

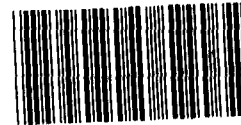
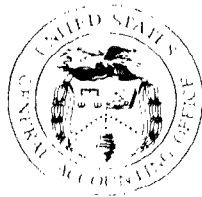
GAO

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

October 1991

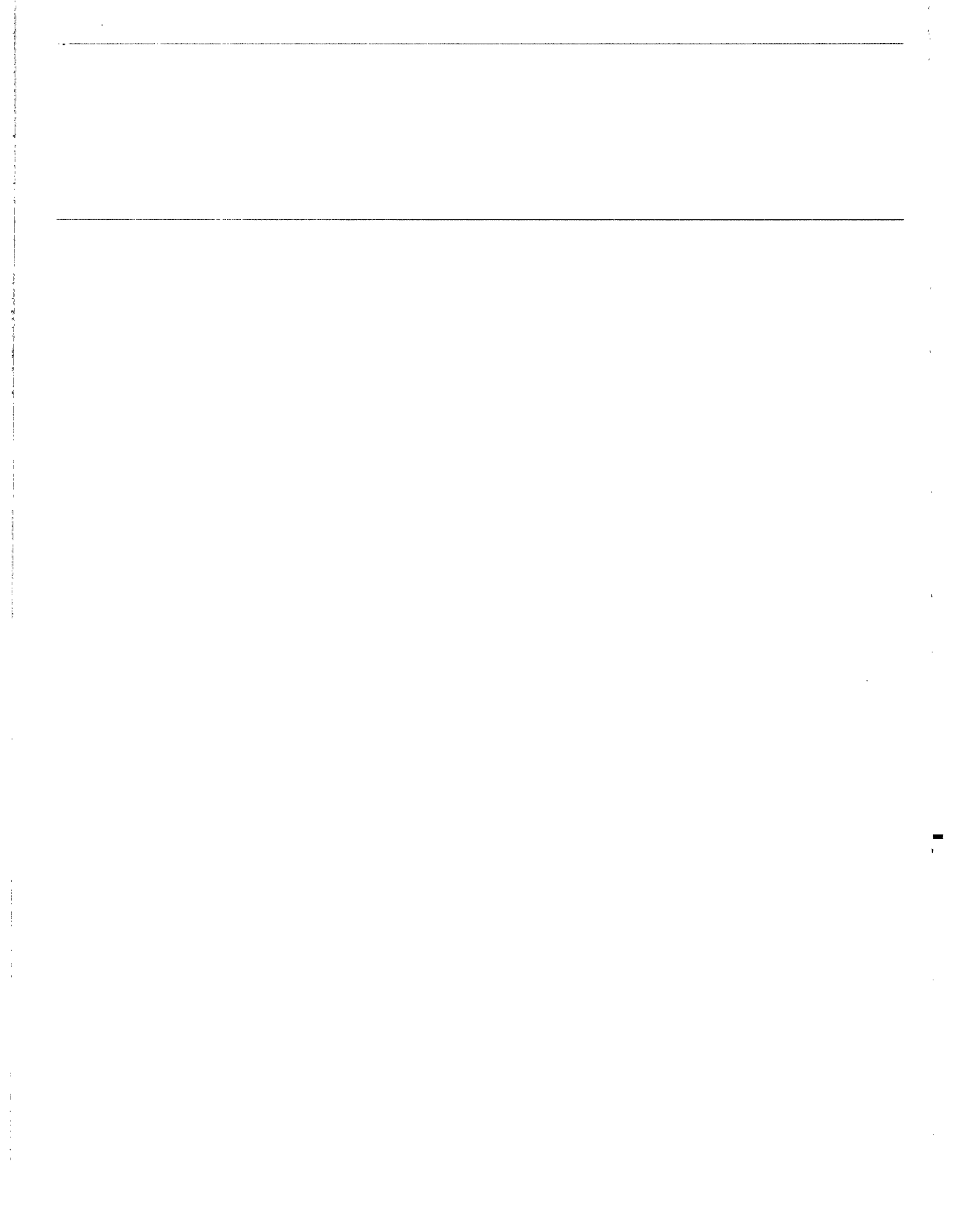
OBLIGATIONS LIMITATION

Resolution Trust Corporation's Compliance as of December 31, 1990



145305





**Accounting and Financial
Management Division**

B-240108

October 22, 1991

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

Dear Mr. Chairman:

This is our fourth response to your December 19, 1989, letter requesting that we report quarterly on the Resolution Trust Corporation's compliance with the maximum obligation limit set forth in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Public Law 101-73. FIRREA established a formula for calculating the maximum allowable obligations outstanding and provided \$50 billion in financing to resolve troubled savings and loan institutions placed into conservatorship or receivership from January 1, 1989, through August 9, 1992. Our reports on the Corporation's first, second, and third quarter compliance were issued in July 1990, December 1990, and May 1991, respectively. See appendix IV for a list of our quarterly compliance reports.

On June 5, 1991, the Corporation issued to you its fourth quarter report of the estimated values of its obligations, assets, and contributions received as of December 31, 1990. The Corporation reported that the financing it received from the Resolution Funding Corporation (REFCORP) plus its outstanding obligations exceeded the values of its assets by \$33 billion. Consequently, its "adjusted obligation level" was \$17 billion below the \$50 billion limitation on outstanding obligations. The Corporation's report and an accompanying table providing details on the computation are included as appendixes I and II.

Results in Brief

Based on our review of the Corporation's June 5, 1991, report and table and its financial records, we determined that none of the categories for the formula required by FIRREA were omitted from the Corporation's calculation and that the reported values appeared reasonable for selected components of the calculation. However, as in its third quarter report, the Corporation did not include \$18.8 billion of Department of the Treasury funding when calculating its fourth quarter adjusted obligation level. As a result of this change in methodology, the adjusted obligation levels calculated in the first and second quarters are not comparable to those calculated in the third and fourth quarters. If the Corporation had included the Treasury funding in its calculation, its fourth quarter

adjusted obligation level would be about \$1.7 billion over the \$50 billion provided by FIRREA, and the Corporation would be precluded from incurring any additional obligations.

The accuracy of the Corporation's obligation limit calculation is highly dependent on the reasonableness of the estimated fair market value of its assets. If the assets are overvalued and ultimately sell for less than estimated, the Corporation may not be able to repay all of its working capital borrowings. Amounts recovered from asset sales are dependent on the behavior of commercial and other real estate markets. Until the Corporation has sufficient experience in selling real estate and troubled loans secured by real estate, we have no basis to assess the reasonableness of its estimated recovery values.

The obligation limit formula as originally implemented provided cash reserves to cover possible future losses due to overvaluation of the Corporation's assets in receivership. We believe that the cash reserve feature served as a valuable safeguard against the Corporation's need to request additional loss funds from the Congress to repay working capital. As a result, we continue to support the recommendation made in our third quarter report¹ that the Congress consider reestablishing the cash reserve feature by amending the obligation limit formula established by FIRREA² to include all funding sources.

Background

In response to the savings and loan crisis and the Federal Savings and Loan Insurance Corporation's (FSLIC) mounting losses, FIRREA was enacted on August 9, 1989. The act abolished FSLIC and transferred its insurance function to the Federal Deposit Insurance Corporation. FIRREA established the Resolution Trust Corporation to resolve the problems of institutions previously insured by FSLIC and placed into conservatorship or receivership from January 1, 1989, until August 9, 1992. The act provided the Resolution Trust Corporation \$50 billion to resolve the

¹Obligations Limitation: Resolution Trust Corporation's Compliance as of September 30, 1990 (GAO/AFMD-91-63, May 31, 1991).

²The obligation limit formula is contained in section 21A(j) of the Federal Home Loan Bank Act, 12 U.S.C. 1441a(j)(1989 Supp.), added by section 501(a) of FIRREA.

problems of those institutions and to pay administrative expenses.³ FIRREA also transferred FSLIC's assets and liabilities, except for those assumed by the Corporation, to the newly established FSLIC Resolution Fund.

FIRREA gave the Corporation certain powers to accomplish its task, including the authority to issue obligations and guarantees when resolving institutions within its jurisdiction. The full faith and credit of the United States is pledged to pay such obligations if the principal amounts and maturity dates are stated in the obligations.

Section 501(a) of FIRREA established a formula for calculating the maximum obligations of the Corporation. FIRREA states that the sum of contributions received through REFCORP plus outstanding obligations may not exceed the Corporation's available cash plus 85 percent of the fair market value of its other assets by more than \$50 billion.

Although FIRREA provided for the Corporation to receive \$18.8 billion from Treasury, the formula established by section 501(a) does not explicitly contain this funding. Therefore, as a matter of law, the Corporation is not required to include the Treasury funding in its calculation of whether the FIRREA limit on outstanding obligations has been reached. On November 2, 1990, the Corporation's Oversight Board directed it to exclude the funding from the formula when computing the third quarter, as well as future, compliance with the obligations limitation. The Oversight Board's action had been expressly encouraged by the Chairmen of the House and Senate Banking Committees.

Objectives, Scope, and Methodology

As agreed with your office, we performed a review of the Corporation's fourth quarter report to test its reasonableness. Specifically, our objectives were to determine if (1) all categories for the formula required by FIRREA were included in the Corporation's calculation and (2) the values reported appeared reasonable for selected components of the calculation. This report also provides information on the possible effect of overvaluing assets and of eliminating the Treasury funding from the obligation limit formula.

³As of December 31, 1990, the Corporation had received \$43 billion in loss funds. This included \$18.8 billion provided by Treasury and \$1.2 billion of contributions from the Federal Home Loan Banks. The Federal Home Loan Bank contributions were transferred to the Corporation through REFCORP. REFCORP, which was created to provide funding for the Corporation primarily through \$30 billion in bond sales, had transferred \$23 billion of bond proceeds to the Corporation by the end of the fourth quarter.

As part of our review work, we also followed up on the implementation status of the recommendations we made to the Corporation's Executive Director which had not been fully implemented as of the date of our last report. Details on the implementation status of those open recommendations are included as appendix III.

To ensure that the formula calculation included all required components, we compared the Corporation's reports with its December 31, 1990, general ledger trial balance. In order to determine the reasonableness of the values of selected components included in the Corporation's calculation, we performed various standard audit tests. When possible, we relied on tests performed for our previous three reports and tested only the fourth quarter's activity. For this report, our review included the following tests:

- confirming contributions received from REFCORP and Treasury;
- reviewing each corporate litigation case presented in the Corporation's Reserve for Potential Losses Report for reasonableness of legal liability reported;
- recalculating lease obligations for headquarters and regional office and storage space;
- judgmentally sampling and tracing accounts payable transactions to supporting documentation and recalculating other accrued liabilities;
- confirming notes payable with the Federal Financing Bank;
- recalculating interest owed to the Federal Financing Bank;
- confirming cash with Treasury and reviewing cash reconciliation reports;
- judgmentally sampling and tracing to supporting documentation 80 percent of the advances disbursed to conservatorships during the fourth quarter;
- tracing to supporting documentation 100 percent of the advance repayments from conservatorships during the fourth quarter;
- independently estimating interest receivable on advances and loans;
- judgmentally sampling and tracing to supporting documentation 95 percent of the increased dollar value in the Corporation's claims against receiverships;
- judgmentally sampling and tracing to supporting documentation 60 percent of the total balance of advance repayments from receiverships as of December 31, 1990; and
- judgmentally sampling and tracing to supporting documentation 75 percent of the increased dollar value in the Corporation's subrogated claims paid to depositors during the fourth quarter.

We have not yet completed any tests of the recorded fair market values of receivership assets. These values are the basis for the estimated total noncash assets shown in the Corporation's obligation limit report.

In addition, we were unable to determine the amount of any undisclosed obligations of the Corporation, which, if disclosed, might have affected the calculation of the obligations limitation. Such undisclosed obligations would decrease the amount the Corporation could borrow to fund its working capital needs.

During our review of the Corporation's fourth quarter compliance report, we performed our work at the Corporation's headquarters and in each of its four regions. We performed our work in accordance with generally accepted government auditing standards. The scope of our work, however, did not include a review of the Corporation's internal control environment. Our review of compliance with laws and regulations was limited to the Corporation's compliance with the obligations limitation.

While we did not obtain written comments on this report, we discussed its contents with cognizant Corporation officials, who agreed with the report's findings and conclusions.

Changes in Calculation Methodology Understate the Corporation's Adjusted Obligation Level

Based on our review of the Corporation's June 5, 1991, report and table and its financial records, we determined that none of the required categories for the formula established by FIRREA were omitted from the Corporation's calculation and that the reported values appeared reasonable for selected components of the calculation. However, as in its third quarter report, the Corporation did not include \$18.8 billion of Department of the Treasury funding when calculating its fourth quarter adjusted obligation level. As a result of this change in methodology, the adjusted obligation levels calculated in the first and second quarters are not comparable to those calculated in the third and fourth quarters. If the Corporation had included the Treasury funding in its calculation, its fourth quarter adjusted obligation level would be about \$1.7 billion over the \$50 billion provided by FIRREA and the Corporation would be precluded from incurring any additional obligations.

Receivership Assets May Be Overvalued and May Require Additional Funding

The Corporation's estimated recoveries on receivership asset sales could be significantly overstated. The Corporation's asset information systems do not provide information on all assets, including their book value, estimated market value, holding period, sales price, and gain or loss on sale. As a result, the Corporation does not have the historical information necessary to evaluate its asset recovery estimates. In addition, the Corporation has implemented a strategy of aggressively discounting selected assets to encourage sales. These factors, together with the government's growing portfolio of troubled assets and the Corporation's need to sell in a soft market, could result in sales that generate significantly less revenue than expected. If this occurs, the Corporation may not recover all of its working capital from asset sales proceeds and will have to request additional loss funds from the Congress to repay some of its Federal Financing Bank borrowings.

Our reservations about asset values apply to the estimated \$48 billion fair market value of noncash assets included in the Corporation's fourth quarter report. At December 31, 1990, the Corporation reported that approximately 70 percent of receivership assets were real estate related. Book values for receivership assets included \$8 billion in real estate owned and \$33 billion in real estate backed loans, of which about \$8 billion was delinquent. Many delinquent loans are likely to become corporate real estate owned through foreclosure proceedings. Amounts recovered from asset sales are dependent on the behavior of commercial and other real estate markets. Until the Corporation has sufficient experience in selling real estate and troubled loans secured by real estate, we have no basis to assess the reasonableness of its estimated recovery values.

Treasury Funding Exclusion Eliminates Reserve

As discussed in our third quarter report, the obligations limitation formula, as originally implemented, provided cash reserves to cover possible future losses due to overvaluation of the Corporation's assets in receivership.⁴ Excluding Treasury funding from the formula, however, effectively eliminated the 15-percent cash reserve feature and resulted in a potentially misleading assessment of the Corporation's ability to fund any future losses resulting from assets sales at less than their recorded value.

⁴See GAO/AFMD-91-63 for an explanation of the cash reserve feature of the obligations limitation formula as originally implemented.

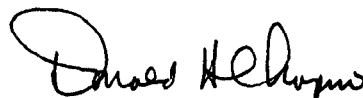
Furthermore, on March 23, 1991, the President signed the Resolution Trust Corporation Funding Act of 1991 (Public Law 102-18), which provided an additional \$30 billion in Treasury funding for losses incurred by the Corporation in resolving failed thrift institutions. However, the obligation limit formula was not amended to recognize this additional funding. As a result, the Corporation is not required to include this funding in its future calculations. Accordingly, the Corporation does not have to reserve any of those funds to cover future losses on assets purchased in connection with the resolutions. Excluding another \$30 billion (a total of \$48.8 billion) from the Corporation's future obligation limit reports will be even more misleading than excluding the original Treasury contribution.

We believe that the obligation limit formula, as originally implemented by the Corporation, provided some protection against unexpected future losses on asset sales. Therefore, in our third quarterly report, we recommended that the Congress consider reestablishing the cash reserve feature by amending the obligation limit formula established by FIRREA to recognize all funding sources in the obligation limit formula. We continue to support such a feature and reiterate our caution that the significant uncertainties related to the economy and the government's growing portfolio of troubled assets may result in losses from the sales of Corporation assets exceeding even a 15-percent cash reserve amount.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to interested parties and make copies available to others upon request.

This report was prepared under the direction of Robert W. Gramling, Director, Corporate Financial Audits, who may be reached on (202) 275-9406 if you or your staff have any questions.

Sincerely yours,



Donald H. Chapin
Assistant Comptroller General

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Abbreviations

FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
FSLIC	Federal Savings and Loan Insurance Corporation
GAO	General Accounting Office
REFCORP	Resolution Funding Corporation
WRAPS	Warranty and Representation Account Processing System

Resolution Trust Corporation Obligations and Assets as of December 31, 1990



June 5, 1991

Honorable Henry B. Gonzalez
Chairman
Committee on Banking, Finance
and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

We are pleased to submit the fourth quarterly report relating to the working capital needs of the Resolution Trust Corporation. This quarterly report provides estimated values of the RTC's obligations and assets as of December 31, 1990, which are used to determine whether the RTC remains within the limitation on obligations as mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. We have also included a table presenting the computation of the obligation limitation as of December 31, 1990. This report was delayed in order to incorporate updated loss estimates and asset values developed by RTC as part of the preparation of the 1990 annual financial statements.

We hope that this information will be of assistance to you. If you have any questions, please let me know.

Sincerely,

A handwritten signature in black ink, appearing to read "David C. Cooke".

David C. Cooke
Executive Director

801 17th Street, NW ■ Washington, DC 20434-0001

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RESOLUTION TRUST CORPORATION

Obligations and Assets
as of December 31, 1990

1. Outstanding Obligations \$ 54.8 billion
Includes \$53.0 billion in notes issued to the Federal Financing Bank (FFB) plus \$0.9 billion accrued interest; and \$0.8 billion in accounts payable and other liabilities, lease commitments, and estimated losses from litigation. Contingent liabilities already applied to the value of RTC's claims on failed thrift assets are not included here. The estimated future costs of resolving RTC conservatorships and other troubled thrifts are also excluded.
2. "Full Faith and Credit" Obligations \$ 54.5 billion
Includes accounts payable and other liabilities, and notes issued to the FFB plus accrued interest.
3. Total Fair Market Value of [Non-Cash] Assets Held by RTC \$ 48.2 billion
Includes \$22.6 billion principal value of advances, loans, accrued interest, and reimbursable expenses due from conservatorships and receiverships. RTC advances have a claims priority ahead of general creditors; most are estimated to be fully collectible. Also includes \$25.5 billion for the net realizable value of RTC subrogated claims on receiverships. The net realizable value accounts for estimated total losses to RTC for resolved cases, including expenses incurred to manage and dispose of assets, as well as estimated losses on assets covered under "put" agreements. The obligation limitation counts the total of all non-cash assets at 85 percent of the fair market value shown above.
4. Cash Held by RTC \$ 5.2 billion
5. Obligations [Bonds] Issued by REFCORP \$ 23.0 billion
Includes \$4.5 billion issued in October 1989, \$5.0 billion issued in January 1990, \$3.5 billion issued in April 1990, \$5.0 billion issued in July 1990 and \$5.0 billion issued in October 1990. RTC also received \$18.8 billion in Treasury funds (excluded from the calculation of the obligation limitation with the concurrence of the Oversight Board and the Congress) and a \$1.2 billion contribution from the Federal Home Loan Banks transferred to RTC through REFCORP.

Resolution Trust Corporation Maximum Amount Limitation on Outstanding Obligations

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RESOLUTION TRUST CORPORATION
FIRREA
MAXIMUM AMOUNT LIMITATION ON
OUTSTANDING OBLIGATIONS
AS OF DECEMBER 31, 1990
(IN MILLIONS)

A) CONTRIBUTIONS RECEIVED FROM REFCORP	<u>24,248</u>
B) OUTSTANDING OBLIGATIONS	
1) LITIGATION - ESTIMATED LOSSES	158
2) LEASE COMMITMENTS	156
3) ACCOUNTS PAYABLE AND OTHER LIABILITIES	533
4) NOTES PAYABLE AND OTHER DEBT	<u>53,930</u>
TOTAL OUTSTANDING OBLIGATIONS	<u>54,777</u>

**Appendix II
Resolution Trust Corporation Maximum
Amount Limitation on
Outstanding Obligations**

-3-

LESS:	
C) CASH AND CASH EQUIVALENTS	5,177
LESS:	
D) ESTIMATED FMV OF OTHER ASSETS	
1) ADVANCES AND LOANS	19,217
22,608 @ 85%	
2) NET SUBROGATED CLAIMS	21,708
25,539 @ 85%	
3) MISC. RECEIVABLES AND OTHER ASSETS	5
6 @ 85%	
TOTAL OTHER ASSETS @ 85%	40,930
ADJUSTED OBLIGATION LEVEL (A+B-C-D)	32,918
MAXIMUM LEVEL	50,000
EXCESS OF MAXIMUM LEVEL OVER ADJUSTED OBLIGATION LEVEL AT 12/31/90 **	\$17,082

** A positive amount indicates compliance with the obligation limitation. It does not represent the limit on additional borrowings. Additional borrowing authority depends on the estimated value of RTC assets.

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FIRREA Section 501(a) (j)
Maximum Amount Limitation on Outstanding Obligations
Explanatory Notes

A. Contributions Received

Includes the \$1.2 billion FHLB contribution (through REFCORP) and REFCORP bond proceeds. Does not include the initial \$18.8 billion Treasury contribution. This contribution has been excluded from the calculation with the concurrence of the Oversight Board and the Congress.

B. Outstanding Obligations

1. Litigation-Estimated Losses: The expected cost of those pending or threatened litigations, claims, or assessments where an estimated loss to RTC (in its Corporate and Receivership capacities) is both probable and reasonably estimable. These are over and above legal expenses already included in the resolution loss estimates.

2. Lease Commitments and Other Contractual Obligations: The non-cancelable portion of outstanding contractual obligations. As of December 31, 1990, these included primarily multi-year lease commitments for space in Washington and other locations.

3. Accounts Payable and Other Liabilities: Full face value of routine, current liabilities such as accounts payable and accrued liabilities. Also, includes the full face value of the liability related to pending claims of depositors (insured deposits owed but not yet paid).

4. Notes Payable and Other Debt: Full face value of all Federal Financing Bank borrowings and accrued interest due thereon.

Additional Notes on Outstanding Obligations:

A. Guarantees: There were no guarantees issued or assumed from FSLIC (i.e., FHLB advances guaranteed by FSLIC) as of December 31, 1990, that the Corporation expects will result in additional losses.

B. Asset Puts: Included in the allowance for losses on claims against receiverships is an estimate of losses on assets likely to be returned to the RTC under a put agreement. Therefore, the Corporation's claims have already been adjusted for the contingent liabilities relating to put agreements.

Appendix II
Resolution Trust Corporation Maximum
Amount Limitation on
Outstanding Obligations

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C. Contingent Liabilities Related to the Resolution of Conservatorships and Other Troubled Thrifts: Not included as outstanding obligations.

C. Cash and Cash Equivalents

Includes cash, cash equivalents (as defined in FAS #95).

D. Estimated Fair Market Value of Other Assets Held by the Corporation (85% thereof)

1. Advances and Loans: Included at 85% of fair market value. Includes principal on advances, accrued interest and other receivables from conservatorships and receiverships. These receivables have a claims priority ahead of general creditors. Reserves are established where the net liquidation value from conservatorships assets does not cover the principal and interest on RTC advances and other priority claims.

2. Net Subrogated Claims: Included at 85% of the Net Realizable Value of such claims. Loss allowances have been revised as part of the preparation of the 1990 annual financial statements. RTC has estimated recoveries from receivership assets, net of all expenses including interest, to determine the value of its claims against receiverships and corresponding loss allowances.

3. Miscellaneous Receivables and Other Assets: Includes current assets, all at 85%.

Implementation Status of Open Recommendations

Our first quarter report on the Corporation's compliance with the maximum obligation limit set forth in FIRREA identified several factors that could affect the cost of resolutions and the point at which the limit is reached. To address these factors, we made specific recommendations to the Corporation's Executive Director. As part of our fourth quarter review, we evaluated the Corporation's response to our remaining open recommendations concerning the (1) lack of asset tracking systems and (2) failure to estimate and disclose the resulting contingent liability for representations and warranties given in connection with the sale of assets.

Comprehensive, Integrated Asset Tracking System Has Not Yet Been Implemented

Because the market value of receivership assets is a key component in the obligation limit calculation, overestimation of these values could result in the Corporation incurring liabilities it would be unable to repay from sales proceeds. Therefore, we recommended that the Corporation track and report the actual results of asset sales to provide the information necessary for evaluating the accuracy of estimated market values. In particular, we noted that collecting data on initial estimated market value assigned, date available for sale and date sold, sales price, and gain or loss would provide historical information to use as the basis for adjusting current estimates and preparing future estimates.

In response to our inquiries during the second quarter review, the Corporation stated that a receivership asset inventory system was being developed to report in detail the sales status of individual assets. The estimated completion date at that time was February 28, 1991. At the time of our third quarter report, the system was behind schedule, and Corporation officials stated that they expected the system to be completely operational by June 30, 1991.

However, in response to our recent inquiries, the Corporation indicated that it had not developed a single integrated asset management system capable of providing all the valuation information necessary to produce and evaluate recovery estimates. Instead, the Corporation is in the process of developing the following:

- the Real Estate Owned Management System;
- the Loans and Other Assets Inventory System;
- the Asset Manager System;
- the Furniture, Fixtures, and Equipment System; and
- the Control Total System.

According to Corporation officials, some of these systems already have the capability to provide recommended valuation information while others will have to be modified. Currently, the Loans and Other Assets Inventory System does not have financial information reporting capabilities. Because these systems are in various stages of completion, the Corporation could not provide a single implementation date. We will continue to monitor the development of asset information systems as part of our ongoing audit work at the Corporation.

Losses Inherent in Representations and Warranties Are Being Recognized

Sellers of asset-backed receivables to the secondary market are generally expected to make certain representations and warranties, in the form of factual disclosures, about the assets being sold. They are also expected to certify the accuracy of those statements. Such warranties and representations create contingent liabilities for conservatorships and receiverships, which could reduce the Corporation's ultimate recoveries from receiverships and decrease the amount of obligations that the Corporation can incur under FIRREA. Therefore, we recommended that when the representations and warranties are given, an appropriate estimate of the resulting contingent liabilities be made and reflected in the Corporation's obligations limitation calculation.

In response to our recommendation, the Corporation has implemented the Warranty and Representation Account Processing System (WRAPS), a national data base, to track mortgage loan sales, servicing-right sales, loss reserve accounts, and related claims activity. The Corporation also established Regional Claims Administrators in each of its regions to monitor conservatorship and receivership mortgage loan sales and servicing sales activities. Finally, the Corporation procured the services of the Mortgage Guaranty Insurance Corporation to handle claims arising from representations and warranties.

As of December 31, 1990, the Corporation had made representations and warranties with respect to nearly \$10 billion of loans and servicing rights. In conjunction with these sales, the Corporation had reserved about \$42 million for contingent liabilities.

The Corporation's actions have adequately addressed our concerns and, therefore, we consider this recommendation to be closed.

GAO Quarterly Compliance Reports

Obligations Limitation: Resolution Trust Corporation's Compliance as of March 31, 1990 (GAO/AFMD-90-101, July 27, 1990).

Obligations Limitation: Resolution Trust Corporation's Compliance as of June 30, 1990 (GAO/AFMD-91-41, December 21, 1990).

Obligations Limitation: Resolution Trust Corporation's Compliance as of September 30, 1990 (GAO/AFMD-91-63, May 31, 1991).

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