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Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

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RESOLUTION TRUST CORPORATION

Asset Purchase Option for Resolution of City Federal Savings Bank

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General Government Division

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April 30, 1993

The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

On March 26, 1992, you asked us to review a $3 billion asset purchase option agreement that involved the Resolution Trust Corporation (RTC), First Fidelity Bancorporation (First Fidelity), and Goldman, Sachs & Co. (Goldman Sachs), a Wall Street investment banking firm. RTC used the option to help resolve City Federal Savings Bank (City Savings), a failed New Jersey thrift.

Based on a discussion with the Committee, our primary objective was to determine whether the use of the asset purchase option was authorized and the selection and sale of assets under the option adhered to statutory and other requirements for competition in asset disposition. Also, we agreed to (1) gather background information on the City Savings resolution transaction, including the development of the asset purchase option; and (2) identify RTC's obligations under the option and determine how they were satisfied.

Results in Brief

RTC acted within its broad statutory authority to structure the terms and conditions of resolution actions when it used the asset purchase option as part of its strategy to resolve City Savings without an insured deposit payout. However, RTC experienced problems in delivering to Goldman Sachs the type of assets required by the option agreement.

In retrospect, it appears that RTC may have used questionable judgment in structuring the option's terms and conditions. An RTC official involved in developing the agreement told us that fulfilling the option was difficult because the asset requirements were too restrictive.

RTC partially satisfied its obligation under the option by providing Goldman Sachs with about $1 billion in assets from a failed Florida thrift. The procedures RTC used to carry out this asset sale did not violate statutory or other requirements for competition in asset disposition.

RTC was unable to provide the remaining assets of about $2 billion that were needed to fulfill the option. As an alternative means of satisfying its obligation, RTC designated Goldman Sachs the lead managing underwriter for two securitization transactions for which Goldman Sachs will receive standard underwriting spreads. In approving these transactions, RTC's Executive Committee acted within RTC statutory authority and policy requirements.

RTC officials told us that given the problems RTC experienced in fulfilling the option, they do not plan to use a similar asset purchase option agreement in the future.

Background

In December 1989, the Office of Thrift Supervision placed City Savings of Somerset, New Jersey, under RTC control. RTC officials told us that at the time of intervention, City Savings was a large thrift with about $9.8 billion in assets and $7.3 billion in insured deposits and 102 branches located throughout New Jersey and Florida. Appendix I shows a timeline highlighting the sequence of key events in the City Savings resolution, including the development of the asset purchase option and RTC's efforts to fulfill the option. Appendix II describes our objectives, scope, and methodology for the assignment.

RTC officials told us that two items played a significant role in determining RTC's strategy for resolving City Savings—the desire to avoid an insured deposit payout and the overall poor condition of City Savings' asset files, books, and records. Shortly before City Savings was placed under RTC control, RTC had resolved two other thrifts in the New York/New Jersey area by insured deposit payouts. RTC officials believed that these payouts contributed to a heightened level of economic uncertainty and market instability in that region. They said RTC did not want to exacerbate this situation by resolving City Savings in the same manner.

Also, the generally poor condition of the failed thrift's asset files, books, and records influenced RTC's decision not to offer City Savings' assets at resolution. For example, a review of City Savings' assets showed that the condition of the thrift's commercial real estate credit files was poor. The files could not provide the most current information on the collateral or the borrowers. The review also showed that accounting problems existed with the residential and commercial real estate owned assets.

Asset Purchase Option Helped RTC Resolve City Savings

RTC made two attempts to resolve City Savings—the first in September 1990 and the second in January 1991. The first attempt, in which the thrift's insured deposits were offered for sale, was partially successful. About 25 percent of the deposits offered were sold to various acquirers. As a result of the first resolution attempt, RTC officials believed they needed to find a way to make City Savings attractive to more bidders, so that it could be resolved without an insured deposit payout.

In the second resolution attempt, RTC officials offered for sale not only the remaining City Savings deposits but also an asset purchase option. RTC officials believed that the option would not only increase bidder interest in City Savings but also would provide RTC an opportunity to test the previously untried option as an asset disposition method. In entering into the option agreement as a means of facilitating the resolution of City Savings, RTC acted under broad statutory authority to structure the terms and conditions of resolution actions.[1]

The initial terms of the option provided bidders the opportunity to buy residential mortgage assets in an amount up to 125 percent of the City Savings deposits acquired. The option stated that the assets may be located in a maximum of three states selected by the acquirer and that the assets would be delivered to the acquirers within 6 months.

The second resolution attempt was successful. About $2.5 billion in insured City Savings deposits and the option were purchased by First Fidelity, which simultaneously assigned the option to Goldman Sachs Mortgage Company, an affiliate of the investment banking firm of Goldman Sachs. After the sale was completed, Goldman Sachs representatives dealt directly with RTC in finalizing the option's requirements and accepting the delivery of assets.

RTC's Desire to Resolve City Savings Led to Restrictive Option Requirements

RTC officials told us that the primary objective of the option was to attract as many potential acquirers as possible to help resolve City Savings and avoid an insured deposit payout. The asset purchase option was developed jointly by RTC's Resolutions and Operations Division (Resolutions) and the National Sales Center. However, officials in these two groups had different approaches for developing the option's asset requirements. In

[1]See sections 11(d)(2)(G) and (I) of the Federal Deposit Insurance Act, 12 U.S.C. 1821(d)(2)(G) and (I). Under these provisions, RTC as conservator or receiver may effect mergers of insolvent institutions or transfer their assets and liabilities and may exercise "such incidental powers as shall be necessary" to carry out the transaction.

retrospect, RTC may have used questionable judgment in structuring the option's terms and conditions.

In attempting to make the option as attractive as possible, Resolutions officials believed that the option should be easy for potential acquirers and RTC to value. To accomplish this objective, Resolutions believed that the asset requirements should be narrowly defined. On the other hand, National Sales Center officials believed that the option's asset requirements should be broader, so that the option could be fulfilled as easily as possible.

For example, Resolutions officials believed that the option should include residential mortgage assets that would be easy for both RTC and potential acquirers to value. However, National Sales Center officials believed that although lower quality residential mortgages are more difficult to value, they should also be included, so that the option would be easier to fulfill. In the end, RTC determined that the option would be attractive to more bidders if it included only high-quality residential mortgage assets.

The terms of the option were finalized in May 1991, and they obligated RTC to deliver a total of about $3 billion in residential mortgages priced according to the secondary mortgage market. Beginning in August 1991, RTC was required to deliver at least $750 million in various residential mortgage assets in four installments with final delivery scheduled for April 1992. The final option agreement stated that the mortgages would be secured by properties located in 11 states rather than the 3 states originally specified.[2]

RTC Had Trouble Fulfilling the Option's Requirements

RTC experienced problems in delivering to Goldman Sachs the type of assets required by the option. An RTC official told us that before the option terms were finalized, RTC had attempted but was unable to locate a sufficient number of qualifying assets that could fulfill the requirements. Nevertheless, RTC was convinced that such assets would become available as additional thrifts failed. Thus, in May 1991, RTC executed the option agreement for delivery of residential mortgage assets to Goldman Sachs.

Between May and July 1991, RTC officials tried to locate qualifying assets to fulfill the option, but they were unable to do so. By the end of July, RTC

[2]The 11 states were Ohio, Illinois, Indiana, Michigan, Maryland, Wisconsin, Minnesota, Virginia, Pennsylvania, New York, and California. Other states could be included with the acquirer's consent.

informed Goldman Sachs that it would not be able to deliver the volume of residential mortgage assets that met the option's requirements. Various events occurred during this time period that contributed to RTC's inability to deliver the assets. First, the number of failed thrifts entering RTC's conservatorship program began decreasing. Thus, the inventory of residential mortgage assets available to fulfill the option was reduced.

Second, around June 1991, RTC's securitization program started showing results. Securitization is the process of assembling similar assets into pools that are used to collateralize newly issued securities. The process results in marketable securities that enable RTC to convert its assets into cash. An RTC official told us that securitization was a better asset disposition method than the sale of loans required by the option. The official also told us that as RTC increased its securitization activities, fewer residential mortgage assets were available to help satisfy the option.

Another factor that may have contributed to RTC's inability to locate qualifying assets was the lack of an adequate information system. In February 1991, we testified before the House Banking Committee that the lack of such a system precluded RTC from fully knowing its financial asset inventory and raised questions about the soundness of marketing decisions.[3] In March 1992, we reported to you that RTC continued to operate without a corporatewide system to manage and sell loans and other assets.[4] In April 1992, RTC terminated its efforts to develop such a system.

RTC Partially Satisfied the Option Through an Asset Sale

After learning in July 1991 that RTC would not be able to deliver the required assets, Goldman Sachs officials discussed with RTC an alternative strategy for partially satisfying the option. Goldman Sachs offered to purchase about $1 billion in various loan assets from Florida Federal Savings, Federal Savings Bank (Florida Federal), an RTC conservatorship scheduled to be resolved in early August 1991, if RTC received no acceptable bids for the assets at resolution. The assets, which included residential mortgages and student, commercial, construction, and consumer loans, were widely marketed together with the Florida Federal deposits, but no acceptable bids were received for the thrift's assets when Florida Federal was resolved in early August 1991.

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

[4] Resolution Trust Corporation: Status of Loans and Other Assets Inventory System (GAO/IMTEC-92-35BR, Mar. 5, 1992).

Goldman Sachs paid RTC a total of nearly $1 billion for various Florida Federal assets, which included approximately $670 million for residential mortgages, $292 million for student loans, and $22 million for commercial mortgages. These amounts were the same prices that RTC expected to receive if the assets had been sold at resolution. RTC estimated that at the time the sale was completed, the book value of the Florida Federal assets that Goldman Sachs acquired was about $1.2 billion. The asset sale satisfied about $1 billion of RTC's $3 billion obligation under the option.

In selling the Florida Federal assets to Goldman Sachs, RTC did not violate statutory or other requirements for competition in asset disposition. The relevant statute, section 21A of the Federal Home Loan Bank Act, required the Oversight Board, in consultation with RTC, to prescribe plans for the disposition of assets and standards for adequate competition and fair and consistent treatment of offerors.[5] The policies and procedures in effect at the time of the Florida Federal asset sale were contained in RTC's Asset Management and Disposition Manual. The relevant part of the manual generally contemplated the packaging of like groups of loans and the national marketing of such packages on a competitive basis. However, RTC was permitted to use a different sales strategy if approved at the appropriate level within RTC.

In this case, the RTC Board of Directors in September 1991 approved the sale of the Florida Federal assets to Goldman Sachs as required by RTC policy. Underlying the Board's decision was a determination that the purchase price offered by Goldman Sachs reflected the market value of the assets, since the assets had been widely marketed at that price in connection with Florida Federal's resolution and no conforming bids for the assets had been received.

RTC Satisfied the Remainder of the Option Through Alternative Means

After completing the sale of the Florida Federal assets in November 1991, RTC continued trying to identify large pools of assets that could satisfy the remaining obligation of about $2 billion. However, RTC had little success. Even when assets were identified, RTC and Goldman Sachs were unable to agree on appropriate prices. For example, at the end of September 1992, RTC identified a pool of about $300 million in commercial and multifamily mortgage assets. The price RTC set for the assets was the same price that would have been set under the securitization program. However, Goldman Sachs found the price too high. At this point, RTC and Goldman Sachs

[5]As of February 1, 1992, the Oversight Board was redesignated the Thrift Depositor Protection Oversight Board by Section 302(a) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991, Pub. L. No. 102-233, 105 Stat. 1761, 1767.

officials concluded that there was no reasonable way to satisfy both RTC's and Goldman Sachs' asset pricing requirements and that an alternative means of fulfilling the option should be considered.

In October 1992, RTC and Goldman Sachs agreed that instead of providing assets, RTC would satisfy the remainder of its obligation by making Goldman Sachs the lead managing underwriter for two securitization transactions. These transactions involved a total of $2 billion in various commercial mortgages, subordinate mortgage-backed securities, and reserve funds. RTC projected that these deals would be completed in the summer of 1993. For these transactions, RTC estimated that Goldman Sachs would receive standard underwriting spreads of between $8 million and $12 million.[6]

RTC officials told us that this agreement would fulfill the option at no incremental cost because RTC had already planned these two securitization transactions and needed to appoint a lead managing underwriter for them. Also, RTC officials told us that Goldman Sachs has served capably as one of RTC's lead managing underwriters on prior securitization transactions. For these reasons, in October 1992, RTC's Executive Committee approved the selection of Goldman Sachs as lead managing underwriter for the two transactions.

RTC was not legally prohibited from assigning the securitization transactions to Goldman Sachs. As discussed previously, the Oversight Board, in consultation with RTC, was statutorily required to develop standards for adequate competition and fair and consistent treatment of offerors. Under the securitization program, RTC used expedited contracting procedures that departed from its standard contracting policies to select underwriters and other program participants. Through this process, RTC competitively solicited and preapproved a group of nine firms, including Goldman Sachs, to act as lead managing underwriters in future securitization transactions. The underwriting solicitation did not guarantee that RTC would assign any particular number or order of transactions to any firm in the preapproved group but provided that such assignments would be made within RTC's sole discretion.

RTC followed its policies and procedures in assigning the two securitization transactions to Goldman Sachs. Since Goldman Sachs had already competed with other potential underwriters and been chosen for

[6]The underwriting spread is the difference between the price paid by the public for a new security and the proceeds received by the issuer of the security. The underwriter receives the spread as payment for its services.

the preapproved group, Goldman Sachs was eligible to provide the required underwriting services. According to an RTC official, the underwriting spreads that Goldman Sachs agreed to receive were the standard spreads that RTC expected to pay for the completion of these transactions.

Conclusions

RTC accomplished its objective of resolving City Savings without an insured deposit payout. In fulfilling the option through the Florida Federal asset sale and the alternative underwriting arrangement, RTC acted within its statutory authority and policy requirements. Yet RTC may have used questionable judgment in structuring the option's terms and conditions, making the option difficult to fulfill. Along with restrictive asset requirements, other factors contributed to RTC's problems in fulfilling the option, including the decrease in RTC's residential mortgage inventory and the increased use of securitization to dispose of residential mortgages. RTC officials told us that given the difficulties they experienced, they do not plan to use the asset purchase option in the future.

Comments on the Report

We provided RTC a copy of a draft of this report for review and comment. Officials in RTC's Department of Resolutions and the National Sales Center generally concurred with the information in the report and the conclusions. In their comments, Resolutions officials suggested that language be included to clarify information about the option's asset requirements. These suggested changes were included in the report where appropriate.

In addition to RTC, we provided First Fidelity and Goldman Sachs copies of a draft of this report for their review and comment. Both First Fidelity and Goldman Sachs generally concurred with the information in the report.

We are sending copies of the report to Senator Slade Gorton and Congressman Bruce Vento, who also requested that we review the RTC transaction that involved the asset purchase option. In addition, we will provide copies of this report to other interested congressional committees and members, the Chairman of the Thrift Depositor Protection Oversight Board, and RTC's President and Chief Executive Officer. Finally, we will send copies of the report to First Fidelity and Goldman Sachs and make copies available to others upon request.

The major contributors to this report are listed in appendix III. If you or your staff have any questions, please contact me on (202) 736-0479.

Sincerely yours,

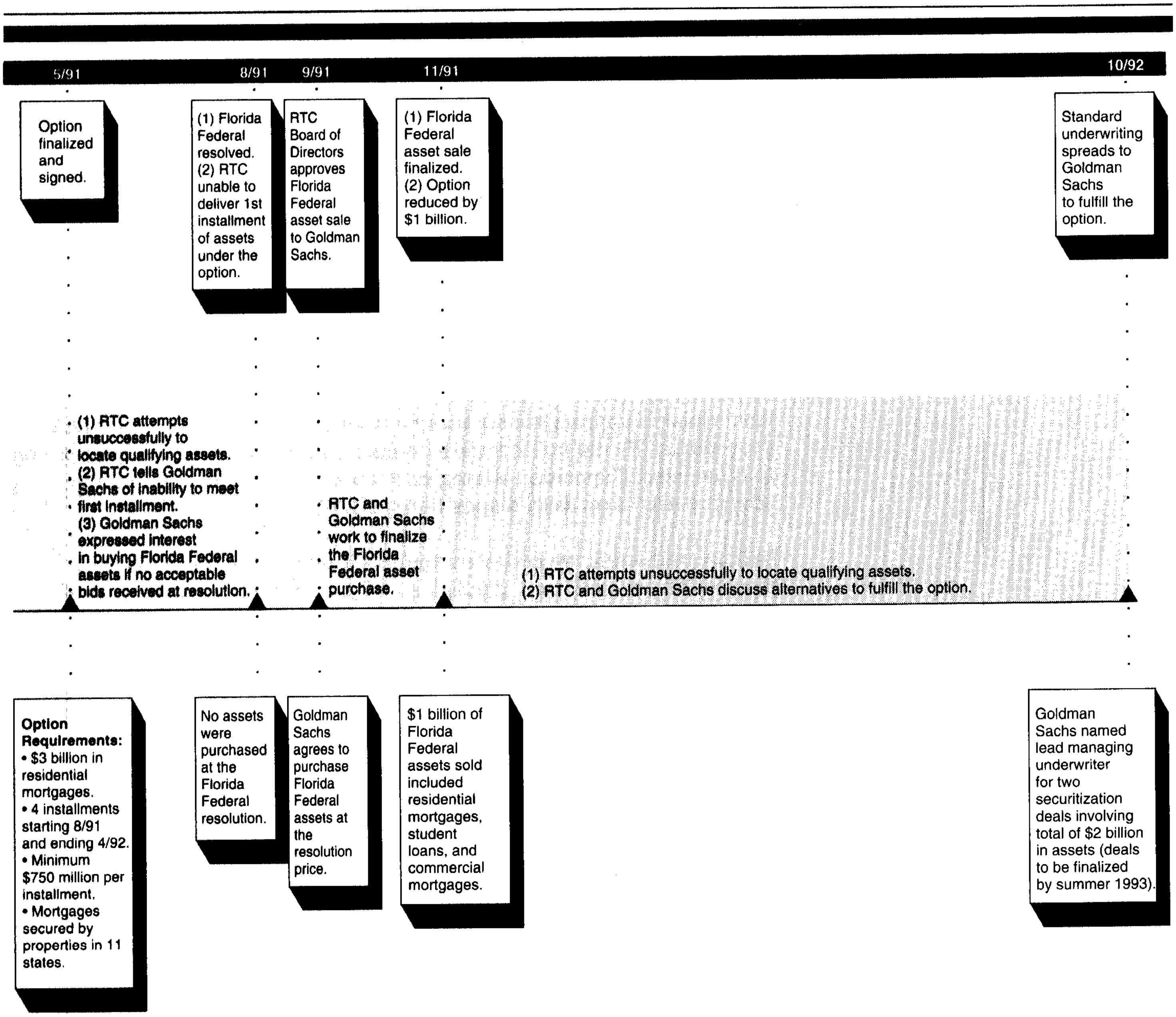
Gaston L. Gianni

Gaston L. Gianni, Jr.
Associate Director, Government
Business Operations Issues

Key Events in the City Savings Resolution, Including the Asset Purchase Option

	12/89	9/90	1/91
Key Events	City Savings placed under RTC control.	1st resolution attempt of City Savings (only insured deposits offered).	2nd resolution attempt of City Savings (remaining insured deposits and option offered).
Important Facts to Know	Review disclosed problems with City Savings' records; RTC decided that no assets could be offered at resolution.	To increase bidder interest and avoid a payout of City Savings, RTC develops the asset purchase option.	(1) RTC and Goldman Sachs negotiate the final option requirements. (2) RTC attempts unsuccessfully to locate qualifying assets.
Additional Information	**Size of City Savings** • $9.8 billion in assets. • $7.3 billion in insured deposits. • 102 branches.	25 percent of insured deposits offered were sold.	(1) First Fidelity purchased $2.5 billion in insured deposits and the option. (2) First Fidelity assigns the option to Goldman Sachs.

Events that happened between those dates specified.


5/91
8/91
9/91
11/91
10/92
Option finalized and signed.
(1) Florida Federal resolved. (2) RTC unable to deliver 1st installment of assets under the option.
RTC Board of Directors approves Florida Federal asset sale to Goldman Sachs.
(1) Florida Federal asset sale finalized. (2) Option reduced by $1 billion.
Standard underwriting spreads to Goldman Sachs to fulfill the option.
(1) RTC attempts unsuccessfully to locate qualifying assets. (2) RTC tells Goldman Sachs of inability to meet first installment. (3) Goldman Sachs expressed interest in buying Florida Federal assets if no acceptable bids received at resolution.
RTC and Goldman Sachs work to finalize the Florida Federal asset purchase.
(1) RTC attempts unsuccessfully to locate qualifying assets.
(2) RTC and Goldman Sachs discuss alternatives to fulfill the option.
Option Requirements:
• $3 billion in residential mortgages.
• 4 installments starting 8/91 and ending 4/92.
• Minimum $750 million per installment.
• Mortgages secured by properties in 11 states.
No assets were purchased at the Florida Federal resolution.
Goldman Sachs agrees to purchase Florida Federal assets at the resolution price.
$1 billion of Florida Federal assets sold included residential mortgages, student loans, and commercial mortgages.
Goldman Sachs named lead managing underwriter for two securitization deals involving total of $2 billion in assets (deals to be finalized by summer 1993).

Objectives, Scope, and Methodology

Our primary objective was to determine whether the use of the asset purchase option was authorized and the selection and sale of assets under the option adhered to statutory and other requirements for competition in asset disposition. Also, we agreed to (1) gather background information on the City Savings resolution transaction, including the development of the asset purchase option; and (2) identify RTC's obligations under the option and determine how they were satisfied.

To achieve our objectives, we focused our work on the events related to the City Savings resolution, including the use of the asset purchase option, and the actions of the three principals involved—RTC, First Fidelity, and Goldman Sachs. We intended to provide the requester detailed information about these events and actions. Also, in accordance with the requester's needs, we agreed to determine whether RTC's actions in this case may have violated appropriate statutory authority and internal policies and procedures. We did not include a comparison of the asset purchase option to other asset disposition strategies or an assessment of the option's effectiveness as an asset disposition method.

In doing our work, we reviewed applicable statutes and RTC's asset disposition and contracting policies and procedures. We also reviewed RTC documents related to the City Savings resolution and the terms and conditions of the asset purchase option agreement.

We interviewed various RTC headquarters and field officials involved in the City Savings resolution and the option agreement. At headquarters, we interviewed officials in RTC's Division of Institution Operations and Sales, the National Sales Center, the Division of Legal Services, and the Division of Asset Management and Sales. In the field, we interviewed RTC officials in the Metropolitan Consolidated Office in Somerset, New Jersey, and the California Consolidated Office in Newport Beach, California. In addition to RTC officials, we interviewed appropriate representatives of First Fidelity and Goldman Sachs who were involved with the City Savings resolution and the asset purchase option.

We did our work from May through November 1992 in accordance with generally accepted government auditing standards.

Major Contributors to This Report

General Government Division, Washington, D.C.

Ronald L. King, Assistant Director, Government Business Operations
Anne M. Hilleary, Evaluator-in-Charge
Philip J. Mistretta, Senior Evaluator
Kelsey Maynard Bright, Evaluator
Theresa Kopriva Elliff, Evaluator
Donna M. Leiss, Reports Analyst
Katherine M. Wheeler, Publishing Advisor

Office of the General Counsel, Washington, D.C.

Susan Linder, Senior Attorney

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