

TESTIMONY OF

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ON

DETERMINING MARKET VALUE OF ASSETS

BEFORE THE

TASK FORCE ON THE
RESOLUTION TRUST CORPORATION

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION,
REGULATION AND INSURANCE

COMMITTEE ON BANKING, FINANCE AND
URBAN AFFAIRS

UNITED STATES HOUSE OF REPRESENTATIVES

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Room 2128
Rayburn House Office Building

Good morning, Mr. Chairman and members of the Task Force. I am pleased to appear before you today to discuss the RTC's proposed policy for determining the fair market value of assets.

As I have stated on many occasions, the magnitude of the RTC's challenge to dispose of assets, whether in conservatorship or receivership, dictates that we seek new and cost-effective ways to sell assets. On February 28, 1990, the RTC's owned real estate asset inventory totaled \$16.4 billion. From the RTC's inception through the end of March, sales of owned real estate exceeded \$2.1 billion--a substantial amount, but not as much as we would have liked. Clearly, the vast majority of our asset sales lies before us, and I will discuss with you proposed policies that will enhance the RTC's ability to accomplish our asset marketing objectives.

I. CURRENT POLICY

Currently, the RTC relies on appraisals to determine the fair market value of real estate assets. All commercial properties are appraised in accordance with the RTC's Uniform Appraisal Instructions to Appraisers (See Attachment 1), which were adopted in November 1989. These instructions state that an appraiser will provide an estimate of current market value, which is defined as "the most probable price which a property should bring in a competitive and ~~open~~ market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably, and assuming the price is not affected by undue stimulus." Furthermore, these instructions provide that an

appraiser is to estimate a normal marketing period, based on market evidence for the property, and is instructed not to assume fire sale or liquidation values.

Due to the subjective nature of appraising, the RTC generally requires two appraisals for any property exceeding \$500,000 in value. The RTC has instituted a policy of waiving the second appraisal requirement on a case-by-case basis if timely appraisals cannot be obtained and if there is sufficient evidence (such as brokers' opinions, analysis of existing appraisals, etc.) to support the single appraisal's valuation. The appraised value, adjusted for holding costs and other costs not reflected in the appraisal, becomes the established fair market value for the asset, assuming the appraisal is deemed adequate and conforms to RTC standards. If two appraisals are obtained pursuant to RTC policy--and rarely are the value conclusions identical--the average of the appraised values, adjusted for holding costs, becomes the basis for the RTC's established fair market value for the asset.

In most cases appraisals are redone annually and we seek updated appraisals from different appraisers where possible. As a result, the established fair market value of an asset is also usually revised annually, unless market evidence or changes to the asset indicate the need to obtain a new appraisal sooner.

We now sell real estate at 95 percent of market value (as determined by the RTC) in the "distressed" states of Arkansas,

Colorado, Louisiana, New Mexico, Oklahoma, and Texas. The RTC has set 90 percent of fair market value as the lowest sales price available in other areas. These percentages will continue to apply to the new determination of fair market value under our proposed new policies.

II. PROPOSED POLICY

Our proposed policy on establishing the fair market value of real estate (See Attachment 2) has two parts. One pertains to conventional marketing, which allows maximum reductions from the appraised value of 15 percent at the end of six months and another 5 percent at the end of nine months. The second part pertains to establishment of reserve prices for auctions. We expect to take this proposed policy to the RTC Board next week for approval.

Under both policies, the RTC will continue to rely on independent, current appraisals for the initial establishment of fair market value. The new policies differ, however, from the current policy in that the new policies give the RTC the flexibility to determine a lower fair market value where there is sufficient information to support the determination made. The purpose of these policies is to save the RTC and hence the taxpayers money by ~~allowing the sale of property~~--whether by conventional marketing methods or by auction--at the earliest possible date, rather than having the RTC absorb its carrying

costs and other expenses due to an unrealistically high appraisal.

A. Conventional Marketing under the Proposed Policy

Similar to the current policy for estimating fair market value, the proposed policy, as applied to the conventional marketing of properties, requires one or more appraisals to be obtained and reviewed for each real estate asset, in accordance with the RTC's existing appraisal instructions. As noted above, if the appraisal conforms to the RTC's standards, then the appraised value, adjusted for holding and other costs not reflected in the appraisal, will become the RTC's established fair market value and the basis for establishing a sales price. Each real estate property will then be exposed to the widest appropriate market for a minimum of six months or, for single family residential properties, four months. If few or no offers are received, or if all offers received are significantly lower than the asset's adjusted appraised value, the asset manager may reconsider the market value of the property, established initially by the appraisal, in light of this evidence from the marketplace.

Other evidence, such as brokers' opinions or recent comparable sales, also may be used by the asset manager to substantiate a reduction of an asset's established fair market value as initially estimated by an appraisal. As measured against the appraised (or average appraised) values, the value as initially established may be reduced by a maximum 15 percent after the

applicable four or six month time period. Subsequent reductions of up to 5 percent could be made after an additional three months of active marketing. The maximum reduction permitted will be a total of 20 percent in the absence of another appraisal. In any event, these are not automatic markdowns. Each new valuation will depend on the circumstances of the individual property, and the new valuation will be documented. Consequently, we believe that these proposed guidelines for revising the initial value will ensure that an appropriate value is being set for each asset.

B. Auctions

The second part of the new RTC policy pertains to our use of auctions. Most auctions require extensive marketing efforts with large-scale regional, national, and possibly international, exposure. Minimum marketing efforts will include extensive advertising in newspapers and appropriate trade journals and publications, and the distribution of brochures and press releases, as well as solicitations to prospects in the RTC's data base of potential buyers.

Auctions offer an excellent method for efficiently selling real estate properties. The theory behind auctions is that, if marketed correctly, properties ~~will be exposed to~~ many potential purchasers--far more than would be possible for each property when marketed individually--and that an early sale will enable the RTC to forgo actual holding and opportunity costs.

Consequently, it is expected that, in the aggregate, the RTC will have as high a net present value return from auction sales as from individual sales. This has been the general experience from auction sales by the FDIC. In the FDIC auction conducted by Cushman & Wakefield last year, for example, the FDIC recovered, of the properties sold, approximately 99 percent of the total appraised value of those properties.

Under the RTC's proposed policy, properties auctioned may be sold absolute--that is, with no minimum reserve price--if the property has an established market value set by appraisal below \$100,000 and the property has been widely exposed to the market. The RTC will reserve the right to reject any and all offers which are made in the absence of a competitive bidding environment. Also, the RTC will not sell at auction the properties in conservatorship which satisfy the eligibility requirements for the RTC's Affordable Housing Program.

All other properties may be sold at auctions with reserve prices set at levels to take into account the benefits of an expedited sale, including savings of holding and marketing costs.

Furthermore, to stimulate active bidding associated with the auction process, the RTC may set reserve prices at less than the appraised value. The lowest reserve price that can be set is 70 percent of current appraised value, as adjusted for any savings of sale's expenses or other costs resulting from an expedited sale. Again, there will not be automatic discounts. Each property will be individually analyzed to determine its reserve

price and that price will have to be rigorously documented prior to its inclusion in the sale.

III. BENEFITS

These proposed changes in valuation policy will allow the RTC flexibility in determining true market price and will more closely match private sector methods of determining market value. An initial fair market value will be made through an appraisal by an independent party. However, this development of fair market value is only a point-in-time estimation, untested in the marketplace. After testing the initial estimate of market value through extensive marketing efforts, the proposed RTC policy will permit the RTC to adjust prices to reflect the realities of the market. These new estimations of market value will be used both in the conventional marketing of properties and in setting reserve prices for auctions.

By contrast, the RTC presently must incur, in order to realign market values, the cost of obtaining a new appraisal, and again, these appraisals are only judgements. We must also incur additional holding costs, such as property taxes, management expenses, asset deterioration costs, costs of risk exposure caused by a delayed sale, and the cost of borrowing working capital. These costs easily exceed 10 percent annually (working capital costs alone are running 8 percent) and are probably closer to 15 percent. Although these costs for any particular asset may not be substantial, these costs become significant for

a \$16.4 billion and growing real estate portfolio. At 10 percent per year in holding costs, selling assets just six months sooner will save the RTC \$825 million; at 15 percent per year, the savings would be \$1.24 billion. It should also be noted that these savings are on an asset base that is certain to grow rapidly as our resolution pace quickens. In addition, in some parts of the country, particularly Texas, the demand for qualified appraisers for commercial properties is so great that substantial delays can occur simply in scheduling an appraisal, further delaying the sale of properties and thus increasing costs.

The principal benefit of the proposed policy will be to increase the rate of RTC real estate sales. This will reduce the RTC's direct and indirect holding costs. Also, like most other merchandise, the longer S&L assets set on the shelf, the more they deteriorate. If a property does not sell, probably it is because we are asking too much in the marketplace.

Also, it is simply not prudent for the RTC to hold properties in the hope that market prices will rise to meet the appraisal. We are in business to sell assets, not to bet on market movement.

IV. CONTROLS AND INCENTIVES

To attract customers, you must provide them with a potential for profit. We have yet to find citizens who will buy assets out of a sense of patriotic duty. The amount of profit investors expect

to receive from RTC asset sales will vary from property to property. We want to sell properties resulting in a reasonable profit for our customers, but not a windfall profit. Our policy requirements that market values, based on an independent appraisal, can only be lowered after market testing on the individual asset, as well as the limits that are placed on the size of the change in values, will help assure that an appropriate price will lead to a reasonable profit.

We believe this to be the case because, as the FDIC's own experience has shown, asset sales that are conducted in an open and competitive environment will result in investors receiving a fair return for their purchase and the RTC receiving fair value for the sale. To promote an open and competitive environment, RTC staff has published a guideline booklet, How To Buy Real Estate, and will be providing investors with computer-based access to the RTC real estate asset inventory later this month.

Further, in using the private sector to provide the vast majority of asset management services required, the RTC has designed asset management contracts so that the contractor has a number of incentives to sell RTC properties at maximum value in the minimum amount of time. These incentives thereby ensure the protections necessary to maintain appropriate pricing strategies.

For example, the RTC's asset management fee structure for contractors varies depending on the composition of the portfolio. Where the RTC holds marketable title, we expect to pay asset

managers a minimal management fee to cover their overhead, along with a substantial disposition fee. This disposition fee, earned upon the close of sale of an asset, is a function of three variables: a) the sale price, adjusted for expenses; b) the length of time a contractor was associated with the asset; and c) the percentage the price exceeds a target sale price. These contracts, with their incentives to maximize sales proceeds, give the RTC additional protections against selling properties at lower than market prices.

To monitor the asset contractors, the RTC oversees the activities of contractors chiefly through its Standard Asset Management Agreement (SAMA) and its Asset and Management Disposition Manual. The SAMA outlines the nature and scope of the contractual relationship between asset managers and the RTC. The Asset and Management Disposition Manual guides the RTC staff and the contractors as to the RTC's expectations and procedures.

V. CONCLUSION

In conclusion, consumers in the marketplace know that we own these properties and that they must be sold. Holding these properties off the market because of unrealistically high asking prices only lengthens the marketing process and increases our costs. The only way we are going to get the government out of the S&L asset sales business is to sell these assets as quickly as possible at current market prices.