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TESTIMONY OF

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WASHINGTON, D.C.

ON

RESOLUTION TRUST CORPORATION WORKING CAPITAL

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

9:30 A.M.
October 31, 1989
ROOM 1100, LONGWORTH HOUSE OFFICE BUILDING

Good morning, Mr. Chairman and members of the Subcommittee. It is a pleasure to be here today for the first time representing the Resolution Trust Corporation ("RTC").

Much has been accomplished since August 9, 1989 when the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") was signed into law. However, much more remains to be done. We and the Congress anticipated that the task at hand would be difficult. It is every bit as difficult as we contemplated. We have a tremendous task ahead of us.

Today we will discuss issues pertaining to working capital for the RTC. Specifically, we will address the RTC's need for, and potential sources of, working capital; the requirements and limitations of a working capital program; and possible alternatives to working capital. In addition, we will comment on H.R. 3469, the "Federal Agency Debt Management Act."

We have addressed some of these issues before. As is evidenced by Attachments 1-4, the FDIC raised the need for working capital both for itself and for RTC while FIRREA was being debated. The outcome of these discussions was that FIRREA did not prohibit the RTC from raising working capital, but placed a ceiling on outstanding RTC obligations based on a complicated formula which in essence limits RTC obligations to 85 percent of the fair market value of the RTC's assets.

At the outset, however, we should state that while working capital is absolutely essential in order to minimize the cost of resolving the thrift crisis, the RTC has not decided on any methods to raise working capital, and stands ready to discuss alternative methods with the RTC Oversight Board, Treasury, and Congress.

The Immediate Need for Funding

Working Capital Funding. The Financial Institutions Reform, Recovery, and Enforcement Act provides the RTC with \$50 billion in cash to be used to eliminate the negative net worth (measured in terms of market values, not book values) in thrift institutions that are currently insolvent or that become insolvent before August 9, 1992. In many cases it will be cost effective to decouple the sale of a thrift franchise from the sale of problem assets. This entails purchasing the problem assets at their true economic values out of the institutions before they are offered for sale to the public. In a payoff, where there are no acceptable bids to purchase an institution, all the assets are, in effect, purchased at their fair market values by the RTC. With the entire \$50 billion provided to the RTC earmarked for eliminating negative net worth or "filling the hole," additional cash is needed by the RTC to fund the purchase of assets at their true economic value until the assets are subsequently sold by the RTC. Hence the need for working capital.

A simple example should help illustrate this point. Suppose an institution comes under the RTC's jurisdiction with a single \$100 deposit as its only liability and a single asset with a book value of \$85 and a true economic value of \$60. The institution's true net worth is negative \$40. The RTC might decide to separate the sale of the institution from the sale of the problem asset -- perhaps in order to include bidders that didn't have the workout expertise necessary to maximize the recovery on the problem asset. The RTC would need \$100 in cash (minus any premium paid by the acquirer of the institution) to offset the liabilities assumed by the purchaser of the institution. Of this \$100, \$40 is needed to offset the negative net worth of the institution.

This \$40 would come from the \$50 billion provided to the RTC. The additional \$60 is required to purchase the asset at its true economic value and would have to be funded with working capital borrowings. Such borrowings would be repaid when the problem asset was sold by the RTC.

The important point is that the purpose of working capital is to smooth out the timing differences between the RTC's cash outlays, which take place when it sells an institution, and its cash inflows, which take place when it receives funds from the Resolution Funding Corporation ("REFCORP") or sells assets. Thus, working capital is fundamentally different from the \$50 billion provided to the RTC to fill up the hole. Working capital will be repaid by subsequent cash inflows, while the \$50 billion represents a non-recoupable loss.

Replacing High-cost Funding. Working capital also is needed to replace high-cost funds at institutions. This lowers the cost of funds at the institutions pending resolution, thus, minimizing the size of the loss the RTC will have to make up upon eventual resolution. Replacing high-cost funds also lowers the demand for deposits, thus, lowering the cost of funds industry wide. Upon resolution of an institution, such working capital borrowings would be repaid from the sale of assets and the \$50 billion allocated to fill the negative net worth hole.

Working Capital Requirements

For the 283 institutions that have been placed under conservatorship as of September 30, 1989, we estimate -- assuming a moderate pace of resolutions and asset collections -- that total cash outlays will peak at approximately \$65 billion. We also estimate that the present value cost of resolving these institutions will come to approximately \$35 billion. This implies a need for working capital just for these 283 institutions of almost \$30 billion.

In addition, last Thursday the Office of Thrift Supervision gave the RTC a list of 223 institutions it expects the RTC may have to take into conservatorship over the next three years. We clearly have not yet had an opportunity to estimate the cash outlays necessary to resolve these 223 institutions, but it is clear that our need for working capital in the resolutions process will be substantial.

High-cost funds accounted for better than one-third of the \$130 billion of liabilities at the 283 institutions that had been placed under conservatorship by September 30, 1989. The 223 additional institutions OTS has identified have total assets of \$164 billion. Assuming their liabilities equal their assets (liabilities probably exceed assets), and that they hold the same percentage of high-cost funds as the original 283, total high-cost funds at all 506 institutions would come to approximately \$98 billion. While it would not be necessary to replace all these funds in order to reduce the funding costs at these institutions to normal levels, replacing just half the high-cost funds would require \$49 billion.

The total amount of funding necessary is not additive, since funds used to replace high-cost funding will subsequently be used in the resolutions process. Nonetheless, our total need for working capital obviously will be in excess of \$50 billion.

As far as transactions to date are concerned, the RTC currently has approximately \$8.5 billion outstanding to replace high-cost funds. On the resolutions side, through October 23, 1989 the RTC had resolved 33 institutions. Of these, four were insured deposit payouts. Twenty-five were insured deposit

transfers, whereby institutions pay a premium to act as the RTC's paying agent for insured deposits, and four were "clean bank" purchase-and-assumption transactions, whereby the acquirer receives good quality assets and cash from the RTC to offset the assumption of deposits and certain other liabilities.

Total cash outlays for these 33 transactions amounted to \$9 billion. Our preliminary estimate of the loss in these 33 institutions is approximately \$5.4 billion. Thus, these transactions required approximately \$3.6 billion in working capital.

The working capital for these transactions came from the \$20 billion allocated to the RTC during the last fiscal year. It is clear that the RTC will not be able to continue funding working capital from funds earmarked to cover the institutions' negative net worth or it will quickly run out of money.

Limitations of Working Capital

It is worth emphasizing that there are a number of things working capital will not accomplish. First, regardless of the source, working capital borrowings will not add to the long run cumulative deficit. The reason for this is that all borrowings for working capital plus carrying costs will be repaid from REFCORP receipts and asset sales. Thus, built in to any working capital program are eventual cash inflows to offset initial cash outflows.

Second, working capital borrowings will not allow the RTC to increase net expenditures beyond the \$50 billion provided for in FIRREA. If the resolutions process reveals that \$50 billion is not enough to cover RTC's resolution costs -- and it is much too early to tell whether or not this is the case -- additional funds will be required to make up the shortfall. Working capital borrowings constrained by REFCORP receipts and the true economic value of the RTC's assets will not be able to provide these funds.

Finally, borrowings for working capital will not add to the risk currently being borne by the Federal government, even if such borrowings come from the Treasury or otherwise carry the full faith and credit of the United States. As explained in greater detail later, the alternative to explicit working capital borrowings is to implicitly borrow working capital by funding problem assets with insured deposits. Both the Savings Association Insurance Fund and the Bank Insurance Fund are backed by the full faith and credit of the United States.

Alternatives to Working Capital Borrowings

The alternative to raising working capital to replace high-cost funds is simply to leave those funds in place raising the eventual cost of resolutions to the RTC and the cost of funds industry wide. The alternatives to raising cash for working capital for the resolutions process are three-fold: structure all resolutions as whole-thrift transactions where all assets are always passed to acquirers; slow the pace of resolutions to correspond to the pace of asset sales; or issue notes to acquiring institutions equal to the true economic value of assets taken back by the RTC. While some of these options may have their place in the resolutions process, prohibiting the RTC from raising cash for working capital and requiring it to rely solely on these alternatives would substantially raise the cost and delay the resolution of the thrift crisis.

Whole-thrift Transactions. Under certain circumstances it may be advantageous to do whole-thrift transactions where substantially all the assets of an insolvent institution pass to an acquirer at their fair market value. The FDIC has done such

transactions with banks in the past and presumably the RTC will do such transactions in the future. However, it would be costly and nearly impossible to restrict the RTC to only whole-thrift transactions.

Acquirers of depository institutions do not necessarily have the desire or expertise to be asset workout specialists. In a whole-thrift transaction the sale of a thrift franchise is bundled with the sale of problem assets. Unless the institution's deposit base is linked to its assets, as is often the case at commercial banks, but is less common at thrifts, this bundling may not be cost effective. If a buyer that is interested solely in a thrift franchise must also purchase problem assets in order to purchase that franchise, it will pay less for the thrift franchise. Conversely, if a buyer that is interested only in purchasing problem assets must also purchase a thrift franchise it will pay less for the problem assets.

Whole-thrift transactions also require careful due diligence on the part of the buyer. This is expensive to the buyer, limiting the number of potential buyers and hence raising resolution costs. It also is very time-consuming, slowing down appreciably the pace of resolutions. Whole-thrift transactions also may not be cost effective because assets in effect are sold in a prearranged package determined solely by the asset portfolio of a particular institution without regard to the business sense of that particular grouping.

Slow down the pace of resolutions to correspond to the pace of asset sales. As we explained earlier, the sole purpose of working capital is to smooth out the timing differences between cash outflows which come at the time an institution is sold or paid off and cash inflows which come when assets are sold. If the resolutions process were slowed down to correspond with the pace of asset sales there would be no need for working capital.

The cost of such a delay, however, would be disastrous. The RTC may have to manage the sale of assets with aggregate book values as high as \$180 billion. As much as \$100 billion (in book value) is anticipated to be difficult to sell, non-liquid assets. It will take years to dispose of these assets in an orderly fashion. Congress has heard much testimony describing the enormous cost of delaying resolution of the thrift crisis. Slowing the resolutions process to correspond to the asset disposition timetable would once again only allow the problem to fester and grow. In addition, holding the resolutions process hostage to the asset disposition process would create a fire sale mentality and put pressure on the RTC to "dump" assets, thus having an adverse effect on local real estate markets and further raising the cost to the taxpayers.

Slowing down the pace of resolutions to correspond to the pace of asset sales also would not eliminate the need to fund problem assets pending resolution. The assets would remain in the insolvent institutions until the cash was available for resolutions, and they would most likely be funded with insured deposits and collateralized borrowings. This has been shown to be a relatively expensive form of funding, which raises the cost of funds for all depository institutions, and is one for which the deposit insurer and hence the taxpayer ultimately bears the risk.

Issuing Notes to Acquirers. As an alternative to providing cash to acquirers, in some cases, the RTC could provide acquirers with notes. As a general rule, however, cash is a much preferable medium of exchange. First, as a practical matter, notes can not be used for insured deposit payouts and insured deposit transfers.

Second, providing notes directly to acquirers is likely to increase borrowing costs. In many cases acquirers would receive few assets other than the note. The acquirer would not have the cash to pay off expensive deposits, and in order to earn a return on its capital investment would have to receive a return on the notes in excess of its cost of funds plus its non-interest expenses. With general and administrative expenses at thrifts running at about 200 basis points, the yield on such notes would have to be in excess of two percentage points over the cost of deposits.

Third, when notes are issued as the primary asset conveyed in a resolution, acquirers assess the transaction based on the yield on the note rather than the underlying profit opportunities inherent in the institution. This promotes transactions that may not make long run economic sense.

Finally, since a note does not give acquirers cash with which to pay down deposits, the problem assets are still, in effect, being funded with insured deposits. This has an adverse effect on the cost of funds for all depository institutions, and the deposit insurer and ultimately the taxpayer still bears the risk of a deterioration in the problem assets.

Sources of Working Capital

The preferable solution, in terms of minimizing cost, is for the RTC to have the flexibility to give acquirers cash and to sell assets in an orderly fashion at a later date. There are a number of potential sources of such financing. Direct Treasury borrowing would be the least costly; although currently RTC's borrowing authority from Treasury is limited to \$5 billion.

Creating a "Resolutions Bank" which would issue what in essence is a new type of agency security is another alternative. If a Resolutions Bank were to issue securities, the securities should be issued to as broad a market as possible to lower funding costs. Also, in order to lower funding costs, the securities should carry a full faith and credit guarantee. FIRREA provides that outstanding obligations of the RTC carry the full faith and credit of the United States with respect to both principal and interest provided that:

- "(i) the principal amount of such obligation is stated in the obligation; and
- (ii) the term to maturity or the date of maturity of such obligation is stated in the obligation."

Guarantees are included in FIRREA's definition of outstanding obligations.

Much has been written about the budgetary implications of such a Resolutions Bank. Frankly, we do not know what the budgetary implications are, and that is not, obviously, for us to decide. Our primary interest in a Resolutions Bank -- as evidenced by a planning document prepared by the FDIC's S&L management group last August (see Attachment 5 for relevant portion) -- is as a centralized "receptacle" where the funding of assets and liabilities of failed thrifts could be coordinated.

The important point is that the RTC needs working capital in order to go about its task in the most efficient way possible, and it stands ready to work with the Congress, the RTC Oversight Board, and the Treasury Department to determine a viable method for obtaining the necessary financing.

H.R. 3469

We would now like to comment on H.R. 3469, the "Federal Agency Debt Management Act." The Act would prohibit the RTC from

borrowing from any source other than the Treasury. However H.R. 3469 does not provide for Treasury financing; it only prohibits other types of financing. FIRREA provides the RTC with only a \$5 billion line of credit from Treasury, an amount wholly inadequate for RTC's working capital needs. The practical effect of H.R. 3469 is simply to prevent the RTC from raising adequate working capital.

In addition, H.R. 3469 may have a number of unintended implications that will severely inhibit the resolution and asset disposition process, and may even bring the resolution process to a complete halt. First, H.R. 3469 could be interpreted to apply to REFCORP. Therefore, REFCORP would be required to borrow only from Treasury and would be prohibited from issuing notes, debentures, and similar obligations after December 1, 1989. In effect, H.R. 3469 would override specific authority for REFCORP financing under Title V of FIRREA which was part of the basic funding framework of FIRREA for the resolution of insolvent thrift institutions. Without REFCORP financing, the resolutions process can not proceed.

Second, the bill could be interpreted as prohibiting the RTC from providing assurances and indemnities against lawsuits routinely provided acquirers of insolvent institutions or assets. For all practical purposes, being barred from issuing such indemnities would put the RTC out of business.

Third, the bill also could be interpreted to ban the RTC from structuring transactions where the acquirer had some right to return certain assets to the RTC; even if such "putback" provisions were only on a limited basis and were only for a short period of time. Such a restriction would make it difficult for the RTC to pass anything but the cleanest assets to acquirers which, in turn, would increase the RTC's need for working capital.

Fourth, H.R. 3469 could prohibit the RTC from issuing any new guarantees. Thus, for example, the RTC might not be able to guarantee the severance contract of a manager of a thrift institution in conservatorship, making it difficult to retain qualified management at institutions in conservatorships.

Finally, H.R. 3469 would make it costly for the RTC to securitize assets. The bill would prohibit the common practice in asset securitization of limited recourse, under certain circumstances, from the trust issuing the securities back to the original owner of the assets.

Conclusion

The RTC has a real need for working capital. H.R. 3469 does not provide for this capital. Indeed, it would restrict the RTC to such an extent that it would be almost impossible for the RTC to function. It is imperative that the RTC, the Oversight Board, the Treasury Department, and Congress all work together to provide the RTC with working capital so that the RTC can carry out its mission at the lowest cost possible.