United States General Accounting Office

GAO

Report to the Chairman, Committee on Banking, Finance and Urban Affairs, House of Representatives

April 1994

# FAILED BANK

# FDIC Sale of CrossLand Conservatorship Satisfied Least-Cost Test

GAO/GGD-94-109

GAO

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

General Government Division

B-256423

April 20, 1994

The Honorable Henry B. Gonzalez
Chairman, Committee on Banking,
Finance and Urban Affairs
House of Representatives

Dear Mr. Chairman:

This report responds to your August 20, 1993, letter asking us to examine the Federal Deposit Insurance Corporation's (FDIC) resolution actions regarding the failed CrossLand Federal Savings Bank of Brooklyn, New York. CrossLand has been the most costly bank failure since the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).[1] Currently, FDIC estimates the failure will cost the deposit insurance fund about $889 million.

In your request, you raised specific questions about whether (1) FDIC complied with the least-cost calculation and documentation provisions of FDICIA in its August 1993 sale of CrossLand and (2) FDIC's projected cost savings were realized from its January 1992 decision to take interim ownership of CrossLand upon its failure and operate it until a final resolution alternative could be determined.

## Background

CrossLand recorded substantial losses from 1989 through 1991 because of the impact the weak New York real estate market was having on its portfolio, which was highly concentrated in real estate development lending. CrossLand's efforts to replenish its capital as required by its primary regulator, the Office of Thrift Supervision (OTS), were unsuccessful. In April 1991, FDIC began the resolution process after OTS notified it that CrossLand would likely fail. FDIC initially tried to sell CrossLand to healthy financial institutions. In December 1991, FDIC received two bids for CrossLand's insured deposits, but none for the whole bank—its $8.7 billion in assets or its uninsured deposits and other liabilities. On January 24, 1992, OTS, in its capacity as the chartering authority, declared CrossLand insolvent. FDIC determined that the least costly way to resolve this bank was for FDIC to take interim ownership of CrossLand, establish a conservatorship, and privately manage it until an acceptable acquirer could be found.

[1]P.L. 102-242 (105 Stat. 2236, sec. 141) This section of FDICIA amended sec. 13(c) of the Federal Deposit Insurance (FDI) Act (12 U.S.C.A. 1823(c)(supp. 1992)).

FDIC is required by FDICIA to resolve a failed bank in a manner least costly to the Bank Insurance Fund (BIF). FDIC made two resolution decisions relative to the CrossLand failure. The first, in January 1992, was to place it in a conservatorship, and the second, in August 1993, was to sell the CrossLand conservatorship through a securities offering, which included common stock and debentures (bonds), to a group of institutional investors.[2] We reported in July 1992 that the decision to place CrossLand into a conservatorship was not supported by adequate documentation of the FDIC Board of Directors' evaluation of the resolution alternatives and the assumptions upon which this evaluation was based.[3] Although there was no record attributable to the FDIC Board of Directors documenting the Board's evaluation and assumptions, we did review the staff analyses prepared for the Board's January 1992 resolution decision in our July 1992 report. FDICIA's requirements for resolving failed banks, as well as our criteria for the adequacy of documentation needed to evaluate FDIC's cost evaluations, are included in this report (see app. I).

When it established the conservatorship on January 24, 1992, FDIC injected $1.2 billion in cash to restore CrossLand's capital to the required level and to strengthen the bank by reducing its high-cost debt. FDIC also hired a chief executive officer to manage CrossLand in conservatorship and approved a business plan that was designed to return the bank to operating profitability by downsizing and stabilizing it. The business plan called for, among other things, selling CrossLand subsidiaries outside the New York City area, reducing the troubled real estate loan portfolio, and reducing related operating expenses.

In December 1992, FDIC began exploring the available alternatives for resolution of the CrossLand conservatorship. After considering various alternatives, in August 1993, FDIC sold the CrossLand conservatorship—by then a smaller bank containing $5.2 billion in assets—through a public offering.

## Results in Brief

FDIC considered the available resolution alternatives and determined that the public offering sale of CrossLand would be the least costly to BIF. We found the process used by FDIC to make this resolution decision was much improved over that used to make the January 1992 CrossLand resolution

[2]The initial sale of securities to individuals or institutional investors in the financial markets is commonly referred to as a public offering sale.

[3]Failed Bank: FDIC Documentation of CrossLand Savings, FSB, Decision Was Inadequate (GAO/GGD-92-92, July 7, 1992).

decision to establish a conservatorship. The process regarding the documentation of the cost estimates for each alternative considered, as well as the underlying assumptions for those estimates, was improved. Thus, we believe the FDIC decision to sell the CrossLand conservatorship to institutional investors through a public offering complied with the least-cost calculation and documentation requirements in section 13(c)(4) of the FDI Act, as amended by FDICIA. FDIC projects the CrossLand resolution will cost BIF $889 million, although the final cost could be more or less than this amount.

An assessment by a public accounting firm and FDIC and OTS examinations did not reveal any significant problem with the management and control of CrossLand during its conservatorship operations. Nevertheless, FDIC did not achieve the total $517 million in savings that FDIC staff projected would result from the conservatorship operations and public offering sale when compared with the next best resolution alternative available in January 1992—insured deposit transfer.[4] Instead, FDIC now believes the savings are likely to be about $333 million (64 percent of the projected $517 million in savings). FDIC officials advised us that the projected savings were not realized primarily because CrossLand's assets proved to be in worse condition than estimated in FDIC's initial valuation before the January 1992 resolution decision. FDIC officials further advised us that FDIC did not recognize that the assets were in worse condition than estimated until the agency placed CrossLand into conservatorship in January 1992.

## Objective, Scope, and Methodology

To respond to your request to determine whether FDIC complied with the least-cost provisions of FDICIA in its August 1993 public offering sale of CrossLand, we reviewed the different resolution alternatives FDIC considered in dissolving the conservatorship and the Division of Resolutions' (DOR) evaluation of these alternatives. To do this, we reviewed documents from FDIC Board meetings on CrossLand and the related resolution files maintained by FDIC. We also interviewed officials from FDIC's Division of Liquidation (DOL),[5] Legal Division, DOR, and the Office of the Inspector General in Washington, D.C., as well as the Division of Supervision (DOS), Legal Division, and former FDIC officials from the New York Regional Office.

To determine whether FDIC's projected cost savings were realized from its January 1992 decision to take interim ownership of CrossLand, we

[4]Selling the bank's insured deposits and certain other liabilities but none of its assets to an acquirer.

[5]In October 1993, the DOL was reorganized and renamed the Division of Depositor and Asset Services.

compared the assumptions justifying the decision to the cost savings FDIC reported after the CrossLand sale. We compared estimated FDIC proceeds from the CrossLand conservatorship operations and sale with FDIC estimated revenues reported after the sale. We also interviewed officials from FDIC's DOL and DOR; officials from OTS' New York region; and the executive management of CrossLand in Brooklyn, New York. We also reviewed the bank's financial reports and FDIC files on the oversight of the conservatorship. FDIC provided written comments on a draft of this report. The comments are evaluated on page 14 and reprinted in appendix II.

We did our work from September 1993 through December 1993 in accordance with generally accepted government auditing standards.

## FDIC's Cost Evaluations Showed the Public Offering Sale to Be the Least Costly to BIF

Section 13(c)(4) of the FDI Act requires FDIC to (1) consider the available alternatives for resolving a troubled depository institution, (2) evaluate the cost of these alternatives, and (3) choose the resolution alternative that involves the least possible cost to BIF. FDIC is required to document cost estimates and the assumptions made in arriving at the cost estimates in determining the least costly resolution alternative. However, there is no specific format required for how documentation is to be presented. It is FDIC's responsibility, specifically FDIC's Board, to select and document the resolution alternative the Board determines to be the least costly to BIF.

### FDIC Has Taken Steps to Improve Its Resolution Process

In our review of the January 1992 CrossLand resolution, we concluded that key assumptions justifying the conservatorship decision were not adequately supported. For example, we concluded that certain assumptions were not supported with empirical evidence, such as the assumption that FDIC would recover 10 percent more on $4.4 billion in troubled assets if CrossLand were privately managed in a conservatorship. We recommended that FDIC (1) develop and implement consistent and complete documentation standards for its resolution decisions, (2) assess and report on historical experience in disposing of troubled assets not readily marketable, and (3) develop policies for addressing uncertainties about the validity of any assumptions that could materially affect the cost evaluation results.

In the August 1993 resolution of CrossLand, we found that FDIC did a better job of documenting its least-cost decision. For example, various data sources used in developing cost evaluations were clearly identified in FDIC documents. We checked several of the key figures that FDIC used to develop the CrossLand resolution cost test. For the figures we checked, FDIC adequately supported and documented its analysis and by doing so, was in compliance with the least-cost calculation and documentation requirements of section 13(c)(4) of the FDI Act and the criteria described in our July 1992 report.[6]

FDIC officials advised us that improving documentation was a result of steps they had taken to improve the overall resolution process. Specifically, FDIC developed a resolution operations manual addressing, among other things, what criteria should be used in determining the adequacy of documentation for assumptions used in resolution decisions.

FDIC has also undertaken several projects designed to track individual assets through disposition. Such data can then be used in future resolution decisions as a "reality check" when estimating costs of various resolution strategies for banks expected to fail or used in sales strategies for failed bank assets assumed by FDIC through resolutions. Although we did not evaluate the adequacy of these asset tracking initiatives, we believe that data on the results of resolution decisions are important to provide a basis for future decisions and thereby reduce uncertainty in those decisions. The resolution operations manual does not specifically address how to incorporate uncertainty into cost evaluations; however, FDIC resolution officials believe the guidance provided in the manual will reduce uncertainties in its cost evaluations. They also believe that uncertainties are most difficult to address in resolutions involving lengthy conservatorships.

In the August 1993 resolution, uncertainty—such as future changes in economic conditions—was not as significant an issue as it was in the January 1992 resolution. Specifically, proceeds to FDIC from the January 1992 resolution were not expected to be realized by FDIC for 2 years, and the ultimate cost could be affected by market conditions and other factors during this time. In the August 1993 resolution, proceeds to FDIC were received primarily in cash at the time the sale was completed. Receiving such a lump sum payment diminishes the potential negative impact of such uncertainties.

## Four Resolution Alternatives FDIC Considered and Evaluated

In December 1992, FDIC began exploring its alternatives for dissolving the conservatorship of CrossLand. FDIC identified and evaluated four possible resolution alternatives that included the (1) liquidation of the

[6]GAO/GGD-92-92. (See app. I for a discussion of the criteria.)

conservatorship's assets and liabilities, (2) piecemeal sale of the bank's assets and liabilities, (3) sale of the entire conservatorship, and (4) sale of CrossLand through a public offering.

One alternative FDIC considered and evaluated involved the cost to liquidate CrossLand in 1993. FDIC officials estimated that the liquidation would provide net proceeds to FDIC of about $15 million from the sale of the assets and would result in a cost of $1.175 billion to BIF.

FDIC also contracted with a financial adviser in January 1993 to assist in analyzing potential resolution alternatives. In March 1993, the adviser recommended a piecemeal sale of CrossLand. This strategy included the sale of some assets, including selected branches and their deposits, with certain hard-to-sell assets retained by FDIC for liquidation. This alternative was estimated to provide FDIC between $110 million and $220 million in net sales proceeds, with a resulting cost to BIF of between $970 million and $1.08 billion.

A third alternative for resolving CrossLand was to sell it to another financial bank. Nine institutions showed interest in bidding for CrossLand. Of the nine, only one New York thrift submitted a bid to FDIC, and this bid was for the whole bank. The FDIC estimated that this bid would generate $291 million in net sales proceeds, thereby costing the BIF $899 million.

In its formal bid, the thrift requested that FDIC consider the potential increase in value of the bidder's warrants that were being held by FDIC that would result from an in-market merger of the thrift and CrossLand. Neither FDIC nor the bidder estimated a potential value for these warrants.

FDIC officials told us that the warrants' proceeds were held by the Federal Savings and Loan Insurance Corporation's (FSLIC) Resolution Fund (FRF), which is a separate resolution fund managed by the FDIC. They said FDIC was prohibited by the FDI Act from combining transactions involving the FRF and the BIF.

These officials said that the FDI Act requires them to consider costs associated with the affected deposit insurance fund (BIF) and that the law further requires that FRF be managed independently of other resolution funds and not be commingled with BIF.

In our view, FDIC's decision not to consider a potential increase on the value of the bidder's warrants is consistent with the least-cost requirements of the FDI Act. Section 13(c)(4) of the FDI Act specifically requires FDIC to resolve a troubled institution in a manner that is the least costly to the deposit insurance fund, in this case, the BIF. Any potential increase in the value of the warrants would be held by FRF and would not affect the cost of the resolution to BIF.

At the same time that FDIC was considering these three alternatives, it was exploring a fourth alternative—resolving CrossLand through a public offering. In early 1993, improving market conditions for thrift securities helped publicly traded thrifts to recapitalize. These successes encouraged FDIC to pursue the fourth alternative. FDIC solicited proposals from four investment advisory firms to determine the feasibility of such a public offering of all, or substantially all, of the equity ownership of CrossLand. FDIC selected two of the four financial advisory firms to pursue the public offering alternative. In the spring of 1993, these firms concluded that the sale of CrossLand would generate approximately $300 million in proceeds.

On August 12, 1993, FDIC's Board chose the fourth alternative, the sale of CrossLand by public offering, as the least costly alternative, and the sale was closed on August 19, 1993. The sale of CrossLand to institutional investors generated approximately $301 million in net proceeds, as estimated by FDIC. FDIC determined the public offering of CrossLand to be the least costly of the four alternatives it considered with an estimated cost to BIF of $889 million (see table 1).

**Table 1: Cost to BIF of Four CrossLand Resolution Alternatives**

Dollars in billions

| Alternative | Cost |
|---|---|
| Liquidation of conservatorship assets and liabilities | $1.175 |
| Piecemeal sale of CrossLand | .970 - 1.08 |
| Sale of entire conservatorship | .899 |
| Sale of CrossLand by public offering | .889 |

Note: The cost of all four alternatives includes the net proceeds plus an approximate $10 million expected return from assets currently held in an FDIC receivership. Thus, the August 1993 CrossLand resolution is expected to generate net proceeds to FDIC of $301 million from the securities sale, plus about $10 million from FDIC receivership, which, when used to offset the $1.2 billion FDIC injected in cash, results in a total estimated cost of $889 million.

Source: FDIC Analysis of Resolution Alternatives Considered, August 12, 1993.

## Assumptions Made in Least-Cost Analysis

FDIC made seven assumptions relating to the August 1993 CrossLand resolution. These assumptions related to a number of areas such as asset liquidation values, completion risk, and assistance agreement outlays between CrossLand and FDIC pertaining to potential losses on assets. With the sale of CrossLand through the public offering, the accuracy of three of the seven assumptions remains unknown. Of these three assumptions, two assumptions were related to the expected future outlays under the assistance agreement, and the other was related to the future selling price for CrossLand warrants received by FDIC as part of the public offering.[7] The three assumptions are based on anticipated future events; therefore, they cannot be evaluated for accuracy at this time. For example, about $2.7 billion (50 percent) of the conservatorship assets contained a loss-sharing provision that provides the acquirers with insurance against losses should the assets be worth less than the stated book value and related reserves for losses. FDIC has estimated that the cost of the loss sharing could be $28 million over the term of the agreement. We will not know the precise cost until the loss sharing and recovery periods end June 30, 2001. FDIC assumed that including loss-sharing assistance as part of the resolution would generate more interest by potential acquirers although it did not formally acknowledge this as an assumption. For FDIC, the use of loss-sharing agreements in the resolution process is a relatively new incentive designed to facilitate the sale of troubled assets. Therefore, although FDIC adequately documented its cost evaluation of the public offering to be $889 million, the actual cost may end up being more or less than this amount. For example, should CrossLand's assets improve in value and its new owners make CrossLand a profitable entity, the final cost to BIF could be less than $889 million. Even if CrossLand continues to sustain losses, the final cost could be less than $889 million because the warrants may be sold for more than FDIC estimated, and the loss sharing ultimately may cost less. However, further losses could result in greater BIF costs because the warrants could end up being less valuable and the loss sharing agreement more costly than FDIC estimated.

## Conservatorship Costs Less Than Other Resolution Alternatives, but More Than Expected

In January 1992, FDIC estimated BIF would save $517 million by selecting the conservatorship alternative for CrossLand over the next best alternative. After the sale of CrossLand in August 1993, FDIC publicly reported that the conservatorship savings from the sale proceeds were about $400 million. From our review of FDIC's data, we believe that an adjustment to the August 1993 $400 million savings estimate is needed to make it comparable to the January 1992 estimate. The adjustment involves

[7] In connection with its conversion from federally chartered mutual savings bank to a federally chartered capital stock savings bank, CrossLand issued warrants to FDIC to purchase 1 million shares of common stock, or approximately 7.2 percent of the fully diluted outstanding common stock of the bank.

converting the August 1993 estimated sales proceeds to the value of those proceeds, if received, in January 1992 for comparability to the projected savings at that time. Consequently, the savings from the conservatorship sale as adjusted would be $333 million (64 percent of the projected $517 million savings). FDIC officials agreed with us that such an adjustment would be appropriate for the estimated proceeds to be comparable to the savings projected in January 1992. Thus, in January 1992 dollars, CrossLand would now be expected to cost BIF $948 million, rather than the $763 million projected in January 1992.[8]

OTS and FDIC examiners who reviewed the CrossLand conservatorship concluded that its operations were well managed and controlled. An accounting firm also did not find significant shortcomings in the operations or controls of the CrossLand conservatorship. Nevertheless, this conservatorship did not restore CrossLand to profitability, nor did it produce the January 1992 projected improvements in franchise value. FDIC officials advised us that the asset quality was worse than expected in January 1992, so the projected asset improvement in conservatorship could not be realized. Senior DOR officials agreed with our findings, but advised us that they believed the savings realized from placing CrossLand into conservatorship were about the same as the amount initially projected. They now believe that the liquidation cost estimate should have been about $200 million higher because the condition of the assets turned out to be worse than originally valued at the time of the January 1992 decision. We cannot, nor can DOR, verify or refute this belief. Nevertheless, the January 1992 decision would not have been affected by a $200 million higher liquidation cost estimate.

## Conservatorship Appeared to Be Well Managed and Controlled

As conservator of CrossLand, FDIC provided guidelines for operating the bank and established reporting requirements for approval of strategies and business transactions, such as the disposition of assets. FDIC hired a chief executive officer and approved his remuneration, as well as other CrossLand executives, consistent with market studies of executive pay in comparable financial institutions. FDIC required the bank's management to prepare a business plan specifying how the bank was going to operate profitably and restructure its assets.

[8]None of the cost evaluations include the substantial time devoted by senior FDIC staff in overseeing the CrossLand conservatorship and in going through the entire resolution process a second time with the same entity. FDIC told us that this overhead expense was no more than $2 million, although no records were maintained to calculate such overhead costs. More importantly, in our view, one cannot measure the cost of having senior DOR staff occupied for 18 months with the responsibilities of overseeing the conservatorship rather than having that time devoted to their other responsibilities.

CrossLand management was also required to submit weekly and/or monthly status reports and brief FDIC officials responsible for overseeing the conservatorship. These reports and briefings were related to CrossLand management's progress in addressing the business plan and specifically in its handling of troubled loans. For example, at the time of the sale, CrossLand's largest subsidiary, CrossLand Mortgage Corp., had a book value of $266 million. The conservatorship received 10 bids, and the subsidiary was sold to the highest bidder. The FDIC Board approved the sale for $305 million, thereby realizing a gain of approximately $39 million over the book value.

FDIC and CrossLand officials told us that FDIC had a constant on-site presence at the bank during conservatorship. There was a staff attorney assigned to the bank corporate office headquarters to represent the conservatorship and FDIC on legal issues. Records also indicate that FDIC staff attended CrossLand executive committee meetings where decisions on asset dispositions were made. FDIC files on CrossLand also indicated that the Director, DOR, met with bank officials on a monthly basis to discuss current strategies, and that reports on the status of the assets and planned action were sent to FDIC.

There were a number of financial and operational audits of the conservatorship performed by regulators or firms contracted by regulators. These audits generally were concerned with the condition of the assets, but also reported that the conservatorship managers were doing a good job in following FDIC operating guidelines and the business plan.

OTS and FDIC conducted limited scope examinations in October 1992. In their examinations, both OTS and FDIC concluded that the conservatorship was well managed, but asset quality was still a concern. OTS also noted in its examination that the business plan was well designed and effectively implemented by conservatorship management.

Two accounting firms reviewed the compliance and financial aspects of the conservatorship. One firm performed the financial audit and concluded that the bank's financial statements were fairly presented. The other firm, contracted by the FDIC Inspector General's Office to review the conservatorship's compliance with guidelines to ensure appropriate management and control of operations, had not issued its report as of March 22, 1994. However, officials from FDIC's Inspector General's Office told us that the firm reviewed 80 to 90 of the largest transactions and a sample of the smaller ones, and did not identify significant shortcomings in the operations or controls of CrossLand.

## Conservatorship Unable to Restore Crossland to Profitability

By establishing a conservatorship with control over virtually all of CrossLand's assets and liabilities, FDIC assumed it could restore the franchise to profitability. Under the conservatorship, the chief executive officer had authority to manage the bank as an independent stand-alone entity with a business plan approved by FDIC that was designed to return the bank to operating profitability. The business plan was to focus on

- resolving troubled assets in a cost-efficient manner through restructuring or disposition;
- divesting nonstrategic business units located outside the New York City area and certain other assets, while shrinking to a bank focused on providing retail banking services and lending activities in the New York City area;
- maintaining quality, competitive services to protect and preserve the core retail banking franchise in the New York City area; and
- maintaining systems and controls, while improving operating efficiencies.

The offering circular for CrossLand Federal Savings Bank reported that the bank, between January 1992 and June 1993, made progress in reducing and restructuring the franchise in metropolitan New York City and in selling or restructuring its nonperforming assets. For example, the bank either sold, or received repayment for, approximately $261.5 million of its nonperforming assets. Substantially all of these were high risk assets. It also sold CrossLand Mortgage Corp. in Utah, and closed 23 branches in Florida, with 9 remaining Florida branches under pending sales contracts, and a number of other New York City area branches either sold or closed. Although management was able to achieve a number of its objectives during conservatorship, CrossLand was not restored to profitability as had been anticipated by the January 1992 resolution.

In January 1992, FDIC assumed that CrossLand would earn $69 million after taxes in each of the 2 years of conservatorship and pay a one-time dividend of $203 million to FDIC at the end of conservatorship. It also projected improvement in the CrossLand franchise value during conservatorship that would result in proceeds of $375 million at the time of its sale after the 2-year period.

Contrary to FDIC assumptions, the 18-month conservatorship did not generate income or pay dividends. Instead, it had a net loss of about $235,000 from operations over the period from January 1992 to June 1993. The actual sales proceeds are expected to be $301 million or 80 percent of the $375 million anticipated in January 1992.

FDIC officials advised us that the major reason for the lower than projected proceeds was that the valuation of the CrossLand loan portfolio did not accurately reflect the condition of the loans at the time of the January 1992 conservatorship decision. They said that the valuation was performed on only a small sample of the bank's assets and was completed several months before the resolution decision. Therefore, the analysis did not allow FDIC to fully recognize the depth of the loan quality problems in the portfolio. In our July 1992 report, we pointed out that FDIC used obsolete data on asset values in its cost evaluations and had failed to show why they believed, at that time, that using more current data was unnecessary. FDIC and OTS' limited scope examinations of CrossLand operations also indicated problems with a high level of troubled assets.

## Savings From Conservatorship Management of Assets Unknown

FDIC identified anticipated savings from a private sector restructuring of troubled assets[9] in an open bank as the principal cost advantage of the conservatorship option over the other available resolution alternatives considered in January 1992. The necessary data for comparing this assumption against experience are not available.

FDIC's January 1992 resolution decision projected that a conservatorship was $517 million less expensive than the next best alternative. About $440 million (85 percent of the $517 million), was attributable to an assumption that troubled assets could be better managed through conservatorship involving private sector management of an open bank. In our July 1992 report, we disclosed that the $440 million was not based on any empirical evidence, and that FDIC records did not contain any such evidence. We also reported that there was disagreement among two FDIC divisions, DOR and DOL, as to the amount of cost savings, if any.

We cannot compare this assumption to actual experience because the assumption was not adequately supported at the time and the data needed to measure the results were not readily available in 1992. The dollar value of assets that could have been disposed of in a liquidation is a matter of conjecture since FDIC disposed of only $11 million of the $5.2 billion in

[9]Troubled assets are loans, including real estate loans and other assets, that are not readily marketable.

CrossLand assets through FDIC liquidation activities. An FDIC official told us that FDIC does not have a system that tracks information on the rate of return for specific assets. In addition, even if FDIC had this information, the comparison may not be valid because other factors could contribute to the valuation of an asset.

## With Hindsight, Protection of Uninsured Depositors Was Unnecessary

FDIC assumed in January 1992 that protecting CrossLand's uninsured depositors would be less costly than a decrease in franchise value caused by depositor runs that may have resulted by forcing the uninsured depositors to share in CrossLand's losses. The cost of protecting the uninsured did not have a major impact on the final resolution cost. The actual cost of protecting the uninsured was $11 million or 61 percent of FDIC's anticipated cost of $18 million in January 1992. The actual cost of $11 million was 1.2 percent of the $889 million estimated cost at the time the conservatorship was sold in August 1993. FDIC officials told us that the lower than anticipated cost of protecting uninsured depositors was because FDIC overestimated the number of uninsured depositors. CrossLand and other financial institutions are not required to, and do not, report extensive data to the FDIC on the insurance status of each deposit account. During conservatorship, a more detailed review of deposit accounts determined that uninsured deposits were less than expected.

FDIC assumed that if it did not protect uninsured depositors from losses and honor certain deposit contracts on certain deposit accounts, there would be a large outflow of deposits during conservatorship. FDIC believed that this would result in a reduced CrossLand franchise value and would lower the expected sales proceeds when Crossland was sold to the private sector. As we previously reported, FDIC did not have documented support for the assumption on depositor reactions. However, since the January 1992 CrossLand resolution decision, other resolutions such as American Savings Bank in New York and First City in Texas show that requiring uninsured depositors to absorb their share of losses in the resolution of a failed bank does not necessarily result in depositor runs. With the benefit of this experience, the Director, DOR, told us that in hindsight it was unnecessary to protect the CrossLand uninsured depositors in the January 1992 resolution decision.

## Conclusions

The process FDIC used to make the August 1993 decision to offer CrossLand for public sale was well documented, with adequately supported cost estimates for each alternative. This process was much improved over that used by FDIC to make the January 1992 decision to establish a conservatorship. Thus we believe the decision was in compliance with the least-cost calculation and documentation requirements in section 13(c)(4) of the FDI Act, as amended by FDICIA.

We found no evidence of significant problems with the management and control of CrossLand during its operation under FDIC conservatorship. Nevertheless, FDIC did not achieve savings from the conservatorship operations in line with its original projections, primarily because when FDIC placed CrossLand into conservatorship it found the institution's assets to be in worse condition than estimated at the time of the conservatorship decision.

## Agency Comments

FDIC provided written comments on a draft of this report and concurred with our results as presented (see app. II). FDIC reiterated in its comments that the cost of the CrossLand resolution was more than initially expected; that is, when FDIC gained control of the bank in January 1992, it found the assets to be in worse condition than it had estimated in making its resolution decision. We note on page 9 that the January 1992 resolution decision would not have been affected by a $200 million higher liquidation cost estimate.

We are providing copies of this report to the Committee Ranking Minority Member, the Acting Chairman of FDIC, and the Acting Director of OTS. We will provide copies to other interested parties on request.

This report was prepared under the direction of Mark Gillen, Assistant Director, Financial Institutions and Markets Issues. Other major contributors are listed in appendix III. If you have any questions, please contact me on (202) 512-8678.

Sincerely yours,

James L. Bothwell

James L. Bothwell
Director, Financial Institutions
and Markets Issues

# Documentation Requirements for FDIC Resolution Decisions for Troubled Depository Institutions

Section 13(c)(4) of the FDI Act, as amended by FDICIA, requires FDIC to evaluate "all possible methods" for resolving a troubled depository institution and to choose the resolution method that entails the "least possible cost to the deposit insurance fund." These statutory provisions establish the basic requirements that FDIC must meet in making its least-cost determination. With respect to the determination itself, the statute requires FDIC to evaluate resolution alternatives by determining and comparing their costs on a present-value basis, and then to select the least costly alternative based on this evaluation.

Section 13(c)(4)(b)(i) provides that in making this least-cost determination FDIC must

"(I) evaluate alternatives on a present-value basis, using a realistic discount rate;

"(II) document that evaluation and the assumptions on which the evaluation is based, including any assumptions with regard to interest rates, asset recovery rates, asset holding costs, and payment of contingent liabilities; and

"(III) retain the documentation for not less than five years."

We believe that these provisions of the statute require, as a threshold matter, the existence of a written record that, at a minimum, shows

- the cost estimates that the FDIC Board arrived at for each alternative considered, and
- the assumptions the Board made in arriving at those cost estimates, with enough specificity to evidence a determination on the part of the Board that the alternative it chose was, under its own analysis, the least costly to BIF.

Because of the unique facts and circumstances surrounding each resolution case, we believe that the amount and type of support underlying each resolution decision may differ. Although we understand that variations in documentation may exist as a result, we believe that certain general documentation criteria would aid FDIC in ensuring the adequacy of support for the Board's evaluation and its assumptions. At the time of CrossLand's 1992 resolution, FDIC had no written policy specifying the support necessary to document its least-cost resolution decision. Since our 1992 report, FDIC has developed policies addressing this issue. We have developed documentation criteria set forth next and have discussed these criteria with FDIC's Director of Resolutions and with senior staff in their Legal Division who raised no objections. These criteria are as follows:

- Documentation should be clear, consistent, concise, and complete so that an outside observer can identify and understand the estimated cost of each option, including the assumptions and discount rates used.
- Data sources for each cost evaluation should be clearly identified so that cost figures can be traced to their source.
- Assumptions integral to the cost evaluations should be documented and supported. In particular, each assumption should be (1) clearly identified, and (2) supported by empirical data or in the absence of such data, by judgment based on relevant experience. This support should be explicitly described in the documentation and, where appropriate, the source(s) used in making the assumption should be identified.
- If there is uncertainty about the validity of an assumption that materially affects the cost evaluation results, some effort to gauge that uncertainty should be made and documented by showing a range of possible outcomes.

# Comments From the Federal Deposit Insurance Corporation

**FDIC**
**Federal Deposit Insurance Corporation**
Washington, DC 20429

Office of Executive Director
Supervision and Resolutions

February 25, 1994

Mr. James L. Bothwell
Director, Financial Institutions and Markets Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Bothwell:

This letter is in reply to your letter of February 16, 1994 to Acting Chairman Hove wherein you discuss your draft report entitled, FAILED BANK: FDIC Sale of CrossLand Conservatorship Satisfied Least - Cost Test (Code 233415).

The FDIC is pleased that your audit confirmed that the CrossLand resolution transaction satisfied the statutorily required least-cost test. We also note that the results of this audit acknowledge that the FDIC has improved the overall resolution process, that our assumptions underlying the CrossLand resolution decision process are well documented, and that the CrossLand conservatorship appeared to be well managed and controlled. We also concur with your finding that the conservatorship cost less than other resolution methods.

Now on pp. 9-10

However, your observation that the cost of the CrossLand resolution was more than initially expected bears some additional clarification. As you point out on pages 16 and 17 of the draft report, it is our firm belief that the cost of liquidating CrossLand was underestimated in January 1992. It was only after the FDIC gained control of the institution that it became evident that the condition of CrossLand's assets was worse than believed in January of 1992.

We appreciate the professionalism of Assistant Director Gillen and his team, the audit's fairness and accuracy, as well as identifying the substantial improvements made by the FDIC during the period that CrossLand was in conservatorship.

Sincerely,

John W. Stone
Executive Director
Supervision and Resolutions

# Major Contributors to This Report

## General Government Division, Washington, D.C.

Mark Gillen, Assistant Director, Financial Institutions and Markets Issues
Monty Kincaid, Evaluator-in-Charge
James R. Black, Senior Evaluator
Ned R. Nazzaro, Evaluator
Edward J. DeMarco, Adviser

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

Rosemary Healy, Senior Attorney

## New York Regional Office

Richard Schlitt, Senior Evaluator
Despina Hatzelis, Evaluator
Trace Wilkins, Evaluator

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