

GAO

Report to the Senate Committee on
Banking, Housing, and Urban Affairs and
the House Committee on Banking and
Financial Services

May 1995

1993 THRIFT RESOLUTIONS

RTC's Resolution Process Generally Adequate to Determine Least Costly Resolutions





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

General Government Division

B-260642

May 15, 1995

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Chairman
The Honorable Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable James A. Leach
Chairman
The Honorable Henry B. Gonzalez
Ranking Minority Member
Committee on Banking and Financial Services
House of Representatives

This report presents the results of our second annual review of the Resolution Trust Corporation's (RTC) compliance with Section 13(c)(4) of the Federal Deposit Insurance Act, as amended by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This section of the act requires RTC to (1) choose the alternative for resolving a failed thrift that results in the least possible cost to RTC and (2) calculate and document its evaluation of the costs of alternatives for resolving a troubled thrift. The act also requires us to annually audit RTC's compliance with the least-cost requirements.

We reviewed three judgmentally selected resolutions of failed thrifts completed between January 1, 1993, and June 30, 1994, to determine RTC's compliance with the least-cost requirements.

Results in Brief

RTC has made improvements to its resolution process that enable it to better comply with FDICIA's least-cost requirements. We found that RTC selected the resolution alternative it determined to be least costly for the three resolutions and adequately documented the bases for those decisions. We also found that, where relevant, RTC effectively implemented changes to its corporate policies regarding the treatment of uninsured depositors and the timing of when it sold the assets of thrifts in conservatorship. These changes brought RTC into compliance with the act's uninsured depositor requirements and better provided for RTC's conformance with FDICIA's requirement that it evaluate other resolution methods before selling assets.

In addition, RTC changed the timing of its liquidation cost estimates. Its current practice is to make an initial liquidation cost estimate at the time a failed thrift is placed in conservatorship to, among other things, determine the amount of estimated losses to be absorbed by uninsured depositors. This practice, along with RTC's intention to resolve any further failing thrifts through its accelerated resolution program, will better provide for RTC's conformance with FDICIA.

Background

Our First Review Identified Compliance Problems

We reviewed RTC's 1992 resolutions process to determine if it provided for compliance with the FDICIA least-cost requirements. We reported that three of RTC's corporate policies raised compliance issues.¹ These policies did not (1) ensure that uninsured depositors would absorb their shares of thrift losses if necessary to achieve least costly resolutions; (2) require RTC to evaluate other available resolution methods prior to selling the assets of thrifts in conservatorship; or (3) require RTC to estimate the cost of liquidating thrifts in conservatorship as of the earliest of three dates specified by the act, which is usually the date when RTC passes the failed thrift through a receivership and is appointed conservator.

We also found numerous documentation shortcomings from our review of a sample of 1992 resolutions. For instance, RTC did not always fully document the bases of the evaluations of the resolution alternatives considered, including the consideration given to all nonconforming bids received from potential acquirers, as its procedures required. Further, RTC generally did not document the rationale for the marketing strategy it selected.

We recommended that RTC evaluate the resolution methods that are potentially available before selling the assets of a failed thrift and make liquidation cost estimates at the earliest of the three dates specified by FDICIA. We also recommended that RTC document the consideration given all nonconforming bids and the rationale for the agency's preferred marketing strategy for resolving a failed thrift. We made no recommendation concerning uninsured depositors, because RTC changed its policy in September 1993 to better ensure that uninsured depositors

¹1992 Thrift Resolutions: RTC Policies and Practices Did Not Fully Comply With Least-Cost Provisions (GAO/GGD-94-110, June 17, 1994).

would absorb their shares of thrift losses if necessary to achieve the least costly resolution.

RTC agreed to initiate actions to improve its documentation, but it maintained that its policies on asset sales during conservatorship and on the timing of its liquidation cost estimates were consistent with FDICIA. We said that unless RTC changed its policies in these areas, neither we nor RTC could assure Congress that RTC was fully complying with FDICIA's least-cost requirements.

Few Thrift Failures Since January 1, 1993

Although over 1,300 savings associations failed from 1980 through 1992, failures since the beginning of 1993 have declined dramatically. Also, the December 17, 1993, passage of the RTC Completion Act (Public Law 103-204, 107 Stat. 2369)—which provided RTC the funds needed to resolve failed thrifts—has enabled RTC to resolve all but one of its backlog of thrifts in conservatorship as of December 31, 1994.

When a thrift fails, the Office of Thrift Supervision (OTS) or the thrift's state chartering authority usually appoints RTC as conservator or receiver. As conservator, RTC operates a failed thrift pending its final resolution, and as receiver, it administers the closing of an insolvent thrift and liquidates all assets not disposed of in conservatorship or at resolution. However, some failing thrifts are resolved prior to being placed into conservatorship through the accelerated resolution program (ARP), which OTS operates jointly with RTC. This program enables OTS to place a thrift it considers to be in serious financial difficulty into ARP for the purpose of selling the troubled thrift's assets, deposits, and other liabilities to a healthy institution before the thrift fails.

During 1993, eight thrifts failed and were placed in RTC conservatorships, and one failing thrift was resolved through ARP. In 1994, no thrifts failed and two failing thrifts were resolved through ARP. Further, due primarily to funding provided by the RTC Completion Act, 80 of the 81 thrifts in RTC conservatorships as of December 31, 1992, as well as the 8 thrifts placed in conservatorships in 1993, were all resolved by the end of 1994.

RTC officials told us they intend to resolve any further troubled thrifts via ARP or ARP-like transactions by selling the thrift's assets, deposits, and other liabilities to a healthy institution prior to the thrift's failure. They also said they expect few—if any—additional thrift failures through June 30, 1995, at which time RTC's responsibility for resolving failed and

failing thrifts ends. The Federal Deposit Insurance Corporation assumes responsibility for resolving troubled thrifts as of July 1, 1995.

Objective, Scope, and Methodology

The primary objective of this, our second, annual review was to determine the extent to which RTC's resolution process enabled it to comply with FDICIA requirements to select the least costly alternatives for resolving failed institutions.

To address the objective, we judgmentally selected and reviewed three thrifts that were resolved between January 1, 1993, and June 30, 1994. In each of these resolutions, RTC applied at least one of the three new resolution policies it established since January 1, 1993. The new policies involve (1) pro rata sharing of resolution losses by uninsured depositors when necessary to achieve the least costly resolution, (2) discontinuing the sale of performing loans during conservatorship, and (3) extending preference to minority bidders in making resolution decisions. We reviewed the three resolutions to determine whether RTC's resolution process, as modified by these policy changes, provided for compliance with FDICIA's least-cost requirements.

We selected one of the three resolutions we reviewed because it was the only failed thrift that was affected by the September 1993 uninsured depositor policy change. It was also 1 of 14 failed thrifts in which RTC discontinued the sale of performing loans. We chose the other two resolutions because they involved preferences extended to minority bidders. In addition, one of the two failed thrifts was a major resolution with assets in excess of \$1 billion.

To address our objective, we analyzed the three resolutions, reviewed pertinent policies and procedures, and interviewed RTC officials and staff. We modified and used the data collection instrument we developed in our first review to document and evaluate the information from our three resolution cases, paying particular attention to the effect the three new policies had on the least-cost determinations. As in our first review, we collected data from the inception of resolution activity through the final resolution decision. We then compared the results of the three case studies with the results of our first-year case studies to identify any improvements or additional shortcomings in RTC's resolution process.

During our assessment of the three resolutions, we reviewed the accuracy of the financial calculations RTC used to estimate the cost of available

resolution alternatives. However, due to the subjectivity inherent in the valuation of assets and in the estimation of future asset recoveries, we assessed the adequacy of RTC's resolution process to select the least costly alternative. We did not determine whether, in fact, the least costly resolution alternative was selected, because the ultimate cost of a resolution cannot be identified until all remaining assets are sold and liabilities are paid by RTC as receiver, which generally takes several years. Further, the results of our review of the three resolutions are not generalizable to all of the resolutions done by RTC since January 1, 1993.

RTC provided written comments on a draft of this report. The comments are summarized on page 8 and reprinted in appendix I.

We did our work between June and October 1994 at RTC headquarters in Washington, D.C. Our work was done in accordance with generally accepted government auditing standards.

Principal Findings

RTC Has Improved Its Resolution Process

RTC changed its corporate policies to require that uninsured depositors share in thrift losses if necessary to achieve least costly resolutions and to curtail its practice of selling performing assets during conservatorship operations. These changes brought RTC into compliance with FDICIA's uninsured depositor requirements and enabled RTC to better conform with the act's requirement that it evaluate other resolution methods before selling assets. In addition, RTC's implementation of a policy to extend a preference to minority bidders when making resolution decisions appeared consistent with FDICIA's least-cost requirements.

Also, for the three resolutions we reviewed, RTC continued to select the resolution method it determined to be the least costly and took several actions in response to recommendations resulting from our first review that have enhanced its resolution process. Specifically, it improved the documentation of its marketing strategies, the consideration given to bids that did not conform to its preferred marketing strategies, and the bases for its resolution decisions. It also changed the timing of its liquidation cost estimates.

Our review of the one resolution that involved the uninsured depositor policy change showed that consistent with FDICIA requirements, RTC paid uninsured depositors only that portion of their uninsured deposits equal to the expected pro rata share of the estimated proceeds from the resolution of the failed institution. RTC initially paid the uninsured depositors a 50-percent advance dividend, which was calculated by multiplying the book value of the assets by a percentage based on RTC's historical asset recovery rates, and then RTC reduced that amount by an arbitrarily determined 18 percent to provide a conservative cushion. About 6 months later, RTC was able to pay an additional 24 percent on the basis of actual asset recoveries.

This resolution also involved the policy change concerning the timing of asset sales during conservatorships. Prior to the change, RTC generally sold high-quality assets, such as marketable securities, investments, and performing loans, from thrifts in conservatorship through a process called "downsizing." RTC believed this approach maximized returns on asset disposition and, as a general proposition, resulted in least-cost resolutions. However, we were critical of RTC's downsizing policy in our report on 1992 resolutions,² because the policy was at variance with FDICIA's requirement that RTC evaluate other available methods of thrift resolution prior to selling assets.

RTC's March 1993 policy change generally required that high-quality assets be retained in conservatorships, although—except for certain performing assets such as one-to-four family mortgages—they could be sold within 45 days of the announced resolution date of a thrift. Thus, performing assets could be sold at or around the time the thrift was to be marketed, providing RTC greater opportunity to assess available resolution methods prior to commencing asset sales. RTC changed the policy primarily because it found that retaining high-quality assets provided conservatorships a better return than selling the assets and investing the proceeds in lower yielding securities. In our view, this policy change made good economic sense and enabled RTC to better conform with the FDICIA requirement that it evaluate available resolution methods before selling high-quality assets. Our review of the resolution case file showed that consistent with the revised policy, RTC retained high-quality assets in the conservatorship until close to the resolution date before selling them. We also found that RTC explored market interest in the thrift, selected the resolution alternative it

²1992 Thrift Resolutions: RTC Policies and Practices Did Not Fully Comply With Least-Cost Provisions (GAO/GGD-94-110, June 17, 1994).

determined to be the least costly, and adequately documented its marketing rationale and the bases for its resolution decision.

RTC also made an initial liquidation cost estimate as of the date the thrift was placed in conservatorship to estimate the expected proceeds from resolution, which was necessary to determine the advance dividend to be paid to uninsured depositors. In addition, RTC made a second liquidation cost estimate, valuing assets based on its asset valuation review process, for purposes of determining the least costly resolution alternative. RTC officials told us they will follow this practice with future failed thrifts that are placed in conservatorship, but their intent is to resolve any further failing thrifts through ARP or ARP-like transactions. Either the new practice or ARP or ARP-like transactions will better provide for RTC's conformance with FDICIA.

We also noted improvements in RTC's resolution process during our review of the case files of the two other thrift resolutions we selected. We found, for example, that RTC adequately documented the marketing rationale, the bases for its resolution decisions, and the consideration given to bids that did not conform to its preferred marketing strategy. It also selected the resolution alternative it determined to be the least costly.

These two resolved thrifts were subject to RTC's new policy, which gave a preference to offers from minority bidders for acquiring thrifts or their branches located in predominantly minority neighborhoods (PMN). This PMN policy, mandated by the RTC Completion Act,³ essentially required RTC to give a minority bidder the opportunity to match the high nonminority bid and thus become the winning bidder. The program's premise was that the matching minority bid would result in the least possible resolution cost to RTC, since it is to be considered only after RTC has determined the least costly resolution alternative based on its review of all bids received.

Our review of the two resolutions showed that RTC applied its PMN policy as designed, which was consistent with the least-cost provisions of FDICIA. In one of the resolutions, minority buyers were successful bidders for two

³The act required us to study how RTC implemented the PMN and other reforms required by the act and RTC's progress toward achieving full compliance with the requirements. We were required to prepare an interim report within 6 months of enactment of the act and a final report not later than 1 year after enactment. The first report, *Resolution Trust Corporation: Interim Report on the Management Reforms in the RTC Completion Act* (GAO/GGD-94-114, June 30, 1994), identified the PMN requirements, noted RTC's definition of "predominantly minority neighborhood," and described the policies and procedures RTC implemented to form its minority preference resolution program. The final report, *Resolution Trust Corporation: Implementation of the Management Reforms in the RTC Completion Act* (GAO/GGD-95-67, March 9, 1995), discussed RTC's efforts to comply with the act's requirements.

of the five PMN offices of an entire thrift located in a PMN because their bids, considered with all other bids, produced the least costly resolution alternative. In the second resolution, the otherwise winning minority bidder for the thrift's two PMN offices did not get the required regulatory approval, and thus its bids were disallowed. In both resolutions, RTC selected the bids that it determined to be the least costly alternative.

Conclusion

RTC has made substantive improvements to its resolution process. It changed its treatment of uninsured depositors and now complies with related FDICIA requirements; it changed the timing of its sales of high-quality assets from thrifts in conservatorship and the timing of its liquidation cost estimates, thereby better providing for its conformance with the act's requirements; and it improved various aspects of its resolution documentation, as we had recommended. RTC also continued to select the resolution alternatives it determined to be least costly for the three resolutions we reviewed, including the selection of alternatives for the two resolutions involving RTC's new PMN program.

As our review did not disclose significant noncompliance, and unless thrift failures accelerate by June 30, 1995, we do not plan to issue further reports on RTC's compliance with the least-cost provisions of FDICIA.

Agency Comments

RTC, in its written comments on a draft of this report, agreed with the content and conclusions. RTC's comments are reprinted in appendix I.

We are sending copies of this report to RTC's Deputy and Acting Chief Executive Officer; the Chairman of the Thrift Depositor Protection Oversight Board; the Chairman, Federal Deposit Insurance Corporation; and other interested parties.

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

A handwritten signature in black ink that reads "James L. Bothwell". The signature is written in a cursive style with a large, stylized initial "J".

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Comments From RTC



RESOLUTION TRUST CORPORATION
Resolving The Crisis
Restoring The Confidence

April 6, 1995

Gaston L. Gianni, Jr.
Associate Director, Government
Business Operations Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Gianni:

We are in receipt of your draft report entitled 1993 Thrift Resolutions: RTC's Resolution Process Generally Adequate to Determine Least Costly Resolutions.

We are appreciative of the constructive comments and conclusions set forth in the report and take no exception to the content. As is effectively commented upon in the report, the RTC has continually made substantive efforts to improve the resolution process on an ongoing basis.

It has been appropriate in the past for the GAO to note certain deficiencies in documentation and perceived technical noncompliance with certain mandates, most of which were attributed to differing interpretations of the applicable legislation. However, as we bring the RTC resolution process to a conclusion it is rewarding to note that at no time that I'm aware has any report prepared by the GAO reflected definitively that other than a least costly resolution has been consummated.

The courtesy and professionalism of the GAO staff with which the Division of Resolutions has dealt is commended and appreciated.

Sincerely,

Paul Ramey
Vice President
Division of Resolutions

801 17th Street, N.W. Washington, D.C. 20434

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