United States General Accounting Office

GAO

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

May 1991

OBLIGATIONS LIMITATION

Resolution Trust Corporation's Compliance as of September 30, 1990

144246

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

Accounting and Financial Management Division

B-240108

May 31, 1991

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

Dear Mr. Chairman:

This is our third report in 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). The act provides the formula for calculating the maximum allowable obligations outstanding and $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 quarter and second quarter compliance were issued in July 1990 and December 1990, respectively.[1]

On February 4, 1991, the Corporation issued to you its third quarterly report of the estimated values of its obligations, assets, and contributions received as of September 30, 1990. The Corporation reported that the financing it received from the Resolution Funding Corporation (REFCORP) plus its outstanding obligations exceeded the value of its assets by $22 billion and that its "adjusted obligation level" was therefore $28 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 February 4, 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. However, at the direction of its Oversight Board and with the approval of the Chairmen of the House and Senate Banking Committees, the Corporation changed its methodology for calculating its third quarter compliance to eliminate $18.8 billion of Treasury funding and, as a result, its adjusted obligation level is not comparable to

[1]Obligations Limitation: Resolution Trust Corporation's Compliance as of March 31, 1990 (GAO/AFMD-90-101, July 27, 1990) and Obligations Limitation: Resolution Trust Corporation's Compliance as of June 30, 1990 (GAO/ AFMD-91-41, December 21, 1990).

amounts calculated in the first and second quarter reports. If the Corporation had included the Treasury funding in its calculation, its third quarter adjusted obligation level would be only $9 billion below the $50 billion provided by FIRREA.

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. 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 asset sales. We believe that the formula as originally implemented served as a valuable safeguard against unexpected future losses which could require significant future funding from the Congress.

The Congress could reestablish a cash reserve feature by amending FIRREA to recognize all funding sources in the obligations limitation formula. To maximize the usefulness of the formula, however, the Corporation must provide the Congress with its best estimate of expected asset recovery values, based on its sales experience to date, and its current asset disposition plans. Corporation funding requests must then include an additional amount equal to 15 percent of these recovery estimates to cover any unexpected losses at the time of sale. However, even with the best estimates and the 15 percent hedge factor, significant uncertainties related to the economy and the government's growing portfolio of troubled assets may result in losses exceeding the reserve amount.

In addition to performing the quarterly review, we are also in the early stages of auditing the Corporation's 1990 financial statements. As a result of this audit work and the specific tests made of the obligations limit calculation, we continue to identify errors and misclassifications in the Corporation's financial accounts. However, none of them materially affect the adjusted obligations level. To date, we have been unable to perform sufficient tests to determine the amount of any undisclosed obligation or overvalued assets of the Corporation which, if disclosed, might have affected the calculation. Except for the effects that undisclosed obligations and overvalued assets might have, it is unlikely that the Corporation exceeded the limitation as of September 30, 1990, even when adjusted for Treasury funding.

We again followed up on the implementation status of the three recommendations we made to the Corporation's Executive Director in our first quarter report. The Corporation has satisfactorily addressed one of our recommendations and continues to work on the other two. Details on the implementation status of our previous recommendations are included as appendix III.

Background

In response to the savings and loan crisis and the Federal Savings and Loan Insurance Corporation's (FSLIC) mounting losses, FIRREA (Public Law 101-73) was enacted into law 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 Corporation $50 billion to resolve the problems of those institutions and to pay administrative expenses.[2] 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 with which to accomplish its task, including the power to issue obligations and guarantees when acquiring institutions within its jurisdiction. The full faith and credit of the United States is pledged to the payment of such obligations if the principal amounts and maturity dates are stated in the obligations.

However, section 501(a) of FIRREA limits the outstanding 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.

FIRREA defines obligations as including (1) any obligation or other liability assumed by the Corporation from FSLIC, (2) any guarantee issued by the Corporation, (3) the total of outstanding amounts borrowed from Treasury as authorized by FIRREA, and (4) any other obligation, direct or contingent, for which the Corporation is liable.

[2]As of September 30, 1990, the Corporation had received $38 billion in funds. This includes $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 $18 billion of bond proceeds to the Corporation by the end of the third quarter.

FIRREA provided for the Corporation to receive $18.8 billion from Treasury in fiscal year 1989, which the Corporation included in the formula for calculating the limit on outstanding obligations for its first and second quarter reports. This treatment was consistent with the views of the Chairman and the Ranking Minority Member, Senate Committee on Banking, Housing and Urban Affairs, as expressed in a September 26, 1989, letter to the Secretary of the Treasury. The letter stated that nothing in FIRREA should be viewed as permanently expanding the Corporation's $50 billion limitation.

However, the formula in section 501(a) does not explicitly contain the Treasury funding and there is no basis in the law for concluding that Treasury funding is encompassed by either the REFCORP contributions or the obligations components in the formula. Therefore, as a matter of law, the Corporation is not required to include the Treasury funding in its calculation of whether the FIRREA limitation on outstanding obligations has been reached.

In its operating plan for the 6 months beginning October 1, 1990, the Corporation indicated that it would soon reach the obligations limit and would then be unable to continue resolving failed institutions. This would occur even though over $10 billion of the $50 billion in loss funds provided by FIRREA would remain unspent. Use of the obligations limit formula resulted in these unspent loss funds serving as a cash reserve for the Corporation's outstanding obligations. To avoid resolution delays, the Oversight Board[3] requested that the Congress provide the Corporation with an additional $40 billion in loss funds to resolve institutions and $17 billion to be used as a cash reserve for any further losses from asset sales. Using this approach, the Corporation would have had access to all loss funds for use in resolution actions. The Congress, however, did not provide the additional funding before it recessed on October 28, 1990.

In the absence of additional funding, the Oversight Board directed the Corporation on November 2, 1990, to exclude the Treasury funding from the formula when computing the third quarter, as well as future compliance with the obligations limitation. Excluding this funding effectively eliminated the formula's cash reserve feature. The Oversight Board's action had been expressly encouraged by the Chairman of the House

[3]The Resolution Trust Corporation Oversight Board was created by FIRREA to review and have overall responsibility for the Corporation's activities. The Secretary of the Treasury serves as the Board's Chairman.

Committee on Banking, Finance and Urban Affairs by letter dated October 31, 1990, and by the Chairman of the Senate Committee on Banking, Housing and Urban Affairs in a formal statement dated November 1, 1990.

Objectives, Scope, and Methodology

As agreed with your staff, we performed a review of the Corporation's third 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 select components of the calculation.

To ensure that the formula calculation included all required components, we compared the Corporation's report with its September 30, 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 two reports and tested only the third quarter's activity. For this report, our review included the following tests:

- confirming contributions received from REFCORP and the Treasury,
- confirming notes payable with the Federal Financing Bank,
- recalculating interest owed to the Federal Financing Bank,
- reviewing each corporate litigation case pending for reasonableness of legal liability reported,
- recalculating lease obligations for headquarters and regional office and storage space,
- confirming cash with Treasury and reviewing cash reconciliation reports,
- judgmentally sampling and tracing to supporting documentation nearly 80 percent of the advances disbursed to conservatorships during the third quarter,
- recomputing the Corporation's estimate of potential losses on advances and loans,
- independently estimating interest receivable due on advances and loans,
- judgmentally sampling and tracing to supporting documentation more than 80 percent of the increased dollar value in the Corporation's claims against receiverships, and
- recalculating the loss allowance for institutions that comprised 75 percent of the dollar increase in the allowance for loss on claims against receiverships.

We have not yet performed any substantive tests of the recorded fair market value of receivership assets. In addition, the Corporation's lack of historical experience in asset sales and its present plans for asset disposition preclude determination of whether recorded market values can, in fact, be realized without substantive additional losses. We are currently developing procedures to begin sampling and evaluating the salability of receivership assets; however, we do not know whether the results of these planned tests will enable us to form an opinion on asset values. Although we expect our valuation work to extend well beyond the fourth quarter reporting period, we will discuss any preliminary results as part of that report.

During our review of the Corporation's third quarter compliance, we performed our work at the Corporation's headquarters and in three of its four regions. In the Eastern, Southwestern, and Western Regions, we identified and began testing key internal controls to ensure receiverships' accountability over cash receipts, cash disbursements, and the resolution settlement process. To date, results of these tests are incomplete; however, we will present and assess test results in future reports.

In the following section, we provide additional information on the impact of eliminating Treasury funding from the obligations limit calculation.

Obligations Limit Calculation

The obligations limitation formula, as currently implemented, no longer serves as a hedge against the Corporation's incurring future losses on asset sales that it cannot fund from available monies. This has resulted from eliminating Treasury funding from the calculation—an action that is allowed but that changes the utility of the formula.

The Corporation's original implementation of the formula established a cash reserve equal to 15 percent of the estimated market value of assets purchased at resolution to cover possible additional losses from sales at less than the estimated value. This reserve was backed by a portion of the $50 billion provided by FIRREA; therefore, if assets sold for up to 15 percent less than estimated, the necessary monies to pay these losses were already available.

By not including the Treasury funding in the formula, the Corporation need not provide cash reserves to cover possible future losses from the sale of assets currently held by its receiverships. Instead, any future losses resulting from differences between the estimated recovery value of the Corporation's assets and their actual net sales proceeds will require the Congress to provide additional funds at some later date.

Because of this change in the calculation, which was approved by the Oversight Board and the Chairmen of the House and Senate Banking Committees, the Corporation's reports on the estimated values of its obligations, assets, and contributions are no longer comparable to its previous reports. For example, as of September 30, 1990, the Corporation calculated that it was $28 billion below the limit; however, the Corporation would be only $9 billion below the limit if Treasury funding was included in the calculation. As another example, the Corporation's operating plan for January through September 1991 indicates that the Corporation will be $4 billion below the limit as of September 30, 1991. However, including Treasury funding in the calculation results in the Corporation exceeding the limit by $15 billion. That $15 billion overage represents possible future losses from overvalued receivership assets for which no cash reserve has been established.

In addition, excluding another $30 billion (a total of $48.8 billion) from the Corporation's future obligations limit reports will be even more misleading. 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 unrecoverable losses incurred by the Corporation in resolving failed thrift institutions. However, the obligations limit formula was not amended to recognize this additional funding. As a result, the Corporation is also not required to include this funding in its future calculations and, accordingly, might not reserve any of those funds to cover future losses on assets purchased in connection with the resolutions performed.

Conclusion

We believe that the obligations limit as originally implemented by the Corporation provided a control over spending which helped ensure that losses were funded as incurred. As we have stated in various reports, including our recent report on the Corporation's 1989 financial statements,[4] the Corporation's assets in receivership could be significantly overvalued. We are concerned that the Corporation has not performed a comprehensive review of assets under receivership control and therefore cannot determine each asset's condition or set a realistic price for its sale. In addition, the Corporation lacks the historical experience in

[4]Financial Audit: Resolution Trust Corporation's 1989 Financial Statements (GAO/AFMD-91-57, April 4, 1991).

asset sales and asset management necessary to evaluate its recovery estimates. Finally, asset sales could generate significantly less revenue than expected, especially if the economy continues its slowdown. Without the reserve feature, the hedge against losses from sales of overvalued assets is gone and future funding demands on the Congress will likely occur as assets are sold.

Matters for Consideration by the Congress

The Congress could reestablish a cash reserve feature by amending FIRREA to recognize all funding sources in the obligations limitation formula. The Corporation would then be required to again set aside a portion of its unspent loss funds to hedge against the possible overvaluation of its assets in receiverships. This would also ensure that the Corporation's future obligation limit calculations are comparable and useful.

However, if the formula is amended, the Corporation should acknowledge the need for cash reserves in its future funding requests or it could again reach the obligations limit before carrying out all its planned resolution actions. To avoid the obligations limit becoming a hindrance, the Corporation should provide the Congress with current estimates of anticipated resolution losses based on expected asset recovery values that consider its sales experience to date and its current asset disposition plans related to the timing of asset sales and offering of discount incentives. The Corporation should also request an amount equal to 15 percent of the expected asset recovery value to serve as the cash reserve for any unexpected losses incurred when the assets are sold. Based on this information, the Congress then needs to promptly provide the Corporation with sufficient funds to cover all estimated losses and the cash reserve.

Although the Corporation needs to provide its best estimate of expected recovery values and then provide a 15 percent factor for unforeseen losses, the amount the Corporation will actually realize on asset sales is subject to significant uncertainties that are beyond the Corporation's control and impossible to predict. In particular, the continuing recessionary economy and the government's growing portfolio of troubled assets could result in unexpected losses higher than the reserve amount. Therefore, the Corporation needs to closely track its sales experience compared to its recovery estimates and advise the Congress promptly if the 15 percent reserve is proving inadequate and request appropriate funding.

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. Also, we did not test or verify the books and records of the Corporation or the data contained in appendixes I and II, except for the procedures detailed in this section. 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. We have incorporated their comments where appropriate.

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. Other major contributors are listed in appendix IV.

Sincerely yours,

Donald H. Chapin
Assistant Comptroller General

Contents

Abbreviations

FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FSLIC	Federal Savings and Loan Insurance Corporation
REFCORP	Resolution Funding Corporation

Resolution Trust Corporation Obligations and Assets as of September 30, 1990

RTC
Resolution Trust Corporation

February 4, 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 third quarterly report which you requested in your letter of March 9, 1990, 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 September 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 September 30.

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

Sincerely,

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 September 30, 1990

1. **Outstanding Obligations** **$ 48.8 billion**

   Includes $42.1 billion in notes issued to the Federal Financing Bank (FFB) plus accrued interest; a $5.8 billion payable for September resolution transactions for which funds were disbursed in October 1990; and $0.8 billion in current and other liabilities, contractual commitments (leases), and contingent liabilities (legal exposure). Contingent liabilities already applied to the value of RTC's claims on failed thrift assets are not included. The estimated future costs of resolving RTC conservatorships and other troubled thrifts are also excluded.

2. **"Full Faith and Credit" Obligations** **$ 48.5 billion**

   Includes accounts payable, other current liabilities, and notes issued to the FFB, including accrued interest.

3. **Total Fair Market Value of [Non-Cash] Assets Held by RTC** **$ 48.2 billion**

   Includes $26.4 billion in 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. (A reserve of $73 million is included for one institution.) Also includes $21.8 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** **$ 5.1 billion**

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5. **Obligations (Bonds) Issued by REFCORP** **$ 18.0 billion**

Includes $4.5 billion issued in October 1989, $5.0 billion issued in January 1990, $3.5 billion issued in April 1990 and $5.0 billion issued in July 1990. RTC also received $18.8 billion in Treasury funds (excluded from the calculation of the obligation limitation) and a $1.2 billion contribution from the Federal Home Loan Banks transferred through REFCORP.

Resolution Trust Corporation Maximum Amount Limitation on Outstanding Obligations

($ in millions)

			AS OF SEPTEMBER 30, 1990
A)	CONTRIBUTIONS RECEIVED FROM REFCORP		19,221
B)	OUTSTANDING OBLIGATIONS		
	1) LEGAL EXPOSURE - RESERVE FOR LOSS	191	
	2) LEASES AND OTHER CONTRACTUAL OBLIGATIONS	144	
	3) ACCOUNTS PAYABLE AND OTHER LIABILITIES	6,393	
	4) NOTES PAYABLE AND OTHER DEBT	42,136	
	TOTAL OUTSTANDING OBLIGATIONS		48,864

LESS:

C) CASH AND CASH EQUIVALENTS

1) CASH AND EQUIVALENTS		5,113

LESS:

D) ESTIMATED FMV OF OTHER ASSETS

1) ADVANCES AND LOANS TO RECEIVERSHIPS AND CONSERVATORSHIPS 26,373 @ 85%	22,417	
2) NET SUBROGATED CLAIMS 21,838 @ 85%	18,562	
3) MISC. RECEIVABLES AND OTHER ASSETS 7 @ 85%	6	
TOTAL OTHER ASSETS @ 85%		40,985
ADJUSTED OBLIGATION LEVEL (A+B-C-D)		21,987
MAXIMUM LEVEL		50,000
EXCESS OF MAXIMUM LEVEL OVER ADJUSTED OBLIGATION LEVEL AT 9/30/90 **		$28,013

** 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 and the volume of REFCORP funds raised.

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

A. Contributions Received

Includes the $1.2 billion FHLB contribution transferred through REFCORP, and REFCORP bond proceeds. Does not include the initial $18.8 billion Treasury contribution.

B. Outstanding Obligations

1. Legal Exposure: The expected cost of those pending or threatened litigations, claims, or assessments where an estimated loss to RTC (in its Corporate, Conservatorship and Receivership capacities) is both probable and reasonably estimable. These are over and above any legal expenses already included in the determination of the allowance for loss on subrogated claims.

2. Leases and Other Contractual Obligations: The non-cancelable portion of outstanding contractual obligations. As of September 30, 1990, these included primarily multi-year leases 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. As of September 30, includes payable for those resolutions in late September where cash disbursements were not made until October. 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:

- Guarantees: Any expected cost to the Corporation of any guarantee issued or assumed from FSLIC (i.e., FHLB advances guaranteed by FSLIC). No expected cost to RTC since there are no deficiencies in the underlying collateral on any of these guarantees at September 30, 1990. There were no other guarantees as of that date.

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

- 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. Net Subrogated Claims: Included at 85% of the Net Realizable Value of such claims. Loss allowances against these claims are estimates at the time of resolution. RTC currently is implementing policies similar to FDIC policies for valuing claims against receiverships, which consider nondiscounted cash inflows, net of liquidation expenses, in determining the cash available to repay the Corporation.

2. Advances and Loans: Included at 85% of fair market value. These receivables have a claims priority ahead of general creditors; most are estimated to be fully collectible. (A reserve of $73 million is included for one institution.) Includes principal on advances, accrued interest and other receivables from conservatorships and receiverships.

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

Implementation Status of First Quarter Review Recommendations

Our first quarter report on the Corporation's compliance with the maximum obligation limit set forth in FIRREA identified three factors that could affect the cost of resolutions and the point at which the limit is reached. These factors included (1) noncompliance with Corporation policy governing pledging collateral for advances to conservatorships, (2) overestimation of the fair market value of assets, and (3) failure to estimate and disclose the resulting contingent liability for representations and warranties given in connection with the sale of assets. To address these factors, we made specific recommendations to the Corporation's Executive Director. We reported on the Corporation's implementation progress in our second quarter report. As part of our third quarter review work, we again evaluated the implementation status of those recommendations with Corporation management.

Secured Advances Policies Are Clarified

In our first quarter review, we found that conservatorship managing agents were not following written Corporation procedures requiring all institutions to execute a promissory note for each advance received from the Corporation, pledge collateral to secure those advances, and perfect the Corporation's security interest in the collateral. This had occurred because managing agents were uncertain about how much collateral should be pledged, how that collateral should be recorded and secured, and whether information regarding the collateral should be sent to the regions or headquarters. We concluded that noncompliance with the Corporation's procedures regarding collateral pledged to secure conservatorship advances could lessen the Corporation's return on asset recoveries, thereby increasing its resolution costs. Therefore, we recommended that the Corporation clarify and enforce its policies and guidelines regarding conservatorship advances.

In our second quarter review, we reported that the Corporation had implemented certain procedural and reporting changes to enhance internal controls in this area. In particular, promissory notes must be (1) executed by conservatorship managing agents, (2) approved by the Deputy Regional Directors, and (3) sent to Corporation headquarters as verification of the conservatorship's receipt of advance funds. The Deputy Regional Directors for Resolutions must submit weekly status reports to headquarters to track compliance with these documentation requirements.

Although the new policies and procedures provided clear guidance regarding required documentation, they were still not being adequately enforced. As part of our third quarter work, we judgmentally sampled and reviewed headquarters' file documentation for 42 conservatorship advances. We found that copies of 8 signed promissory notes were missing and that 2 notes maintained in the files did not match the actual funds advanced. Upon our request, all 10 of the notes that supported the amount of conservatorship advances were readily obtained from the conservatorships. In response to our findings, the Corporation has since reassigned responsibility for maintaining the advances files. As part of our review work, we will continue to follow up on advances file documentation each quarter.

As part of our recommendation on advances, we advised that the Corporation follow its policies on perfecting claims to decrease its risk of loss. Perfection refers to the performance of certain legal procedures required to give the Corporation a claim to a particular asset and to protect that claim against challenges by other creditors. The Corporation has since reviewed this issue and determined that the cost of perfection on an institution-by-institution basis is not justified by the risk of nonperfection. According to Corporation attorneys, advances to conservatorships become the highest-priority unsecured claims when institutions are resolved and will be repaid before any funds are distributed to other unsecured claimants. As a result of its findings, the Corporation has revised its policies to rescind the perfection requirement. We agree with the Corporation's position that the risk of nonperfection does not justify the cost of perfection at this time. However, the Corporation could reinstate the perfection requirement if other creditors began perfecting claims on the same collateral that secures the Corporation advances. Therefore, we will consult with Corporation officials each quarter to ensure that conditions do not warrant reinstitution of the perfection requirement.

To ensure that the collectibility of advances is accurately reported in its quarterly financial reports, the Corporation calculates the estimated value of assets available in each institution to cover all advances and other secured claims. Where insufficient collateral exists, the Corporation establishes an allowance for loss against its receivable for that advance. To date, the Corporation has had to establish a loss allowance of $73 million for one institution. We will continue to review and verify the Corporation's calculation each quarter to ensure that allowances are established when necessary.

Asset Tracking System Is Behind Schedule

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 was then February 28, 1991. However, Corporation officials recently stated that the system currently has preliminary reporting capability for only one region. The Corporation expects the system to be completely operational by June 30, 1991.

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 that increase the Corporation's outstanding obligations and decrease the additional amount of obligations that the Corporation can incur under FIRREA. Therefore, we recommended that when representations and warranties are given, an appropriate estimate of the resulting contingent liabilities be made and reflected in the Corporation's obligation limitation calculation.

In its recent response to our follow-up effort, the Corporation indicated that it had provided representations and warranties on nearly $10 billion of loans and servicing rights as of December 31, 1990. To cover the contingent liabilities that may arise, the Corporation said that it had established reserves of nearly $42 million on the books of its receiverships and conservatorships. As part of our fourth quarter review work, we will evaluate the Corporation's policy regarding the reserve amount and will examine some conservatorship and receivership records to ensure that appropriate amounts are recorded as reserves for contingent liabilities.

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