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GAO

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

General Government Division

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July 16, 1992

The Honorable Bruce F. Vento
House of Representatives

Dear Mr. Vento:

This letter responds to your February 12, 1991 request that we review the Resolution Trust Corporation's (RTC) implementation of the cost test used in making resolution decisions. You asked us to look at a sample of transactions to determine whether the cost test is being applied properly and whether it is a valid reflection of market values.

As discussed with your staff, we examined the asset valuation review (AVR) process and the cost test implementation in three resolution transactions from RTC's Southwest Region. The AVR process provides estimated market values for failed thrift assets for use in the cost test. The cost test calculates and compares the estimated costs of various resolution transactions with an insured deposit payout to show the least costly resolution method.

Based on our review of RTC guidelines in effect at the time, we believe that the AVR process contained elements necessary to arrive at reasonable estimates of market value. However, in one of the three cases that we reviewed, we found weaknesses in the implementation of the AVR process that caused us to question the reasonableness of the asset valuations. In addition, in April 1992, RTC's Office of Inspector General reported that it could not determine whether AVRs were done in accordance with applicable policies and procedures, and whether the asset valuations were reasonable or reliable, due to poor or non-existent supporting documentation.[1] As agreed with your office, we are assessing the implementation of the AVR process further and will provide the results of this work in a separate report.

We believe that the cost test was applied properly in the three transactions that we reviewed. However, there were some

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[1]Asset Valuation Methods and the Appraisal Review Process, RTC Office of Inspector General Audit Report A92-016, April 28, 1992.

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minor differences between the resolution of the larger thrift handled by RTC headquarters and the two smaller thrift resolutions done by RTC regional offices. In these three transactions, the AVRs were used to estimate asset values and the cost test was used to select the least costly resolution method for each failed thrift.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to determine whether the results of the AVR process were a valid reflection of market values and whether the cost test was applied properly in selected transactions.

We reviewed RTC's AVR process and the Southwest Region's implementation of that process to determine whether the asset valuations used in the cost test reflected market values in selected cases. We reviewed the AVRs for three resolved thrifts in RTC's Southwest Region--Southwest Federal Savings Association (FSA) of Dallas, First South FSA of Houston, and Windsor FSA of Austin. These thrifts ranged in asset size from $90 million to $4.9 billion, with total assets of $5.3 billion (book value). Each thrift was managed by one of the three RTC consolidated field offices in the Southwest Region. The AVRs for these thrifts were done by three different RTC contractors in April 1991. A summary of the AVRs that we reviewed is enclosed.

We also reviewed the resolution transactions for these thrifts to assess whether the cost test was applied properly. Because the scope of our review was limited and RTC's practices may vary, our results apply only to the resolution cases that we reviewed.

Our work included detailed reviews of the AVR methodology, thrift asset files, AVR contractor workpapers, RTC regional retention files, and final AVR reports. We also reviewed RTC resolution practices, cost test documentation, and resolution cases. We interviewed appropriate RTC field office, regional office, and headquarters officials to determine whether they believed that the AVRs reflected market values and that the cost test was applied properly in these cases. We also interviewed AVR contractor personnel to obtain additional information on the AVR process and the assumptions they used in valuing the assets of these thrifts.

Our review was done between June 1991 and April 1992 in accordance with generally accepted government auditing standards.

BACKGROUND

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) gives RTC responsibility for resolving failed thrifts. At the time of our work, the Federal Deposit Insurance Act (FDIA), as referenced in FIRREA, generally prohibited RTC from pursuing any resolution transaction for a failed thrift if its cost would exceed the cost of a liquidation through an insured deposit payout. This FDIA provision was amended in December 1991 to prohibit FDIC and RTC from engaging in an assisted resolution of any failed depository institution unless it is determined that the total amount of expenditures and obligations they incur is the least costly alternative. Furthermore, FIRREA requires RTC to maximize the net present value return from the sale or other disposition of failed thrifts and to minimize the amount of losses realized in the resolution of cases.

In the December 31, 1989 strategic plan for RTC, the Oversight Board directed RTC to allow potential acquirers to bid on a variety of resolution structures and required RTC to select the least costly resolution method.[2]

In a November 21, 1990 letter you requested that we review RTC case resolutions to determine whether RTC had selected the least costly method of resolution. You also requested a concise description of how RTC determines costs, minimum required premiums, and other necessary figures. This information was provided in our February 4, 1991 letter.[3] In that letter, we provided a description of the cost test methodology and RTC's resolution process. We explained how the cost test is used by RTC to compare the estimated cost of various resolution transactions with an insured deposit payout. We noted that the key element of the cost test is the liquidation cost estimate--the difference between the estimated market value of a failed thrift's assets and the amount of claims against those assets. We also said that the reliability of the cost test depends on RTC's assumptions and estimates regarding the market values of assets, among other factors. Although we did not evaluate RTC's asset valuation process at that time, we noted that estimating asset values is difficult and subjective.

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[2]The Oversight Board has been succeeded by the Thrift Depositor Protection Oversight Board.

[3]Letter G1-0032, February 4, 1991.

WHAT IS RTC'S RESOLUTION PROCESS?

RTC's resolution process, including the application of the cost test, follows a standard schedule with minor differences between major transactions and field resolutions.[4] The major transactions section of the Resolutions and Operations Division in Washington, D.C., is responsible for resolving thrifts with over $500 million in total liabilities. Thrifts with less than $500 million in total liabilities are to be resolved by the RTC regional offices, with assistance from the field resolutions section of the Resolutions and Operations Division in Washington, D.C.[5]

The prescribed sequence of events in RTC's standard resolution process is as follows:

(1) The thrift is scheduled for resolution.
(2) The thrift is advertised and marketed.
(3) The AVR is contracted and reviewed.
(4) The bid information package is compiled.
(5) The bidders' conference is held.
(6) Bidders' due diligence is scheduled.
(7) Final bids on the thrift are accepted.
(8) Using the cost test, the best bid is selected.
(9) The thrift is resolved and closed.

RTC officials told us that their goal is to resolve each failed thrift within 6 months of its conservatorship date but that the scheduling of resolutions depends on the availability of adequate funding.[6] The prioritization of resolution cases also depends on thrift size and operating losses.

In the marketing and bidding stages of the resolution process, RTC usually offers a purchase and assumption transaction in which

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[4]This standard process was followed at the time of our review. Over time, RTC has slightly modified its marketing and bidding procedures, and resolution transaction structures, in response to market conditions.

[5]On February 1, 1992, RTC reorganized and changed the names of several of its units.

[6]In the Accelerated Resolution Program, thrifts are closed without first being placed in the conservatorship program. We have not evaluated the Accelerated Resolution Program or other alternative resolution strategies.

all the deposits, certain other liabilities, and a portion of the assets are to be sold. If no bids or acceptable bids are received, RTC usually offers an insured deposit transfer in which the acquiring institution is to establish accounts on its books for the depositors of the failed thrift and may acquire some assets. If no bids or acceptable bids are received again, RTC resolves the thrift through a payout in which RTC is to directly pay the depositors their insured deposits and retain all of the assets and other liabilities.

Both major transactions and field resolutions use the cost test to evaluate final bids and select resolution methods. The cost test may be applied to several bids for larger resolution cases, depending on the types of transactions offered and the number of bids received.

For major transactions, the analysis section of the Resolutions and Operations Division applies the cost test--using AVR information and actual bids--to determine the transaction with the lowest cost to RTC. Then the resolution case is prepared by a resolutions specialist and presented to RTC's Board of Directors for approval.[7]

For field resolutions, a resolutions specialist runs the cost test--using AVR information and assuming a hypothetical payout transaction--to determine the liquidation cost estimate. Then a resolution case, estimating RTC's cost of resolution, is prepared and sent to RTC's Board of Directors for approval. Finally, actual bids are accepted and evaluated using the cost test, and the least costly resolution method is selected.

HOW DOES RTC ESTIMATE ASSET VALUES?

RTC estimates the market value of a failed thrift's assets through the AVR process. Most AVRs are done for RTC by independent contractors. For each thrift, the contractors review both a dollar volume of assets and a certain number of assets to determine an estimate of the total loss in the asset portfolio. This estimated loss is critical because it enters into RTC's cost test and is used to determine the most cost-effective method of resolving the thrift. In addition, the results of the AVR may be

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[7]Succeeded by the RTC Executive Committee. As of February 1, 1992, RTC's Chief Executive Officer has delegated approval authority for resolution transactions to various levels of RTC officials according to the size of the institution.

used for other purposes, including determining estimated recovery values of assets.

RTC awards contracts for AVRs to registered and prequalified contractors. The contractors are solicited by RTC headquarters, selected on the basis of technical qualifications and cost criteria, and awarded annual contracts and specific task orders. As of November 1991, RTC's headquarters staff had registered and prequalified 37 AVR contractors.

RTC's regional staff is responsible for monitoring the AVR contractor's performance. A project specialist is assigned to each AVR and remains on-site with the contractor's personnel during the assignment. According to RTC policy, the project specialist is to prepare a contractor performance rating when the final AVR report is approved. These ratings are to be sent to the AVR coordinator at RTC headquarters and used when selecting contractors for other AVR assignments.

RTC's regional staff have been delegated authority to issue task orders for the AVRs for thrifts with total assets of less than $500 million. However, for larger thrifts RTC headquarters staff contracts for the AVR.

A summary of the AVR process follows:

(1) The managing agent completes the AVR Questionnaire, providing information on the volume of each type of asset and the sufficiency of asset documentation.

(2) On the basis of information given in the questionnaire, the AVR coordinator solicits bids from eligible contractors and awards the AVR task order.

(3) A regional AVR coordinator assigns a project specialist to the AVR.

(4) The project specialist meets with thrift personnel and the AVR contractor.

(5) The project specialist oversees the contractor's work.

(6) The contractor selects a sample of assets for review in accordance with the AVR methodology.

(7) The contractor calculates the estimated loss for the assets sampled and determines an estimated loss ratio for each asset category.

(8) The contractor applies the estimated loss ratio to the remaining assets in each asset category.

(9) The contractor completes the narrative section of the AVR report and the asset loss summary tables.

(10) The project specialist, regional AVR coordinator, and resolutions specialist in Washington, D.C. review the AVR report.

(11) The resolutions specialist incorporates the AVR information into the cost test.

DOES THE AVR PROCESS REFLECT MARKET VALUES?

We believe that the AVR process contains elements necessary to arrive at reasonable estimates of market value. RTC has developed a methodology that includes guidelines for asset sampling, portfolio review, discount rates, and data reporting to estimate the market value of a thrift's assets. In addition, it has developed specific oversight and review procedures to ensure that the methodology is followed.

In all three cases that we reviewed, the AVRs were done by registered and prequalified contractors. In the case of the two field resolutions--First South FSA and Windsor FSA--the contractor generally followed the AVR methodology and reporting format. Also, the regional staff carried out the oversight and review function. The regional project specialists monitored the contractor's work and prepared required documentation. However, in the case of the major transaction, Southwest FSA, we found several problems because the contractor failed to follow the AVR methodology. For example, the contractor did not strictly follow the asset sampling guidelines prescribed in the AVR methodology or adequately justify the discount rates or holding periods used to estimate market values. Because the contractor failed to follow the applicable AVR methodology, we could not determine whether the asset valuations for this thrift were reasonable.

We are continuing to assess the AVR process to determine whether AVR results reflect market values. We will report on the results of this assessment at a later date.

In April 1992, RTC's IG released a report detailing the results of its nationwide audit of RTC's asset valuation methods. Because of inadequate supporting documentation, the IG was unable to determine whether the asset valuation calculations were made in accordance with all requirements of the AVR methodology and, therefore, could not assess whether the valuations were reasonable or reliable.

HOW IS THE COST TEST USED?

RTC uses the cost test to estimate the cost of liquidating a failed thrift through an insured deposit payout and to estimate the costs of various resolution alternatives (purchase and assumption and insured deposit transfer). RTC applies the cost test to the highest bid it receives for each type of transaction offered, compares the estimated costs, and selects the least costly resolution method.

The liquidation cost estimate is determined by the thrift's total liabilities relative to its total assets. The assets are adjusted to market value using an asset loss estimate from the AVR process and an indirect expenses estimate. If a potential acquirer offers to purchase any assets at a transfer price higher than RTC's estimated market value for those assets, then the potential acquirer could be considered to absorb some of the thrift's loss. In this case, the cost test would indicate that RTC should select the proposed transaction because RTC's resolution cost would be lower than the cost of an insured deposit payout.

RTC officials told us that the lack of market demand for failed thrifts has diminished their available resolution alternatives and that the cost test has become less important in RTC's resolution decisions over time.

WAS THE COST TEST APPLIED PROPERLY?

The cost test was applied properly in the three resolution transactions that we reviewed. Each transaction followed the standard resolution process regarding evaluation of bids using the cost test.

One of the three resolution cases, Southwest FSA, was a major transaction. RTC received one bid for the entire thrift when it was offered as a purchase and assumption. However, two branch groups were sold to two affiliated acquirers because they presented the least-cost resolution to RTC. RTC paid off the insured depositors at the remaining branches and retained most of Southwest's assets.

The other two resolution cases, First South FSA and Windsor FSA, were field resolutions. In each of these cases, RTC received no bids for either a purchase and assumption or an insured deposit transfer. These two thrifts were eventually resolved through insured deposit payouts, and RTC retained all of their assets.

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We discussed the contents of this letter with a senior official of RTC's Resolutions and Operations Division, who generally agreed with our findings and observations.

As arranged with your office, we are sending copies of this letter to RTC's President and Chief Executive Officer, the Chairman of the Thrift Depositor Protection Oversight Board, interested congressional committees, and other interested members of Congress. We will also make copies available to others upon request.

If you or your staff have any questions concerning this letter, please contact me at (202) 736-0479.

Sincerely yours,

Gaston L. Gianni

Gaston L. Gianni, Jr.
Associate Director,
Federal Management Issues

Enclosure

SUMMARY OF ASSET VALUATION REVIEWS
IN THE RTC SOUTHWEST REGION
REVIEWED BY GAO

Thrift	Location	Total asset book value (000's)	AVR contractor	RTC consolidated field office
Southwest FSA	Dallas, TX	$4,915,131	Grant Thornton	Metroplex
First South FSA	Houston, TX	$ 302,871	Peterson Consulting	Gulf Coast
Windsor FSA	Austin, TX	$ 90,155	KPMG Peat Marwick	Southern

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