United States General Accounting Office

GAO

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

1989

FAILED THRIFTS

Bank Board's 1988 Texas Resolutions

119202

GAO/GGD-89-59

119202

GAO

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

General Government Division

B-232785

March 11, 1989

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

Dear Mr. Chairman:

This report provides our preliminary views in response to your request that we review the Federal Home Loan Bank Board's (FHLBB) 1988 resolutions of insolvent thrifts in Texas. Almost all of the resolutions were accomplished under the FHLBB's Southwest Plan in complicated assistance transactions. In 1988, FHLBB approved 15 assisted transactions in Texas involving 87 insolvent thrifts at a projected cash cost of about $44 billion.[1]

In February 1989, a moratorium on such transactions was announced following the Bush Administration's proposal for a resolution of the thrift crisis.

Results in Brief

A thrift industry still exists in Texas, but we are concerned about its viability. Also, the ultimate cost to the government of the Texas thrift transactions is uncertain. With little cash to liquidate insolvent thrifts, the Federal Savings and Loan Insurance Corporation (FSLIC) provided a wide range of financial assistance in the form of notes and guarantees to attract acquirers to buy packages of thrifts. The long-term cost of this assistance could be more than FSLIC's estimates if

- the assets for which FSLIC provides an operating subsidy have lesser value than the unaudited financial reports indicate, requiring increases in FSLIC subsidies, or
- interest rates increase, making it more difficult for the thrifts to realize projected income levels and increasing the amount of FSLIC assistance needed during the assistance period.

The process used to solicit and select acquirers for the Texas thrifts was loosely structured and was administered inconsistently by FHLBB and the Dallas District Bank.

[1]This includes one transaction involving eight thrifts that were merged and assisted without a final acquirer. The purpose of this transaction was to stablize and take control of these thrifts.

Objectives, Scope, and Methodology

Our objective was to provide information on the background and current status of the Plan; describe a typical assisted transaction or "deal"; and provide our preliminary assessment of the Plan's progress in achieving its objectives, along with our concerns about the transactions. To develop this information, we (1) reviewed FHLBB's policies and procedures; (2) reviewed documents, studies, and statistics concerning the Plan, which were available at the Dallas District Bank and FHLBB; (3) interviewed a FHLBB member, the former head of FSLIC, the director of the Plan, and other FHLBB and district bank officials responsible for the Plan or transactions; and (4) reviewed statistics and other data concerning all 15 transactions completed in 1988. We also assessed eight of the transactions in detail. The eight transactions covered the resolution of 60 insolvent thrifts with total assets of about $32 billion. Our work was done in accordance with generally accepted government auditing standards.

The information provided by FHLBB and the Dallas District Bank was often insufficient for us to draw firm conclusions concerning their actions or decisions. The data has not been audited and often contained inconsistencies. Additionally, we asked for information on the status of controls over the assisted transactions. The FSLIC division responsible for administering the large, complex transactions is still developing the information.

Special Plan to Reorganize the Texas Thrift Industry

On February 3, 1988, FHLBB approved the Southwest Plan, a program designed to resolve the multibillion dollar problem of insolvent thrifts, primarily in Texas. FHLBB based the Plan on its opinion that consolidating insolvent thrifts "with some combination of healthy institutions and capital infusions will produce viable thrifts. . . ." The Plan was unusual in that all insolvent thrifts in the state were to be included in the program. The thrifts were to be grouped and sold in prearranged packages, but the makeup of the groupings would be unknown to the investors until they entered the final negotiation process. As a result, the investors did not know precisely what they were bidding on. Even more importantly, neither the investor nor FSLIC determined the true value of the failed thrifts' accounts through the normal process known as due diligence before bidding on the packages. Consequently, neither FHLBB nor the investors knew the true financial state of the thrifts being merged and sold.

FHLBB did know that Texas thrifts were in serious distress. By our calculations using generally accepted accounting principles (GAAP), 125 of

279 Texas thrifts were insolvent[2] as of December 31, 1987. Nationwide, Texas thrifts represented almost 25 percent of all insolvent thrifts and held almost 34 percent ($47 billion) of insolvent thrift assets.

In implementing the Southwest Plan, FHLBB sought, among other things, to (1) retain a competitive environment and therefore preserve the basic thrift industry in Texas, (2) reduce or eliminate any duplications and redundancies in the Texas industry, (3) identify the most capable individuals to manage the new thrifts, (4) reduce expenses and control losses in problem thrift assets, (5) use FSLIC's resources efficiently, and (6) enable FSLIC to share in any future profits of the assisted institutions.

Provisions of a Typical Assistance Transaction

Common features of the 15 Texas transactions were FSLIC's agreements to contribute a promissory note for the negative tangible net worth[3] of the insolvent thrifts being sold, guarantee the value of and a certain return on the most risky of the thrifts' assets (covered assets), and pay legal and other expenses arising from the acquisition. (See app. I for details on the 15 transactions.)

The interest rate on the FSLIC notes and return guarantees on covered assets were variable, based on the average cost of funds for all Texas thrifts plus a premium expressed in basis points. The return guarantee decreased during the agreement period. For example, in one transaction the guarantee premium started at 250 basis points and declined to 150 basis points in the ninth and tenth years. The premium is meant to defray the thrift's costs associated with the covered assets plus provide some profit. FSLIC can usually prepay the notes with no penalty and can also buy the covered assets at book value.

The acquirer was required to invest new capital in 13 of the 15 transactions. In all but one transaction, FHLBB obtained the right to purchase an equity position in the new thrift and will receive some or all of the acquirer's tax savings arising from the transaction.

[2]A thrift is considered insolvent when its net worth is less than zero. The FHLBB can place a thrift into receivership or conservatorship when its capital, measured according to FHLBB regulations, is less than zero.

[3]Tangible net worth in the transactions was defined as the owners' capital less goodwill further adjusted by adding the amount of reserves for losses.

Concerns About Texas Transactions

Our assessment of how well the objectives have been achieved, based on available data, and our related concerns follow.

Retain a Competitive Environment and Preserve the Thrift Industry

While there is still a thrift industry in Texas, we are concerned about the viability of the new thrifts. These thrifts are thinly capitalized and will continue for some time to be dependent on FSLIC assistance.

Many Thrift Assets Are in FSLIC-Assisted Thrifts

Many Texas thrift assets are now concentrated in a small number of very large thrifts assisted by FSLIC. The 15 new thrifts created by the 1988 transactions purchased 42 percent of all Texas thrift assets as of December 31, 1987. These thrifts are now and, according to FSLIC's analyses, will for some time be dependent on FSLIC assistance for their viability. During the first 5 years of operations, FSLIC assistance will make up more than half of the projected gross income of seven of the eight thrifts we reviewed in detail. In the other thrift, assistance will make up at least 43 percent of total projected income. By the fifth year, FSLIC assistance will range between 45 and 80 percent of each thrift's total projected income. These income projections are based on optimistic business assumptions. Also, FSLIC maintains considerable operational control and has a long- term equity interest in the new institutions.

Assisted Thrifts Have Competitive Advantages Over Unassisted Institutions

The assisted thrifts have a strong degree of protection against adverse economic circumstances because they have little or no risk of losing the value or return on covered assets. For example, a further decline in real estate values would not affect covered assets because of FSLIC's indemnification against loss of principal. FSLIC and two of the eight thrifts we reviewed in detail share in losses when the assets are sold for less than half of book value. These provisions, however, expire for one thrift after the third year.

Also, a rise in market interest rates will not affect the income that assisted thrifts derive from covered assets because FSLIC guarantees that the return on covered Texas thrifts' assets will exceed the average cost of Texas funds, whatever that cost may be. A rise will also not affect interest income from FSLIC notes because interest rates on the notes will also vary with the average cost of funds.

Capitalization and Profitability of the New Thrifts Are Not Strong

Once it selected the preferred acquirer of a thrift group, FSLIC determined the viability of the new institution by analyzing projected capital and profit levels. The capital measure used by FSLIC was net worth to total liabilities, or capital ratio. Profitability was based on return on assets.

To measure the relative strength of the new Texas institutions created during 1988, we compared them to other healthy U.S. thrifts in terms of capital and profitability. Because 12 of the 15 new Texas thrifts have assets of over $1 billion, we compared them to the 100 largest thrifts in the Nation as of September 30, 1988, as measured by total assets. Nine of the 100 largest U.S. thrifts had a negative GAAP net worth as of September 30, 1988, and were excluded from the capital ratio comparison. Thirty unprofitable ones were excluded from the profitability comparison.

In general, the largest U.S. thrifts had higher capital ratios than did the new Texas thrifts. FSLIC's projected capital ratios of the new thrifts ranged from 1.3 percent to 5 percent, and the median ratio was 2.2 percent in the first year. By contrast, the median ratio for the largest U.S. thrifts was 4.5 percent. We also considered the projected capital ratios of the Texas thrifts after 5 years of operations.[4] The median ratio was 4 percent, which is still below the 4.5 percent median for the largest solvent U.S. thrifts. In other words, the mergers completed in Texas during 1988 left the new thrifts thinly capitalized from the outset relative to the industry's largest solvent thrifts.

The above comparison of projected capital levels ignores the fact that capital requirements for most nonassisted thrifts are expected to increase significantly over the next 5 years. The thrifts in these transactions, however, are to a large extent sheltered from these increasing requirements by capital forbearance on covered assets. Furthermore, the assets on which capital levels are based result substantially from the assistance agreements themselves, rather than from the acquirer's contribution. Capital, or the owner's stake, serves as an incentive to prudent management. With the limited capital in these institutions, it is unclear whether adequate and proper incentives exist.

[4]The 5-year projections have not been adjusted downward to reflect tax benefits paid to FSLIC.

FSLIC's projections of the thrifts' profitability assumed moderately rising interest rates.[5] The projections showed annual returns on assets improving over a 5-year period to a point where they were about equal to the returns generated by the largest profitable U.S. thrifts in the third quarter of 1988.[6]

Specifically, in the fifth year after the assisted mergers, the projected returns on assets ranged from negative 14 basis points to 195 basis points, with a median of 52 basis points. Of the 100 largest U.S. thrifts as of September 30, 1988, 70 were profitable in the third quarter. Annualized, the median return on investment for these U.S. thrifts was 42 basis points, slightly less than the level projected for the Texas thrifts after 5 years of projected generally improving performance.

Reduce or Eliminate Costly Duplications, Such as Redundant Branch Operations

This objective has been partially achieved. A Bank Board member told us that 239 branches out of 1,821 in Texas as of December 31, 1987, were scheduled to be closed by March 31, 1989, and that this goal had been 60 percent accomplished by mid-January. According to a February 3, 1989, FSLIC interim report, 167 branches had been closed and 100 were scheduled for closure. The report said that the ratio of operating expenses to total assets was reduced by 33 percent in the first five 1988 transactions.

Identify the Most Capable Management to Implement the Plan

While FHLBB established processes for evaluating prospective management, we cannot assess whether the "most capable" management was attracted. FHLBB and the Dallas District Bank reviewed examination reports as well as other documents and met with the management of thrifts to assess them. Prospective acquirers that were not affiliated with financial institutions were asked to provide financial and other background information. FHLBB also reported that they checked the names of key managers against records of the Federal Bureau of Investigation.

We could not assess the full extent to which FHLBB followed its prescribed processes because it did not always document the basis of its decisions. FHLBB allowed much of the senior management team from one

[5]FSLIC assumed that interest rates would increase 100 to 150 basis points over 10 years, with most of the increase occurring during the first 3 years.

[6]The 5-year projections have not been adjusted downward to reflect FSLIC's share of tax benefits.

insolvent thrift in the package (together with a new president) to manage the new entity. These managers were in charge when district bank officials found that the insolvent thrift had inaccurately reported its assets. In another transaction, FHLBB signed one agreement when the new management had no known experience in operating thrifts.

Provide a Mechanism for Reducing Expenses and Controlling Losses in Troubled Assets

FHLBB has attempted to provide the means to reduce expenses and control losses in troubled assets by requiring business plans for the management of each large covered asset. This is an important feature of the transactions, but we are concerned whether this approach will be effective and whether the highly detailed nature of the required plans will prove an efficient tool for both thrift management and regulators.

Adequate Incentives for Aggressive Disposition of Troubled Assets May Be Lacking

While the thrifts are indemnified against loss from the sale of covered assets, the FSLIC yield guarantees may be incentives not to sell assets. This is because the interest rates paid by FSLIC on covered assets may be higher than the after-tax yield the thrift could obtain by reinvesting the proceeds if these assets were sold.

Though the guaranteed yield declines over the life of the agreements, there is no certainty that the reductions themselves provide sufficient incentive for acquirers to properly manage and dispose of property. The acquirers' plans to sell an asset could be influenced by such factors as

- any gain or loss sharing agreement with FSLIC,
- the amount of profit included in the yield guarantee compared to the expected net profit after tax from reinvesting the proceeds from the sale, and
- the best timing for the use of the tax benefits from the capital loss deduction.

Provisions in the transaction agreements give FSLIC some control over the acquirer's management and disposition of assets. A typical provision obligates the acquirer to use its best efforts to manage and liquidate assets in a manner that will minimize losses. Also, FSLIC may require an acquirer to sell a covered asset and may have the right to approve the sale of any covered asset. The effectiveness of such controls, however, is dependent on the effectiveness of FSLIC's monitoring, about which we have concerns.

The administration has already taken a positive step by combining FSLIC's resources with those of FDIC and placing most activities more directly under FDIC's direction. Even before that positive move, the examination and supervisory staff had increased in numbers and, according to FHLBB, in expertise. The Dallas District Bank established a special unit of supervisors and analysts to monitor Plan institutions. The Dallas District Bank plans to place full-time, "resident" examiners at the larger institutions. Nine FSLIC staff are now based at the Dallas District Bank to review and approve business plans for covered assets as well as related payments for yield maintenance and asset sales. The Dallas District Bank will also have to monitor and control the amounts of FSLIC notes and the thrifts' rights to receive FSLIC payments, both of which are accepted as collateral for advances by the Dallas District Bank.

Despite these new arrangements, we have fundamental concerns about the effectiveness of FHLBB's supervision because of its conflicting roles as both promoter and regulator of the thrift industry. We have recommended that regulatory functions, such as supervision and examination of the industry, be separated from FHLBB, which is influenced by the industry. The staff responsible for examination and supervision should not be accountable to FHLBB.

Provide for the Efficient Use of FSLIC Resources in Resolving Problems

We cannot say if FSLIC used its limited resources most efficiently in resolving the problem thrifts. While the basic premise of the Plan did not preclude liquidating any of the insolvent thrifts, FSLIC's poor financial condition precluded major liquidations—an option that may have been more economical had substantial cash been available to FSLIC. All institutions, no matter how poor their financial condition, were assigned to a group to be marketed. It is possible that FSLIC may have been able to make better deals without including some of the most insolvent thrifts.

Under the transactions, FSLIC has the option of prepaying its notes without penalty or buying covered assets at book value if cash becomes available. Whether these actions would reduce overall FSLIC costs would depend on such factors as FSLIC's borrowing costs and asset management capabilities as well as the viability of the affected thrifts after these transactions.

Solicitation and Selection Process

FHLBB's solicitation of interested acquirers may not have enabled it to attract the largest pool of qualified prospective acquirers. To market the Texas thrifts, FHLBB sought "statements of interest" from Texas thrifts and others deemed to be financially and managerially suitable as acquirers and from other potential acquirers. Most prospective acquirers, however, were not told which thrifts were being marketed, how FSLIC planned to combine them in groups, or the thrifts' current financial condition. This "blind" process may have discouraged prospective investors from pursuing acquisitions. It also meant that most investors proposed buying only some portion of the prearranged groups, and FHLBB, therefore, evaluated their proposals on the basis of incomplete information. Unless the potential investors passed this initial screening, they had no opportunity to refine their proposal on the basis of information subsequently provided by FHLBB, such as the identities of the thrifts.

Monitoring Will Be Difficult

The complexity and uniqueness of each merger makes oversight very difficult. The previous discussion of typical components of a consolidation agreement provides some insight into their complexity. Some standard materials are being required to monitor each new institution. For example, a separate business plan proposing the management, marketing, and ultimate disposition of each significant covered asset is required, with financial and operating details being frequently (as often as monthly) submitted for approval.

However, because requirements vary depending on the agreement, FSLIC and district bank monitoring must be individually tailored for each agreement. For example, the agreements require an initial report, including budgeted income and expenses for each asset, followed by regular updates. Periodic reports related to the institutions' use of specific regulatory forbearances are also required. In addition, FSLIC must approve asset schedules, asset summaries, collection plans for large assets, asset budget summaries, asset sales requests, and asset term sheets if the thrift is providing the financing. FSLIC must approve plans and budgets for litigation. It must also review itemized charges for yield maintenance and capital losses submitted quarterly for payment.

The new institutions are combinations of up to 15 failed thrifts with combined assets of up to $12 billion. The complexity of the work is increased by the poor condition of the books of many of these institutions, making accurate audits difficult and time consuming.

Designate Shares of the Future Profits of Assisted Institutions for FSLIC

The transaction agreements generally provide FSLIC an equity position in 14 of the 15 new institutions as well as its participation in certain tax benefits. However, FSLIC's projections for the new thrifts' profits are modest. FSLIC's cost analyses estimated the value of all its returns from profit sharing and stock warrants at about $400 million. In February 1989, FSLIC estimated its share of tax benefits at about $2.2 billion for 14 of the 15 transactions.

As arranged with your office, we will send copies of this report when it is made public to the Senate Committee on Banking, Housing and Urban Affairs; the Federal Home Loan Bank Board; the Federal Reserve; the Department of the Treasury; the Federal Deposit Insurance Corporation; and other interested parties.

Sincerely yours,

Richard L. Fogel
Assistant Comptroller General

Assistance Provisions of the Transactions

Table I.1: Estimated Costs of Southwest Plan Resolutions Actions Through Deceber 31, 1988 (Unaudited)

Acquirer	Estimated costs of assistance agreements (cash value)	Cash Basis[a]					
		Cash	Notes (principal)	Notes (interest)	Capital loss coverage	Yield subsidy	Other[b]
Coastal Banc SA	$237,225	$3,627	$32,639	$35,041	$112,752	$61,670	($8,704)
Southwest SA	3,521,024		569,682	450,050	1,738,990	762,302	
Merabank FSB	1,241,227		187,602	153,658	662,206	257,014	(19,253)
Gibson Group, Inc.	2,379,171		535,743	472,633	752,155	617,277	1,363
Sunbelt SA	11,509,284		2,459,761	2,383,834	4,061,931	2,603,758	
Pulte Diversified Co.	1,993,689		511,840	526,547	562,961	429,733	(37,392)
Temple-Inland	2,808,221		710,146	681,456	804,641	700,065	(88,087)
Club Corporation	1,620,461		264,443	258,962	538,782	571,406	(13,132)
Adam Corporation	2,293,491		303,408	283,990	950,953	819,216	(64,076)
Americity FSB	281,661		21,233	18,945	142,163	108,324	(9,004)
CFSB Corporation	3,377,666		836,702	807,083	946,449	821,432	(34,000)
Utley Ford	8,908,369		2,106,126	1,925,459	2,743,863	2,049,848	83,073
Pacific USA Holdings	986,968		161,738	150,370	365,304	309,556	
Centex Corporation	813,222		222,900	246,702	256,318	87,597	(295)
Hyperion Partners	2,200,353		261,135	242,805	946,338	717,982	32,093
Total	**$44,172,032**	**$3,627**	**$9,185,098**	**$8,637,535**	**$15,585,806**	**$10,917,380**	**($157,414)**[b]

[a]All figures in thousands.

[b]"Other" column includes mark-to-market adjustments, prepayment penalties on FHLB advances, and projected future income from FSLIC ownership interests and return of tax benefits.

Source: FSLIC Records

Table I.2: Estimated Costs of Southwest Plan Resolutions Actions Through December 31, 1988 (Unaudited)

Acquirer	Estimated cost of assistance agreements (present value)	Present Value Basis[a]					
		Cash	Notes (principal)	Notes (interest)	Capital loss coverage	Yield subsidy	Other[b]
Costal Banc SA	$146,226	$3,627	$12,584	$22,569	$52,001	$52,888	$2,557
Southwest SA	1,980,323		219,637	290,136	817,137	653,413	
Merabank FSB	665,655		69,122	96,177	291,277	215,326	(6,247)
Gibson Group, Inc.	1,313,780		197,393	297,739	317,319	481,404	19,925
Sunbelt SA	6,166,657		918,691	1,492,472	1,721,553	2,033,941	
Pulte Diversified Co.	1,090,233		191,189	330,929	238,959	335,846	(6,690)
Temple-Inland	1,489,130		253,385	426,691	329,844	540,300	(61,090)
Club Corporation	999,545		98,766	164,138	294,455	446,061	(3,875)
Adam Corporation	1,287,382		113,319	178,442	399,893	645,349	(49,621)
Americity FSB	160,787		7,823	11,790	59,456	84,466	(2,748)

(continued)

Acquirer	Estimated cost of assistance agreements (present value)	Present Value Basis[a] Cash	Notes (principal)	Notes (interest)	Capital loss coverage	Yield subsidy	Other[b]
CFSB Corporation	1,846,254		313,405	515,294	404,391	639,966	(26,802)
Utley Ford	5,046,258		822,383	1,234,481	1,346,093	1,546,902	96,399
Pacific USA Holdings	566,203		63,990	96,606	163,932	241,675	
Centex Corporation	428,770		87,039	160,305	113,898	67,734	(206)
Hyperion Partners	1,372,166		102,760	154,315	520,792	561,219	33,080
Total	**$24,559,369**	**$3,627**	**$3,471,486**	**$5,472,084**	**$7,071,000**	**$8,546,490**	**($5,318)[b]**

[a]All figures in thousands.

[b]"Other" column includes mark-to-market adjustments, prepayment penalties on FHLB advances and projected future income from FSLIC ownership interests and return of tax benefits.

Source: FSLIC Records

Major Contributors to This Report

General Government Division Washington, D.C.

Craig A. Simmons, Director, Financial Institutions and Markets Issues - (202) 275-8678
Alison, D. Kern, Assistant Director
Larry D. Harrell, Assignment Manager
Charles M. Roberts, Evaluator
Margaret K. Harris, Evaluator
Carolyn Lemon, Secretary

Dallas Regional Office

Willie D. Watson, Evaluator-In-Charge

Requests for copies of GAO reports should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first five copies of each report are free. Additional copies are $2.00 each.

There is a 25% discount on orders for 100 or more copies mailed to a single address.

Orders must be prepaid by cash or by check or money order made out to the Superintendent of Documents.

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

Official Business
Penalty for Private Use $300

First-Class Mail
Postage & Fees Paid
GAO
Permit No. G100