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Failed Thrifts: Resolution Trust Corporation and 1988 Bank Board Resolution Actions

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Committee on Banking, Finance and Urban Affairs
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UNITED STATES GENERAL ACCOUNTING OFFICE

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SUMMARY OF STATEMENT BY
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Almost eight months have passed since the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 created the Resolution Trust Corporation (RTC) to resolve insolvent thrifts. In January RTC believed that it would have to resolve at least 558 to 628 thrifts.

GAO has compared RTC's pace of resolution, the structure of its resolutions, and the marketing and selection process used with Federal Home Loan Bank Board actions in 1988. In general RTC's approach to its tasks represents a significant improvement over the Bank Board's approach prior to and during 1988. GAO found that RTC's policies if properly implemented should avoid the risk exposure, cost, and uncertainties that existed and continue to exist for the Bank Board's 1988 resolutions. Nevertheless, GAO has some concerns about RTC's resolution process.

-- GAO recognizes that startup problems have impeded RTC's ability to rapidly resolve its caseload, but believes it is now time to deal with any remaining constraints it faces in resolving cases and speed up the pace of resolutions. For example, RTC needs to adopt policies and procedures to quickly sell thrifts in which high buyer interest has been expressed to accelerate resolutions and maximize the return from sales.

-- RTC needs to continue adhering to its policies for an open and competitive bidding process even though it might impede the pace of resolutions. Negotiated deals should be avoided, and RTC actions must be auditable and defensible.

RTC's extended conservatorship program can allow it to control insolvent thrifts, assess their condition, begin liquidation actions, and determine the resolution method and priority. There clearly are benefits to this program, but GAO believes more attention is needed to reducing management turnover, training RTC managing agents, and developing guidance on running the thrifts.

GAO also emphasizes the importance of bringing to justice those whose illegal or improper acts contributed to thrift failures and describes its work in this area.

Mr. Chairman and Members of the Committee:

We are pleased to participate in your hearings on the progress being made by the Resolution Trust Corporation (RTC) in meeting its legislative mandate to resolve insolvent savings and loans.

My testimony today addresses three areas. As you requested, I will first compare the pace, the structure, and the marketing and selection process of RTC's recent and planned resolution actions with the Federal Home Loan Bank Board's 1988 resolution actions. Within each of those areas, I will also discuss certain concerns that we have about RTC's approach to managing and resolving its caseload. Second, I will discuss concerns we have with RTC management of thrifts in its conservatorship program. And, finally, I will briefly discuss some of GAO's work involving oversight of the federal response to improper or illegal activities that contributed to thrift failures.

COMPARISON OF RTC AND BANK BOARD APPROACHES TO CASE RESOLUTION

The RTC and Bank Board faced dramatically different conditions. Provisions in FIRREA and policies set forth in the RTC Strategic Plan establish an environment that should insure that RTC will not repeat the mistakes of the Bank Board.

Pace Of Resolution

Bank Board delays in taking action against insolvent thrifts contributed to the enormity of the resolution cost that eventually had to be funded in FIRREA. The Bank Board did not take resolution action on the ever-growing number of insolvent thrifts in the mid to late 1980s. These thrifts were, instead, allowed to continue operating in hopes that somehow their fortunes would reverse themselves. Bank Board officials denied that catastrophic problems existed, even as the number of insolvent thrifts grew and losses in insolvent thrifts mounted. Then, in 1988, it belatedly began to take action. Some 223 thrifts were acted on that year; 75 were sold in December alone.

The RTC experience thus far has been quite different. As of March 21, some seven months after it was established, RTC had sold or liquidated 52 thrifts and was managing another 350 thrifts as conservatorships. Of these conservatorships, 56 had been publicized as "for sale" and were in various stages of the selling process. RTC testified in January that it expects to be responsible for resolving a total of 558 to 628 institutions, and that around 300 more thrifts are classified as distressed by the Office of Thrift Supervision.

While the pace of resolutions seems slow given the staggering number of insolvencies, there is little question that RTC, unlike the Bank Board, has recognized the need to deal with these institutions as promptly as possible and seems prepared to recognize the financial magnitude of the losses involved. It is important to realize that since the RTC's creation last August, it has had to simultaneously scope out its enormous job, help the Oversight Board develop the Strategic Plan, develop implementing policies and procedures, and design and staff a new organization, while also waiting for the Administration to make arrangements for needed working capital. These constraining factors have now been largely removed.

It is time for RTC to identify and deal with any remaining constraints, move ahead more expeditiously in resolving institutions, and adjust the marketing schedule to take advantage of franchise value that some failed thrifts may still have. RTC officials tell us that one factor contributing to the slow pace of resolutions is low market receptivity for the insolvent thrifts. The unexpectedly low level of market interest in purchasing thrifts may be related in part to erosion in the value of the thrift charter as a result of certain FIRREA provisions, such as the increased capital requirement.

RTC has acted to remove one factor that was inhibiting thrift purchases. The Strategic Plan had limited the period during which RTC would buy assets back from an acquirer to 6 months. Potential acquirers felt this was not sufficient unless extensive pre-bid due diligence was provided for. The RTC Oversight Board's recent approval of a longer "put" period will allow acquirers to complete due diligence after the acquisition. This action may attract more bidders and may also speed up the resolution process.

Another factor that may be inhibiting the pace of resolution is the fact that RTC's priority system for resolving thrifts does not allow for the sale of thrifts in which there is more market interest and less deterioration than in others.

RTC's prioritization system for dealing with its caseload gives first priority to those institutions where losses are mounting most rapidly. We have no objection to that priority. However, total reliance on it does mean the better thrifts may stay in conservatorship for long periods, which erodes their franchise value. Not allowing for their sale outside of the priority schedule may slow the overall pace of resolutions and increase their ultimate resolution costs. While we do not know how many thrifts are of interest to potential buyers, a large number of thrifts have been in the RTC conservatorship program for quite some time. Of the 350 thrifts in the RTC's conservatorship program as of March 21, 223 have been in conservatorship over 6 months and 126 of those have been in the program over 12 months.

We are pleased that the RTC has now recognized the need to take advantage of buyer interest in certain thrifts. We believe it should move ahead to set up a separate track to accept bids on and sell the institutions with more franchise value.

Structure of Resolutions

As we reported to you last year, there were major problems with the 1988 Bank Board transactions.[1] The assisted sales created thrifts that were thinly capitalized[2], had cost advantages over healthy thrifts, and lacked incentives to manage the assets whose book value and yield the government is guaranteeing. In addition, the transactions may have cost more than liquidations and the agreements reached in the transactions require a huge monitoring effort because of their complexity and the length of time they remain in effect.

One of the reasons for the structure of the 1988 Bank Board transactions was FSLIC's lack of financial resources to pay for thrift insolvencies and effectively close the institutions. Now that RTC has a process for obtaining working capital, a lack of

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[1]GAO/T-GGD-89-10 (March 11, 1989) and GAO/GGD-89-59(March 11, 1989)

[2]The Office of Thrift Supervision has announced that FIRREA supercedes capital forbearances given in connection with the 1988 transactions. Twenty-one thrifts that did not meet the new capital requirement as of December 31, 1989, have submitted plans detailing how they will meet it, in accordance with FIRREA.

financial resources should not lead it to designing resolutions that involve extended guarantees and other noncash approaches. Indeed, RTC policies, together with those of the bank and thrift regulatory agencies should prevent a repetition of these types of transactions. RTC resolved thrifts:

-- Are to meet applicable capital standards and other regulations.

-- Are not to be given long-term asset book value and yield guarantees. Tax costs to the government are to also be taken into consideration in comparing resolution methods.

-- Are not to be sold in prearranged and administratively determined groups that include thrifts that should be liquidated.

In its resolutions so far, we have seen no evidence that RTC is not following these policies. However, only 10 of the 52 thrift resolutions as of March 21 have involved the sale of more than half of the failed thrift's assets and only 21 have involved the sale of any assets. Assets sold have been the more desirable ones, typically cash, securities, and performing loans.

In many instances, RTC has contracted with the acquirers of the deposits to manage any of the thrifts' assets they do not purchase. These contracts, under which billions of dollars of assets are being managed, run for a limited period of time. This arrangement may be necessary until RTC implements its own asset management and disposition structure. However, the present contracting arrangements concern us because they do not appear to provide adequate incentives for good asset management. Also, RTC officials tell us that these asset management arrangements are not welcomed by the acquirers. For both these reasons, RTC needs to implement as quickly as possible the asset management and disposition structure envisioned in the Strategic Plan.

Marketing and Selection Process

We expressed concerns about the marketing and selection process used in 1988 by the Bank Board, particularly with respect to the Southwest Plan. Under this plan, potential investors were asked to submit initial proposals without knowing which thrifts were being marketed, how they were to be combined into groups, or what their true financial condition was. We testified that this "blind" process, along with FSLIC's practice of combining less desirable insolvent thrifts in packages with those for which there was more interest, may have (1) decreased the likelihood of attracting the largest pool of qualified prospective bidders, (2) inhibited FSLIC's ability to evaluate the acceptability of proposals, and (3) resulted in a less efficient use of FSLIC's limited resources.

Our work on Southwest Plan and other transactions, including follow-up work done by our Office of Special Investigations, found that: FSLIC often negotiated the terms of the sale with a selected potential acquirer, excluding other qualified bidders; only a few officials at the highest Bank Board and FSLIC levels were involved in the decision-making; and, the documentation for the basis of the decisions was inadequate. Because of these characteristics, it is extremely difficult, at best, to determine if the most cost effective action was taken.

FIRREA sought to prevent a repetition of these marketing and selection problems by requiring that RTC develop fair and competitive bidding procedures and that it document its selection decisions. The RTC Oversight Board's Strategic Plan says RTC will have an open and widely publicized bidding process and will broadly disseminate information about institutions being marketed and the terms of previous transactions. The process is to be documented.

A central feature of RTC's resolution and acquirer selection method is its "menu" driven approach to bidding on institutions. This approach is intended to allow market flexibility and access to the bidding process and to minimize RTC's costs. Under it, a qualified party may bid on the whole thrift or standardized parts of it. We are satisfied at this point that the process laid out for comparing bids should result in selection decisions that can be understood and evaluated.

The RTC Chairman noted in February, however, that one side effect of the menu approach is that since the options are fairly standardized, negotiations with individual bidders for more complex or customized transactions are precluded in the interest of open and competitive bidding. He warned that this may discourage some potential bidders, especially in an ever-increasing buyer's market. In light of the unacceptable process used by the Bank Board, which relied heavily on customized negotiations, we believe that the side effect of the menu approach voiced by the Chairman is a reasonable price to pay for a process that occurs in the open and can be understood and defended.

CONSERVATORSHIP PROGRAM

Although we believe RTC should speed up the resolution process, we appreciate the need for and utility of RTC's extended conservatorship program. Indeed, under the approach that RTC has taken to its conservatorships, partial liquidations are occurring prior to actual resolution. We do, however, have some concerns about the management of conservatorship thrifts.

RTC typically places a managing agent and a credit specialist at each thrift. The agent is to take control of the thrift and direct its operations, while also assessing its condition. These thrifts sometimes have extremely poor records and management information systems. And, they are often still run on a day-to-day basis by their previous officers and staff. The managing agents must know not only how to run thrifts but also how to implement FDIC and/or RTC policies and procedures.

RTC has only a limited number of officials with FDIC experience and often has had to reassign them. As a result, turnover of managing agents in RTC conservatorships has been high. For example, some 53 of the 103 thrifts in the Dallas RTC region have had 3 or more managing agents since they entered the conservatorship program. On average, these 103 thrifts had been in conservatorship about 9 months, as of mid-March. Two thrifts have had 7 managing agents during a one-year period. Such frequent changes result in a lack of continuity and impede RTC's ability to effectively manage the thrifts.

There is a need for a formal training program for the managing agents. RTC has been hiring managing agents from the private sector to supplement or replace some of the FDIC employees who have filled this role. One-third of the managing agents in the Dallas region have been hired from the private sector. Such individuals are not familiar with FDIC culture, policies, and procedures. While "on-the-job" training, often as the credit specialist, is important, it cannot replace comprehensive formal training. For example, training should address conflict-of-interest situations and the application of policies for dealing with delinquent loans.

We are also concerned about the lack of guidance with respect to "downsizing" thrifts while they are in the conservatorship program. Downsizing involves the selling off of assets and removing or replacing high-cost liabilities and is, in essence, the start of the liquidation process. Billions of dollars worth of conservatorship assets have been sold by thrifts. Liquidating certain assets while a thrift awaits resolution is expedient and can reduce ultimate resolution costs. It also serves to mitigate to some extent the urgency of final resolution actions.

The fact that so many thrifts have been kept under RTC management for so long necessitates, we believe, the need for detailed policies on how to manage and "downsize" them. As noted earlier, 223 thrifts have been operating in conservatorship status for six months or more and 126 of these for over a year, as of March 21. But we have found no specific policies regarding either the type or quality of assets that should be sold in (1) those thrifts judged to have assets that are transferrable in a sale and (2) those assessed as deposit transfer or pay off candidates.

MISCONDUCT LEADING TO THRIFT LOSSES

During our review of FSLIC's 1988 assistance transactions, we became aware of several allegations of misconduct. We found some situations in which we believe there might have been misconduct. For example, examiners found that one acquired institution, in a series of transactions, loaned over $40 million to the cousin of the institution's Chairman of the Board of Directors, in violation of the loans to one borrower regulation. After receiving the loans from the institution, the cousin loaned the Chairman $250,000. This matter is now being investigated by the Federal Bureau of Investigation.

In another case, we found that, due to lax supervision, FSLIC may have been the victim of false submissions by an asset management contractor regarding the sale and repurchase of time-share units. We have referred information on this and other matters to the Department of Justice for further investigation.

It is essential for the Justice Department, as the agency charged with criminal law enforcement, to investigate and prosecute those individuals whose misconduct contributed to thrift insolvencies. The government must send a strong signal to directors and officers of all insured institutions that such misconduct will not be tolerated.

We are now assessing federal efforts at prosecuting those whose fraud and wrong-doing caused losses to thrifts and banks. Our work is currently focused in two areas. First, we are assessing the information systems available for managing the federal response to fraud and wrong-doing. So far, we have found that there is no centralized or integrated system for monitoring and tracking actions taken against banks, thrifts, and affiliated parties. This concerns us.

Because systems used by the bank and thrift regulatory agencies to track their own activities lack uniformity, it is difficult to get a clear picture of the overall federal response. For example, because the regulators' criteria for tracking referrals to the Justice Department vary, we cannot determine the total number of referrals. The Office of the Comptroller of the Currency tracks referrals where there is an estimated loss of over $200,000, where a bank insider is involved, or where there is some unique circumstance -- 824 in 1989. The Federal Deposit Insurance Corporation, on the other hand, tracks referrals where the estimated loss exceeds $10,000 or where a bank director, officer, or principal shareholder is involved -- 902 in 1989. The Office of Thrift Supervision (OTS) and the Federal Reserve Board track all their referrals, but unlike the other three agencies, the Federal Reserve tracks referrals by individual rather than by activity. OTS made 5,014 referrals in 1989; the Federal Reserve sent referrals on 3,239 individuals.

Because of the absence of a centralized or integrated system, we have also been unable to tie the 1989 referrals tracked by the regulatory agencies to investigations being performed by the FBI. The FBI had 7,819 investigations underway as of September 30, 1989, about 46 percent of which involved potential dollar losses of $100,000 or more.

Finally, we are reviewing the Justice Department's establishment of a regional fraud office in the northern district of Texas and, as mandated by FIRREA, determining whether regional fraud offices should be established elsewhere. The Dallas fraud task force was begun in 1987 with 50 investigators, prosecutors, and support staff. The newly established Dallas Regional Fraud Office numbered 74 as of February 1990 and has plans to add another 38 staff. The office has charged 58 individuals involved in financial institution fraud, obtaining 46 convictions. Those convicted include 22 bank officers, two accountants, a real estate broker, two developers, a consultant, and 18 borrowers. Sentences for those convicted ranged from 6 months to 35 years, and fines and restitution orders ranged from $1,000 to $2.5 million. The fraud office currently has over 500 individuals targeted for investigation, and has opened investigations on 38 failed financial institutions. Our work to determine the adequacy of this effort continues.

This concludes my testimony. I would be pleased to answer any questions.