TESTIMONY OF

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ON

FDIC MANAGEMENT OF FSLIC ASSISTANCE AGREEMENTS

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

2:00 PM
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Room 2128, Rayburn House Office Building

Mr. Chairman and members of the Committee, as Director of Accounting and Corporate Services at the Federal Deposit Insurance Corporation, I have responsibility for the FDIC's new Division of FSLIC Operations. After eight months of dramatic change, I am pleased to report on the FDIC's progress in managing FSLIC assistance agreements.

OVERVIEW

The FDIC Division of FSLIC Operations (DFO) was created immediately following enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). As of August 9, 1989, this Division administered 219 assistance agreements involving covered assets of approximately $53 billion. In administering these agreements, we have worked diligently to complete the opening inventory audits of all assistance transactions, and to establish appropriate accounting systems and controls which will enable us to finalize the total cost of obligations of the FSLIC Resolution Fund.

The following statistics indicate the number of assistance transactions and concomitant workload:

ASSISTANCE AGREEMENTS

SELECTED STATISTICAL & FINANCIAL DATA

	12/31/88	8/9/89	12/31/89
Number of Agreements	222	219	202
Estimated Number/Covered Assets	254,000	244,000	225,000
Estimated Book Balance ($/Billions)	$ 57.5	$ 53.4	$ 35.9

We are not yet comfortable with our ability to provide accurate cost estimates of the obligations of the FSLIC Resolution Fund until the completion of all audits in May. However, we are not optimistic that the costs projected in FIRREA accurately reflect the size of the FSLIC Resolution Fund's obligations. We will report our findings to you as soon as our assessment is completed and we obtain the concurrence of the General Accounting Office.

FDIC IMPROVEMENTS

Since August, FDIC has taken many steps with respect to management of the assistance agreements which resulted from transactions approved by the Federal Home Loan Bank Board (FHLBB). Our testimony highlights four major steps.

First, we drafted a strategic plan to assure that FDIC's philosophy and direction are understood by staff and the assisted institutions. A definitive set of three year goals and objectives will be presented for FDIC Board action in May. A draft of the strategic plan is contained in Exhibit I.

Second, we have added resources to deal with the enormous workload. This includes a major management and staff commitment including authorization of 70 positions for the field offices and adding an experienced bank regulator to strengthen liaison with supervision in the Office of Thrift Supervision (OTS) and the FDIC's Division of Supervision (DOS). Additionally, we created special teams to supplement DFO staff to assure completion of audits and implementation of financial and management information systems.

Third, we have assessed the tremendous impact of certain FIRREA provisions on these transactions and their potential for an unintended increase in the cost of resolutions. Division of FSLIC Operations and FDIC's legal staff have worked with the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) to seek an exemption from loan-to-one-borrower provisions on the basis that assets covered by assistance agreements are secured by guarantees from the government. This effort is being undertaken in order to reduce the additional cost that these restrictions could create by severely limiting the assisted institutions' ability to restructure or dispose of covered asset portfolios. We are pleased to report that the OCC has provided a favorable opinion dealing with this issue. We are hopeful that OTS will provide a similar exception.

Finally, we have implemented a program to renegotiate capital instruments. The FSLIC Resolution Fund holds various capital instruments purchased or acquired by the former FSLIC to facilitate case resolutions. These capital instruments include: 1) preferred stock (mostly cumulative) with a book value of $507 million; 2) subordinated debentures of $185 million; 3) capital and net worth certificates of $353 million; and 4) stock warrants generally representing a 20 percent ownership position in each of 17 assisted institutions. The capital instruments portfolios are assets of the FSLIC Resolution Fund. The income derived from these instruments -- interest, dividends, and potential value of appreciation -- reduces the cost of assistance provided.

With the enactment of FIRREA, these capital instruments no longer qualify for primary capital purposes. As a result, the FDIC has been presented with requests to negotiate exchanges of existing instruments for instruments that qualify as primary capital, and/or to consider the redemption of the securities at discounted values. Additionally, in some cases, the existence of governmental equity positions has created impediments to additional private capital infusions due to anti-dilution provisions in our securities agreements.

The FDIC has contracted the firm of Donaldson, Lufkin & Jenrette to act as the FDIC's advisor in the evaluation of securities liquidations and restructuring transactions. The FDIC's objectives in these transactions are to: 1) facilitate the sale of FSLIC Resolution Fund-owned securities at fair values; 2) facilitate compliance with acquirers' FIRREA Capital Requirements; and 3) facilitate mutual-to-stock conversions.

OBSERVATIONS REGARDING FHLBB RESOLUTIONS

The Committee has asked for a discussion of the mechanisms employed in past FHLBB resolutions compared to the mechanisms employed in resolutions by the FDIC. My colleague, Mr. Stone, will discuss the types of resolutions employed by the FDIC. However, it is too early to provide the Committee with more than the impressions we have gained over the past six months of administering the 1988 FHLBB transactions, pending completion of the FIRREA-mandated review by the Resolution Trust Corporation.

These observations would suggest that the FDIC's commentary over the past year holds true -- that the absence of cash to conclude transactions limits the list of potential bidders and results in transactions which are too long in duration, lacking in incentives and geared toward problem asset income maintenance rather than a less costly means of asset resolutions. It also would appear that some acquirers were motivated by tax-driven opportunities rather than a desire to enter the S&L business. In any event, the RTC Study is now underway and the RTC will reach a final position on the 1988 transactions by the end of the summer.

Mr. Chairman, your invitation letter of March 9, 1990 asked the FDIC to respond to several specific questions regarding the FSLIC Resolution Fund. We will respond to each question in the order they were raised and then will be pleased to answer any additional questions you or other Members of the Committee may have.

<u>QUESTIONS AND FDIC RESPONSE</u>

Questions:

<u>In regard to the FSLIC assistance agreements, has FDIC developed an overall strategy for covered asset disposition?</u>

FDIC Response:

The FDIC has developed a strategic plan for management of assistance agreements which includes guidance on covered asset disposition. Implementation of the strategic plan requires development of goals and objectives and specific policy directives. A set of three-year goals and objectives will be presented for FDIC Board action in May.

We recognize the strategic plan cannot be static. The results of the RTC review of 1988 case resolutions and resolutions of issues resulting from FIRREA changes may significantly affect the process of managing the financial liability associated with the assistance agreements. A planning process which includes a quarterly review was initiated by DFO in December. This planning process will continue.

Question:

Has the FDIC developed any formal guidance or criteria to be used for approving/disapproving various asset plans submitted by acquirers?

FDIC Response:

Yes. Guidance and criteria are set forth in our overall delegations of authority. In addition, a committee structure was imposed immediately following FDIC's assuming responsibility for the FSLIC Resolution Fund. Detailed manuals for acquirers and case managers guide the submission and approval process for asset business plans and budgets.

Recently, revisions to the business plan and budget formats were made to improve the quality of information used in the decision-making process. These revisions significantly expand income and expense information. In addition, for markets in Texas in which there is an extremely heavy concentration of commercial and multifamily assets, income and expense budget standards have been developed. Utilization of these standards will allow comparisons of acquirer proposals against regional norms.

In this process there is no substitute for analysis and evaluation by staff with real estate, financial, and appraisal expertise. Staffing levels have been greatly enhanced with the addition of 70 positions in field offices to allow more complete analysis and to assure follow up to determine that acquirers are operating within approved parameters. This will have the additional benefit of reducing reliance on contractors. We anticipate reducing costs associated with the use of contractors by approximately one third at the end of 1990.

Question:

How are asset management plans that propose sale of assets with financing from assisted thrifts treated?

FDIC Response:

A policy on this topic has been developed. Plans that propose financing are reviewed to determine whether maximum value is being obtained for the asset and that risk and cost to the FSLIC Resolution Fund is minimized.

Our analysis requires that non-cash considerations be valued on a cash-equivalent basis. A critical factor in this process is the use of an appropriate discount rate in determining the present values of cash flows. In no case will the discount rates be less than the FDIC's cost to carry the asset.

Another factor we have addressed is submarket rate financing and the requirement that the sales price be sufficiently high to compare favorably on a cash-equivalent basis.

While cash transactions or those financed by third parties are clearly desirable, it is unrealistic to expect disposition of the troubled real estate and loan portfolios covered by assistance agreements without some financing by the assisted institutions. Exhibit II contains policy direction regarding financed vs. cash sales.

Question:

<u>Has FDIC fully implemented a Management Information System (MIS) for tracking the amount of covered assets in assisted thrifts - or made progress in meeting the goals outlined in various asset management plan submissions?</u>

FDIC Response:

A senior level MIS Task Force has been established to meet DFO's management information needs. Several significant efforts have been completed and others are in process. General ledger data for the FSLIC Resolution Fund has been transferred from the FHLBB's Controller's records into the FDIC's Financial Information System (FIS). Subsidiary ledgers and more detailed financial information is in the process of being transferred. DFO staff have been transferred from the former FHLBB computer system to FDIC's network system. Implementation of a PC based authorization tracking system is nearing completion in the Dallas office. This system will track property, business, and collection plans. The system includes features that will allow monitoring of assisted institutions' compliance with approved plans. The task force is evaluating this effort to determine whether it will require mainframe support.

Plans for the conversion of other specialized FSLIC systems from the OTS mainframe to FDIC's system continue on target. FDIC systems include features that will enhance information available for management of assistance agreements and related financial obligations.

Question:

<u>What progress has been made in completing the already overdue initial inventory audits</u>?

FDIC Response:

The Committee asked that we provide a progress report on the initial inventory audits of thrift institutions acquired or merged with FSLIC assistance. These audits provide an independent validation of the asset inventory and the negative net worth of failed thrifts acquired under these assisted case resolutions. The audits therefore confirm initial information needed to establish the covered assets eligible for various forms of financial assistance under terms of the agreements.

Most of these audits were begun while the program was administered by the Inspector General of the former Federal Home Loan Bank Board. Some of these unfinished audits administered by the Bank Board involve cases resolved before 1988. In November 1989, shortly after the organizational transfer of former FSLIC staff to FDIC, responsibility for the 191 unfinished audits was assigned to FDIC's newly formed Division of FSLIC Operations. This placed administration of the audits in the hands of the division with direct knowledge of and responsibility for the financial assistance program. Since then, we have completed 49 audits. The pace has accelerated in recent weeks. Significantly, there are now draft audit reports in hand for 129 of the 142 remaining unfinished audits.

To further expedite the process, we have formed a dedicated project team of agency staff whose sole duty is to complete the audits. Project team members will meet as appropriate with our contract audit firms to reduce the time needed to complete the final audit reports. We expect the majority of the remaining audits to be completed by the end of May, 1990.

In addition to the initial inventory audits, periodic compliance audits will be performed by the FDIC Office of Inspector General over the term of the assistance agreements. Compliance audits provide us an independent assurance that the amounts of assistance claimed by the acquirers is supported by proper documentation and is consistent with the terms of the agreements.

As we have indicated, results from a few of the initial audits completed determined that the extent of insolvency in a number of the failed thrifts in the Southwest region is greater than originally projected. We candidly expect this increase to loss estimates to continue as the remaining initial inventory audits are completed. However, at the present time, we are unable to quantify the amount for the Committee.

This concludes my prepared statement. I will be pleased to respond to any questions the Committee may have.