Testimony of

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Madame Chair and members of the Congressional Oversight Panel: I welcome this opportunity to discuss my experiences and lessons learned as the Executive Director of the Resolution Trust Corporation (RTC). While I recognize the current situation threatens our economy more than the problems we faced with the failing S&Ls – and banks- during the mid-1980s and early 1990s, I also believe some of the lessons learned also apply today.

My views are based primarily on my experience as RTC's Executive Director but also are influenced by my years at the FDIC and work in other countries. It's been a long time since I served as Executive Director but lessons would apply whenever the government intervenes in a market based economy to solve a financial crisis.

I will begin with a brief history of the S&L crisis that led to the creation of the RTC and then, summarize my experience starting up this new agency along with the operational challenges we faced, particularly with regard to toxic assets; how we approached them; and, what lessons would be relevant today

How it Began

The origins of the S&L problems from the mid 1980s to early 1990s date back to the high interest rates of 1979 to 1981. Back then, most thrifts invested in long term mortgages and bonds funded by short-term deposits. As interest rates rose, so did the funding costs of S&Ls as depositors left to earn higher returns. Most S&Ls started losing money rapidly depleting their capital accounts. Fortunately, interest rates started to decline before the industry collapsed. Still, the financial condition of most S&Ls had been seriously weakened. A number of institutions sought new investors by converting from mutual to stock ownership. Many S&Ls encouraged by the government and their new owners to diversify their risk using expanded lending and investment authority granted by congress in the early 1980s. Unfortunately, too many S&Ls were attracted to the upfront fees of commercial real estate loans and had too little experience or too much insider conflicts of interest. Loan losses started to noticeably rise in 1985, especially in Texas and Louisiana that had a high dependency on rising oil costs. .

By 1986, increasing numbers of S&Ls turned to the Federal Home Loan Bank Board (FHLBB) and the Federal Savings & Loan Insurance Corporation (FSLIC) for help. The FHLBB relaxed capital rules and enforcement but the number of troubled S&Ls continued to rise. By the end of 1987, FSLIC had resolved 102 S&Ls holding $28 billion in assets and many more S&Ls on the verge of failing. Industry experts and the media were starting to say FSIC was going bankrupt. The Administration and the Federal Home Loan Bank Board (FHLBB) that oversaw FSLIC requested $15 billion but, after intense lobbying for less by the S&L trade group, Congress only provided $10.8 billion in 1987.

S&L insolvencies continued to mount throughout 1988 and the new FHLBB Chairman along with FSLIC started an aggressive initiative to encouraged healthier S&Ls and other investors to buy failing S&Ls. The assistance packages typically involved providing S&L buyers loss guarantees or a note that offered attractive tax benefits and favorable accounting rules, particularly with regard to capitalizing "Goodwill" – a practice that soon became very controversial and litigious.

How FDIC Got Involved

Critics started to clamor loudly that FSLIC was rushing into transactions without sufficient competition, financial resources or authority. The FHLBB maintained it had the necessary authority. FDIC Chairman L. William Seidman, in response to a congressional request, provided an estimated S&L cost of $50 billion but cautioned that the estimates were based on S&L regulatory reports and failed bank loss experience and may not prove reliable or applicable. Nonetheless, the Chairman's estimate received a lot of attention as it was far greater than other government estimates. Meanwhile, FSLIC continued on an aggressive pace completing nearly 200 resolutions (often called the 88 Deals) while public confidence in the S&L industry and their regulators continued to decline.

During the fall of 1988, U.S. Treasury officials met with Chairman Seidman to discuss the FDIC taking over S&L deposit insurance and managing the RTC, a new temporary agency that would be responsible for resolving problem S&Ls. At that time, the FDIC was also experiencing an increase in failures but the banking industry was fundamentally sound and the insurance fund was considered sufficient to handle failure costs. Chairman Seidman was well respected for his leadership and forthrightness and the FDIC had valuable bank failure experience. Bank failures continued to rise over the next several years putting a strain on resources but the banking industry funded all losses. During the following months, Treasury drafted legislation that was presented to Congress in early 1989. The draft provided for $50 billion in funds to resolve failures, of which$20 billion would come from taxpayers and $30 billion from the S&L industry. While the legislation was going through congress, the Treasury requested the FDIC to begin managing S&Ls placed in conservatorship by FSLIC. By the time the law was enacted on August 9th, the FDIC was overseeing 271 S&Ls in conservatorship with $110 billion in assets.

The Financial Institutions Reform, Recovery and Enforcement Act (FIRREA)

FIRREA became law on August 9, 1989 and included provisions that significantly impacted the financial sector. The existing S&L regulatory authorities, the Federal Home Loan Bank Board (FHLBB) and the Federal Savings and Loan Insurance Corporation (FSLIC) were abolished and their duties transferred to the FDIC and three new agencies, the Office of Thrift Supervision (OTS), the Federal Housing Finance Board (FHFB) and the Resolution Trust Corporation (RTC). OTS was created as a bureau of the Treasury Department charged with chartering and supervising thrift institutions; FHFB was created as an independent agency to oversee the 12 federal home loan banks; and, the RTC was created as a temporary agency primarily to resolve all failing S&Ls already in conservatorship or failing over the three following years.[1] The RTC was to terminate by December 31, 1996[2] and transfer assets and activities to the FDIC. FIRREA also transferred to FDIC the responsibility for administering a thrift deposit insurance fund and serving as a contract agency responsible for operating the RTC.

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[1] As it turned out, RTC continued to takeover such S&Ls through 1995 to help preserve the industry's insurance fund.

[2] Later shortened to December 1995.

In addition to overhauling the S&L regulatory framework, FIRREA provided for more stringent thrift capital standards. It dramatically shortened the period for amortizing “goodwill” counted as regulatory capital which contributed to increased S&L failures and extensive lawsuits. The law also made other provisions relevant today. Notably, it authorized FDIC to establish “Bridge Bank” and impose cross guarantees on insured institutions affiliated with a failing one.

Regarding RTC governance, FIRREA created a structure that clouded responsibilities. It established a high level Oversight Board to oversee and be accountable for RTC and to develop a strategic plan for conducting its activities. Oversight Board members included the Secretary of the Treasury, the Chairman of the Federal Reserve, the Secretary of Housing and Urban Development and two private sector experts. Essentially, the Oversight Board had responsibility for RTC’s operating policies and budget while the FDIC Board of Directors served as RTC’s operating board. A new agency with such a complex task requires strong lines of communication between policy and operations. This was not practical given the very high level of the Oversight Board and the fast need for operational challenges. The Oversight Board recruited a sizeable staff structure to help communications and understanding. This helped somewhat although it required a lot of time and effort to bring the staff up to speed with operations. Still, the Oversight Board seemed to more driven by political than operational concerns.

FIRREA’s primary mandate for the RTC was to manage and resolve S&Ls designated as failed or failing by OTS but, also called for RTC to dissolve the Federal Asset Disposition Association (FADA) the existing asset management company established by FSLIC and to review all the so called 88 Deals for competitiveness and cost savings and renegotiate accordingly. FIRREA also had a number of other provisions that had to be “operationalized”. It required RTC to establish a Real Estate Asset Division and quickly publish an inventory of real property assets; to establish guidelines and provide opportunities for lower income families when selling rental properties; to develop methods for increasing minority ownership of financial institutions; to work with regulators to establish and use new real estate appraisal criteria.
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<u>RTC Funding.</u>

Original cost estimates of $50 billion quickly proved inadequate. Treasury’s estimates reportedly were based on 400 failures with roughly $200 billion is assets occurring over a three year period after the law was enacted. Over 500 S&Ls and $260 billion in assets were taken over by the end of 1990 and many more were expected. In addition to not having enough funding to cover losses, no provisions were made for “working capital”, the money needed to pay financial institutions for taking over deposits. Usually, healthy institutions are very reluctant to buy questionable assets even at steep discounts. While we had the authority to provide loss guarantees or provide a note for the balance, the activity was discouraged because of its resemblance to the widely criticized 88 deals. (Refer to Figures below and Tables on page 7.)

As the number of failures kept growing, the RTC repeatedly found itself in the unpopular position of having to request more funding. (See Figures 1 & 2). Cost estimates changed several times through the first few years. Additional funding was requested and approved in early 1991, then again at the end of the year and again in December of 1993. The total funds requested by RTC totaled $105 million. Fortunately, most of the final appropriations was not lost as discussed below.

Figure 1

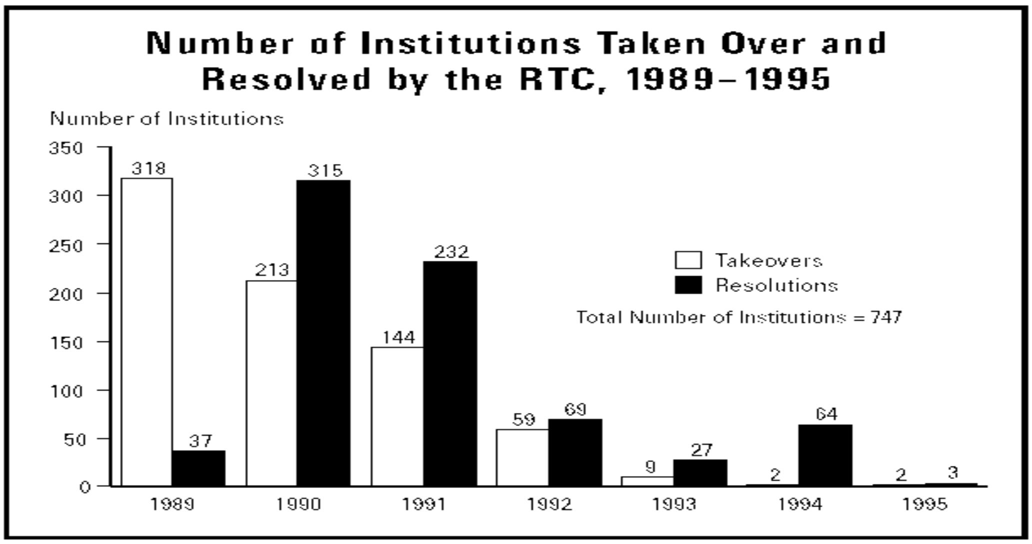
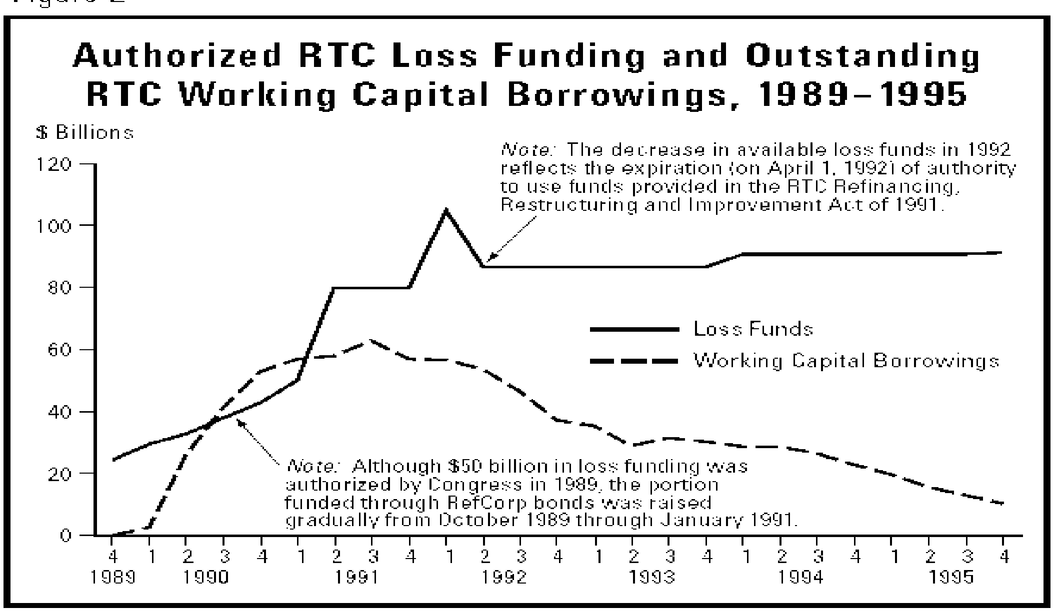


Figure 2



Source: 2006, VOLUME 18, NO. 2 38 FDIC BANKING REVIEW

As of year end 1999 when the S&L resolution was nearly complete[3], the FDIC completed a study entitled "The Cost of the Savings and Loan Crisis: Truth and Consequences" that estimated the costs of all S&L failures from the beginning of 1986 through the sunset of the RTC in 1995. (See Tables 1 to 4 on following pages) Direct and indirect costs were estimated at $153 billion, of which taxpayers paid $124 billion or 81% and the S&L industry paid the rest.

Direct costs of resolving S&Ls were estimated at $146 billion and indirect costs at $7 billion. These indirect cost estimates included $6 billion in tax benefits given to buyers of failing S&Ls prior to RTC and $1 billion in higher interest costs from using REFCORP rather than Treasury appropriations to fund RTC.

Of the $146 billion in direct resolution costs, FSLIC resolved failures accounted for $63 billion and RTC $83 billion. Taxpayers funded 65% of FSLIC resolved failures and 91 percent of RTC resolved failures.

Certainly, these FDIC estimates are much higher than early estimates given the public. Estimates mentioned in 1986 were about one tenth as big. Even estimates given in 1989 to pass FIRREA were only about 60% of the Treasury estimate. The good news is the FDIC's estimate for RTC is much lower than later government estimates. The bad news is no one really knew and the obvious question is why?

Several factors likely influenced early low cost estimates by FHLBB and FSLIC. Strong industry pressures to keep estimates low and/or an overly optimistic outlook probably played a role. Another likely factor was a lack of sufficient regulatory expertise to identify problems. The ownership and lending practices of many S&Ls changed rapidly but it wasn't until around 1985 that FHLBB recognized the need to recruit experienced examiners to better understand their exposure.

The FDIC might have been able to provide revised estimates based on S&Ls in conservatorships but lacked the resources and mandate to do so. The FDIC had to recruit and borrow staff to takeover this function. All estimates were based primarily on S&L records with little time for due diligence. Putting any reliance of such records eventually proved problematic. When FIRREA became law, the RTC quickly began to build staff and hire experts to understand just how bad the S&Ls in conservatorship were. .

While many early forecasts underestimated the size of the problem, later ones tended to be too high. They did not fully recognize the impact of lower interest rates and an improving economy. The number of failing S&Ls began to decline and the value of their assets and franchise improved. In addition, the RTC adopted very conservative asset recovery estimates resulting in realized gains as the economy improved.

[3] Remaining assets of both the FSLIC and the RTC were about $7 billion, mostly cash and low-risk securities. Goodwill litigation cost estimates were largely unknown and excluded but may change final estimates.

Table 1
Thrift Failures, 1986–1995
($Millions)

Year	FSLIC Number	FSLIC Assets	RTC Number	RTC Assets
1986	54	$ 16,264		
1987	48	11,270		
1988	185	96,760		
1989	9	725	318	$134,520
1990			213	129,662
1991			144	78,899
1992			59	44,197
1993			9	6,148
1994			2	137
1995			2	435
Total	**296**	**$125,019**	**747**	**$393,998**

Table 2
Chronology of Thrift Crisis Events

December 31, 1986	FSLIC insolvent
August 10, 1987	FICO created to fund FSLIC
August 9, 1989	Enactment of FIRREA
	– FSLIC abolished
	– FRF created (succeeds to FSLIC's assets, liabilities, and operations)
	– SAIF created to handle thrift failures starting August 9, 1992
	– RTC created to resolve thrifts placed into conservatorships or receiverships between January 1, 1989 and August 8, 1992[a] (RTC to cease operations December 31, 1996)[b]
	– REFCORP created to fund RTC

Table 3
RTC Funding Legislation
($Billions)

Legislation	Loss Funds	Date of Enactment
FIRREA, 1989	$ 50.1	August 9, 1989
RTC Funding Act of 1991	30.0	March 23, 1991
RTC Refinancing, Restructuring and Improvement Act of 1991	6.7	December 12, 1991
RTC Completion Act of 1993	18.3	December 17, 1993
Total Funds Appropriated	**$105.1**	
Total Funds Provided to RTC	**$ 91.3**	

Table 4

Estimated Savings and Loan Resolution Cost, 1986–1995

($Billions)

	Private Sector	Public Sector	Total
Direct Cost			
FSLIC/FSLIC Resolution Fund, 1986–95			
FSLIC year-end equity and reserves, 1985	$6.1		$6.1
FSLIC insurance premiums, 1986–89	5.8		5.8
SAIF assessments diverted to FRF, 1989–92	2.0		2.0
FICO bond proceeds, 1987–89	8.2		8.2
FRF appropriations, 1989–95		$43.5	43.5
Less: FRF equity at 12/31/99[a]		(2.5)	(2.5)
Estimated Direct FSLIC/FRF Cost	$22.0	$41.0	$63.0
RTC, 1989–95			
Raised through REFCORP bond proceeds:[b]			
FHLB payments to defease REFCORP debt, 1989–91	1.3		1.3
SAIF assessments paid to defease REFCORP debt, 1990	1.1		1.1
Net present value of FHLB-paid interest on REFCORP bonds[c]	3.5		3.5
Net present value of REFCORP interest paid by U.S. Treasury[d]		24.2	24.2
Total REFCORP bond proceeds	5.9	24.2	30.1
Appropriations from U.S. Treasury[e]		55.9	55.9
Initial contribution from FHLB system	1.2		1.2
Less: RTC equity at 12/31/99[a]		(4.5)	(4.5)
Estimated Direct RTC Cost	7.1	75.6	82.7
Estimated Total Direct Cost	$29.1	$116.5	$145.7
Indirect Cost			
Estimated cost of tax benefits to acquirers from FSLIC assistance		6.3	6.3
Increased interest expense from higher interest rates on REFCORP bonds compared with U.S. Treasury borrowings[f]		1.0	1.0
Estimated Indirect Cost		7.3	7.3
Estimated Total Cost	$29.1	$123.8	$152.9
Memo: goodwill litigation cost through 12/31/99[g]		0.4	0.4

Source: FDIC - The Cost of the Savings and Loan Crisis: Truth and Consequences

RTC Governance

Establishing clear governance and an optimal organizational structure and staffing model are a critical first step to any organization. Originally, the RTC governance structure included a high-level Oversight Board to dictate policy and budget and the FDIC Board serving as the RTC Board responsible for all operations. Those of us involved with operations soon found this approach limited our operational clarity and line of sight and contributed to confusion in the public about RTC's mission and operations. It also impacted RTC's operational independence, which is important given the specialized expertise of staff and accelerated pace of their workload.

Having someone clearly in charge improves both accountability and program implementation. After about a year operating under its original governance, the RTC argued that its governance needed to be restructured and consolidated and proposed changes that were eventually passed into law a year later. These changes as well as international experiences demonstrate the benefits of consolidated governance that clearly designates accountability, reduces the potential of conflicting programs, and relieves the Department of Treasury and the Federal Reserve Board (FRB) from detailed program operations. Such a consolidated approach also leads to better consistency in information and system needs, performance metrics as well as stakeholder coordination.

Another organizational lesson learned by the RTC was the importance of having adequate staffing and the risks of depending on others for support. Originally, the RTC planned to draw heavily on FDIC and other regulatory agencies for skilled personnel to help in closing S&Ls and managing conservatorships. However, the mounting demands on these agencies significantly reduced their ability to support RTC operations. Importantly, the RTC also relied heavily on FDIC for operational support in key areas such as systems, accounting, legal, media, and public relations. As demands increased on everybody, the RTC concluded it needed to develop its own support staff operations.

We also learned the importance of *reliable* information systems for almost every part of operations – not only for measuring performance but also to establish baselines when setting goals and managing expectations. We learned early on the unreliability of troubled thrift prepared regulatory reports and the problems created when estimates were based on them. The reports were too often overly optimistic and did not reconcile with their own records. Estimates of conservatorship assets and losses based on these reports had to be revised causing lost confidence in RTC. The lack of good data also resulted in problems securing government funding that delayed the resolution of larger institutions resulting in even larger losses.

Good data and information systems are critical to identify, prioritize, and mitigate high-risk areas. For RTC, the biggest risk areas were managing S&L conservatorships, managing and disposing institution assets—including asset due diligence and valuation processes, and quality of asset information systems—as well as selecting and overseeing contractors. Congress tied future funding to faster improvements in these areas. Without good information systems, confidence in everything you do suffers. Case in point: The RTC's 1990 "qualified" GAO Opinion became "unqualified" in 1991 after improvements in initial systems and processes proved inadequate for: Inventorying assets acquired, reconciling general and detailed asset records, analyzing and reporting on assets sales, and estimating asset recovery values

RTC Resolution Operations

Essentially insolvent S&Ls involved three phases: Conservatorship; Resolution; and, Receivership.

The conservatorship phase involves placing an S&L under RTC control upon designation by OTS (or the appropriate state authority) that it has failed due or in imminent danger of failing. The RTC typically replaces executive management; limits operations and downsizes the institution. During this phase the RTC begins due diligence, cataloging and selling assets and preparing the institution for final resolution.

The resolution phase usually involved transferring insured deposits and as many high quality assets as possible to a healthy institution. In some cases, where fraud was prevalent or the S&L offered no deposit franchise value, the RTC would arrange for direct payoff of insured depositors. In all cases, the RTC would have to provide cash in excess of expected asset losses. Initially, this caused a rapid depletion of funds that slowed resolution. Eventually, RTC obtained authority to borrow from the Federal Financing Bank based on expected asset recoveries. Due to very conservative asset valuations all these borrowings were eventually repaid with interest. (See Figure 2 on page 5)

The receivership or final phase involves the recovery of any remaining assets (usually the most toxic ones) pursuing and defending claims and distributing proceeds to RTC and other general creditors. The difference between RTC's cash outlays and cash dividends received determines the cost of the failure.

RTC Asset Management and Disposition

The RTC was charged with managing and disposing of $400 billion of loans, real estate and other assets located throughout the country. The RTC did not have to deal with the complex securities of today backed by subprime home mortgages. Most of the home mortgages taken over were performing and marketable. About half of the assets taken over were marketable home mortgages and securities and most were sold with less than 5% loss. The other half was a much different story. They were mostly illiquid and hard to value assets such commercial real estate construction and development loans, undeveloped land and other assets where losses were much higher. (See Chart Below for sample losses) Still, no valuations or negotiations were required to obtain them since they came from failed S&Ls. We did establish approaches to value these assets for selling them however. Essentially, we relied on conservative real estate appraisals and present value analysis using market based discount rates.

RTC's strategy for selling S&L assets rapidly evolved. Early influences included provisions in FIRREA not to sell real estate assets less than 95% of fair value in distressed markets where most such assets were located. RTC's Governance also played a role. The Oversight Board was initially resistant to such strategies as providing seller financing, providing reps and warrants or bulk sales. The political environment was also a factor. There was considerable concern that the RTC would sell assets rapidly at fire sale prices bring down values of similar holdings by other institutions. After about a year however, attitudes began to change. Concerns went from selling too slow to the uncertain impact when the RTC started to sell its large holdings. One banker group that originally encourage a go slow approach later said the overhang of RTC assets was freezing the market. Funding or the lack of it was also a factor. Slow sales increased our need for working capital. The RTC gradually developed a strategy that prioritized disposition strategies by type. These strategies ranged from negotiating loan modifications to securitization or bulk sales, to auctions to seller financing to equity partnerships.

Sample of RTC Sales ($ Millions)

Asset Type		Number of Pools	Book Value	Net Sales Proceeds	% of Book Value Recovered
REO Land		5,880	$3,574	$828	23%
REO Commercial/Multifamily		2,940	$2,902	$1,609	55%
REO 1-4 Residential		3,542	$441	$356	81%
Mixed Commercial/Consumer	Non-Performing	40	$168	$31	18%
Land/ Construction	Non-Performing	288	$3,035	$946	31%
Consumer	Performing	82	$1,055	$1,061	101%
Consumer	Non-Performing	233	$355	$132	37%
Commercial/Multifamily	Performing/Sub-Performing	74	$6,177	$5,217	84%
Commercial/Multifamily	Sub-Performing	52	$30	$22	73%
Commercial/Multifamily	Non-Performing	646	$33,339	$22,607	68%
Commercial	Non-Performing	5	$134	$39	29%
1-4 Family Mortgages	Performing	179	$30,854	$30,726	100%
1-4 Family Mortgages	Performing/Sub-Performing	665	$1,157	$768	66%
			$83,221	$64,342	77%

Source: FDIC study of RTC Rep and Warranty Claims

The RTC also worked closely with the private in the management and sale of assets including:

- Asset management contractors: The ability to use the expertise and resources of private sector contractors was essential given the volume and complexity of assets under RTC management.
- Seller financing: In a number of cases, including equity partnerships, the RTC successfully provided the financing investors needed that the financial system was unwilling or unable to provide during a period of economic uncertainty. The losses suffered on such loans were very small.
- Equity partnerships: One of the more innovative methods that RTC used for asset disposition was the equity partnership, created to capture the expertise and efficiencies of the private sector and reserve some upside potential from the recovery of depressed markets. More recently, the FDIC has used a similar approach.

RTC Interventions

As previously noted, the OTS was the agency deciding whether or not an S&L should be taken over and the RTC had limited flexibility in structuring the intervention. Assistance transactions similar to those of the prior FSLIC were strongly discouraged. The FDIC intervention experience is more relevant. While most FDIC resolutions are similar to those used by RTC, it has a broader array of options when resolving large or complex failures. The FDIC has assisted and taken effective ownership of the nation's seventh largest bank in the early 1980s it has since provided loss guarantees on assets sold and used its Bridge Bank authority on a number of occasions.

Lessons learned from RTC and FDIC:

Listed below are highlights of important lessons learned that I will be happy to discuss in greater detail.

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Financial Institution Interventions

1. Prompt intervention is essential to curtail losses in institutions plagued with toxic assets who, otherwise, will either curtail lending or take even bigger risks to increase earnings;
2. Base intervention decisions on established guidelines supported by understandable and sound cost – benefit analysis and proper due diligence;
3. Isolate toxic asset risk to attract new investor capital;
4. Intervention strategy should be transparent, cost effective, and fair.
    a. Establish clear guidelines regarding selection criteria;
    b. Quickly stabilize systemically important banks or remove them with as little disruption as possible.
    c. Minimize perceptions of a banker bailout or that failing bankers are being rewarded.
    d. Do not rely on the accuracy of an institution's own assessment of problems;
    e. Manage "toxic assets" separately by qualified and properly incented professionals.
    f. Use independent experts to identify high risk assets;
    g. Preserve market discipline principles by ensuring executive management and shareholders accept responsibility and consequence of intervention...
    h. Do not place healthy banks at a competitive disadvantage against assisted banks.
    i. Establish limits on time and scope of assistance supported by approved repayment plans;
5. Modify FDIC Bridge Bank authority as necessary to better accommodate large complex bank interventions - especially to address unrealistic timeframes for decisions and/or if key functions are located in affiliated companies outside the bank.

6. Establish rules and guidelines and responsibilities should the temporary nationalization of a Bank Holding Company become necessary.
7. Place time limits on government ownership supported by approved exit plans to minimize conflicts or loss of franchise value.

Toxic Assets Acquired

8. Minimize time for assets in government ownership or control;
9. Avoid holding large inventories of assets that can adversely impact market functioning;
10. Selling illiquid assets requires initially establishing low price reserves to attract investors and competition to drive prices up.
11. Buying toxic assets will require a standardized valuation and sales approach to promote seller competition; and. avoid perceptions of unfairness, protracted negotiations and conflicts between assisting a bank today and minimizing future losses;

Strategy Governance & Organization

12. Provide for clear governance and Isolate operations from political influences as much as possible
13. Avoid or prioritize conflicting objectives.
14. Give maintaining public trust and operational transparency a high priority;
15. Make every effort to minimize taxpayer losses by operating effectively and pursuing those who caused the loss.
    a. Establish high ethics standards and internal controls
    b. Develop and disclose meaningful performance metrics as soon as possible.
    c. Focus on eliminating waste, fraud and abuse.
    d. Vigorously pursue claims against bankers and other professionals who contributed to losses.
16. Base funding decisions and cost estimates on *reliable* information and conservative assumptions.
17. Provide for adequate and well qualified staff and encourage use of private sector expertise;
18. Develop reliable and inter-connected information systems for every part of operations.
19. Minimize time and effort required creating and organizing new government entities when dealing with a crisis.