors, what procedures does the RTC presently have in place for monitoring and reviewing these contractors' performance?**

GAO Response

RTC has hired an independent advisor to gather information on the selected properties. We have not reviewed RTC's oversight of this advisor because RTC's Inspector General has been asked to review implementation issues of the Patriot transaction, including asset selection and qualification.

The Master Agreement of Sale for the Patriot transaction identifies parameters for asset selection and qualification. Of the properties purchased by Patriot, at least 33 percent must be hotels. In addition, 25 percent of the office buildings and 20 percent of the hotels must be negative cash flow properties. The properties must also be widely marketed by RTC for at least 6 months or unsuccessfully offered in a sealed bid or other organized marketing program. Using this information, RTC is to determine whether the properties are qualified. Asset prices are to be determined by the independent advisor using a valuation method approved by both RTC and Patriot.

RTC officials report that they are to meet with the advisor on a weekly basis to coordinate and review the advisor's activities. They review documentation gathered by the advisor and make the final determination on asset qualifications. They also review asset valuations and due diligence done by the advisor for conformance to the methodology and procedures agreed to by RTC and Patriot.

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April 6, 1992

Attached is the corrected version of Supplemental Information on Portfolio Sales (GAO/GGD-92-5R, April 1, 1992) The version that was previously distributed contained printing errors.