

(Exerpt From Planning Document)

#### V. Funding of Assets

The problem of "funding assets" is the problem of paying the liabilities of failed institutions. These institutions created liabilities in order to purchase assets which subsequently became problem assets. The liabilities are now indirectly the responsibility of the U.S. government through the deposit insurer.

Economic Cost vs. Initial Outlay. The economic cost to the U.S. government of resolving the remaining failed S&Ls.

will be the amount by which their (insured) liabilities exceed the discounted value of proceeds from the collection and sale of their assets. This economic cost, in present value terms, is currently estimated at about \$50 billion. It is a cost which has already been incurred and this document will not discuss how it should be financed.

Since liabilities come due very quickly, however, and recoveries on problem assets will take a long time, the initial outlay by the federal government could substantially exceed the economic cost, depending on who pays off the liabilities. In the remainder of this discussion, "the liabilities" refers to liabilities of the failed institution equal in amount to the estimated value of the problem assets, and which therefore do not represent economic cost, but which would require outlay while one waits for the problem assets to generate cash.

#### The "Resolution Bank"

This document envisions that many assistance transactions will be "clean bank purchase and assumption transactions." That is, the RTC will remove problem assets from the failed institutions; acquirers will receive core deposits, performing assets and cash assistance. Part of the liabilities removed from the failed institutions will represent pure economic loss to the RTC (estimated to be about \$50 billion). The remainder, by definition, will be equal in amount to the estimated market value of the assets removed from the failed institutions.

A financing vehicle, which might be called the "Resolution Bank," could be set up to coordinate the funding of problem assets and provide liquidity to S&Ls in conservatorship. Its assets would be the problem assets removed from failed S&Ls, carried at their estimated market values. Initially, its liabilities would be the liabilities of the failed S&Ls equal in amount (again, initially) to the estimated market value of the problem assets.

The resolution bank would issue notes secured by the market value of its problem asset portfolio and guaranteed by the RTC; the RTC's obligations, in turn, would be backed by the full faith and credit of the U.S. government. Such guarantees would make the resolution bank's notes very attractive to investors. The proceeds of the resolution bank's note issues would be used to retire the liabilities of the failed S&Ls it carries on its books, as well as to provide liquidity to conservatorship S&Ls, thereby reducing their funding costs. At any given time the resolution bank's liabilities would consist partly of resolution bank notes and partly of liabilities of failed S&Ls not yet retired.

The resolution bank would have several financial options for the disposal of assets apart from servicing contracts or direct sale. For example, similar types of problem assets from different failed S&Ls could be packaged

and sold (securitized) to pay down the resolution bank's liabilities. Alternatively, the problem assets could serve as collateral for "junk" bonds issued by the resolution bank. Funding costs might be reduced by the use of an appropriate senior/subordinated debt structure. Equity participation arrangements similar to "asset backed CDs" might also be explored. The common goal of all these approaches would be to package the cash flows from the problem assets in ways that appeal to investors' divergent risk preferences. The choice of financing options, however, is independent of whether to use a "resolution bank" structure to fund assets. The defining feature of the resolution bank would be its role as a centralized "receptacle" where the funding of assets and liabilities of failed S&Ls would be coordinated.

Over time the resolution bank's net worth would increase or decrease, depending on the degree to which actual asset collections diverge from initial estimates. As assets were sold or collections were made, proceeds would be used to retire resolution bank liabilities, and the bank's net worth would be adjusted based on gains or losses from initially estimated asset values.

Asset collections and sales could be made either by third party asset managers under contract to the resolution bank, by private parties under profit and loss sharing "sale" arrangements with RTC, or by the RTC itself (although we prefer the first two alternatives--see previous section). The decision on who will manage assets, however, is distinct from the question whether a "resolution bank" structure for funding assets should be used.

The primary advantage of a resolution bank structure is that it will enhance flexibility in disposing of problem assets. It will provide an alternative to relying on acquirers to fund problem assets with deposits. As has been argued throughout this document, it would not be desirable to constrain the resolution process by placing heavy reliance on acquirers to fund and manage problem assets.

Another advantage of a resolution bank structure is that centralizing the funding process can result in lower funding costs. Especially if assets were disposed of using "creative" methods such as securitization, junk bond style financing or equity participations, centralization of the funding process would enhance the RTC's market power and its ability to construct the most efficient funding vehicles.

Finally, the resolution bank structure would provide a convenient vehicle for accounting for liquidation costs and revenues. Sales and collection results, as well as updated estimates of asset values, would all flow through the resolution bank's asset side. Income accounts of the resolution bank could track incentive payments to contractors, profit/loss sharing payments, etc.

#### Types of Financing

We conclude by briefly summarizing the financing instruments available or potentially available to RTC, together with their advantages and disadvantages.

### (1) Treasury Financing

Upon the formal failure of the insolvent institution these liabilities can be paid by the insurer through liquidation of part of its inventory of Treasury securities or other sources of income, or indirectly by the Treasury through the issuance of new securities. Both these options are equivalent in their effects on the federal budget deficit and will be referred to as "Treasury financing." To the extent this arrangement is used, the U.S. government will have a claim on the recoveries on problem assets, but its initial outlay will exceed its ultimate cost. The advantage of this approach is that interest costs are minimized, and that it will not be necessary to make compromises in collection arrangements by being forced to leave problem assets with acquirers.

This tradeoff between the size of the initial outlay on the one hand, and the minimization of interest expense and maximization of flexibility regarding asset disposition on the other, is the key decision that will have to be made regarding the funding of assets.

### (2) Agency Financing

Alternatively the liabilities can be paid by the issuance of agency debt, which could conceivably be either on-budget or off-budget. Again, outlay would exceed cost in some sense, depending on the budgetary treatment. Interest costs would be higher than under the Treasury financing option, but flexibility in collection arrangements would be maintained. The resolution bank notes described above would fall under this category, although they might be perceived as being closer to Treasury notes depending on the structure of guarantees used.

### (3) Deposit Financing through Acquirer

The liabilities could also be paid by the issuance of new deposits by the acquiring institutions. In this scheme the problem assets would be carried on the books of the acquirer or an affiliate, and the liabilities of the failed institution would become deposits of the acquirer. The advantage of this approach is that the RTC's initial outlay is limited to its cost. There are two potential disadvantages. First, the acquirer may not have been the best problem asset manager (as compared with some third party private firm). Second, interest cost may be higher than the first two alternatives. Even if this cost is not higher, one must remember that the acquirer's interest cost reflects the existence of the deposit insurance guarantee.

(4) Private Financing

Finally, the liabilities could be paid with proceeds of a sale to private investors of financial instruments whose cash flows are based on the performance of the troubled assets ("private financing"). Again, the government's initial outlay is limited to its cost. Interest costs may be substantially higher than under other alternatives. Flexibility in the handling of assets is retained.

Funding Alternatives. One approach would be for the assets to serve as collateral for long-term debt issues, the proceeds of which would be used to pay down existing liabilities. A model for this might be the overcollateralized investment-grade bonds Mellon Bank was able to issue to finance its collecting bank. Asset-backed CDs paying a low (or no) interest rate but with equity participation on the upside and perhaps a U.S. government guarantee of principal might also be explored. Some assets might be packaged and sold to special "mutual funds" specially created to invest in these assets, as discussed at length in an earlier section.

If private-sector financing was used, there would be value (especially in the initial stages) in "diversifying" the approaches to financing. With experience, the most satisfactory methods of financing would be identified and excessively costly ones discarded.

Overview of Financing Alternatives

The financing decision involves tradeoffs between initial outlay, interest expense and efficiency of the asset disposition process. Treasury financing means minimum interest cost and maximum flexibility in asset disposition at the expense of maximum initial outlay. Agency financing can potentially achieve the same flexibility regarding asset disposition, and (depending on the budgetary treatment) lower initial outlay, but results in higher interest cost. Private or acquirer financing restricts outlay to equal cost, but at the cost of high interest expense (private financing) or reduced flexibility and constraints to the resolution process (acquirer financing).

It would be inadvisable to require that acquirer financing be used at all times. This would preclude the use of insurance payoffs, and in the case of transactions other than payoffs, it would dramatically reduce the range of options available regarding asset disposition.

If unlimited direct Treasury financing is not available, a single "receptacle," perhaps called the Resolution Bank, could be used to hold and finance assets acquired from failed S&Ls. This has several advantages, enhancing the flexibility of the asset disposition process, minimizing funding costs (given that direct Treasury

financing is unavailable), and providing a convenient vehicle for accounting for liquidation costs and revenues.