CHAPTER 12

Evolution of the Asset Disposition Process

Introduction

This chapter provides an overview of the various asset disposition methods employed by the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) in their various capacities. The chapter also describes how the FDIC and the RTC adapted their asset disposition methods to meet the enormous challenges during the 1980 through 1994 period. Chapters 13 through 17 describe in greater detail the evolution and issues associated with specific asset disposition methods.

Between 1980 and 1994, the FDIC handled the resolution of 1,617 failing or failed banks with total assets of $302.6 billion, and from 1989 to 1995, the RTC resolved 747 failing or failed thrift institutions with total assets of $402.6 billion. During 1980 to 1989, the Federal Savings and Loan Insurance Corporation (FSLIC) also acquired a significant volume of assets when it resolved 550 thrifts with total assets of $219 billion. Altogether, from 1980 to 1994 these agencies resolved 2,912 banks and thrifts with assets of $923.8 billion. (See chart I.12-1.) (In 1995, the RTC resolved two thrifts with assets of $0.4 billion.)

The FDIC disposed of the majority of the assets in failed or failing banks at the time of resolution by selling them to assuming banks. Of the $302.6 billion in failed bank assets, about $230 billion, or 76 percent, were sold immediately at resolution to assuming banks. The remaining $72 billion in assets were retained by the FDIC and disposed of over time. Those remaining assets were usually the most difficult and problematic to resolve.

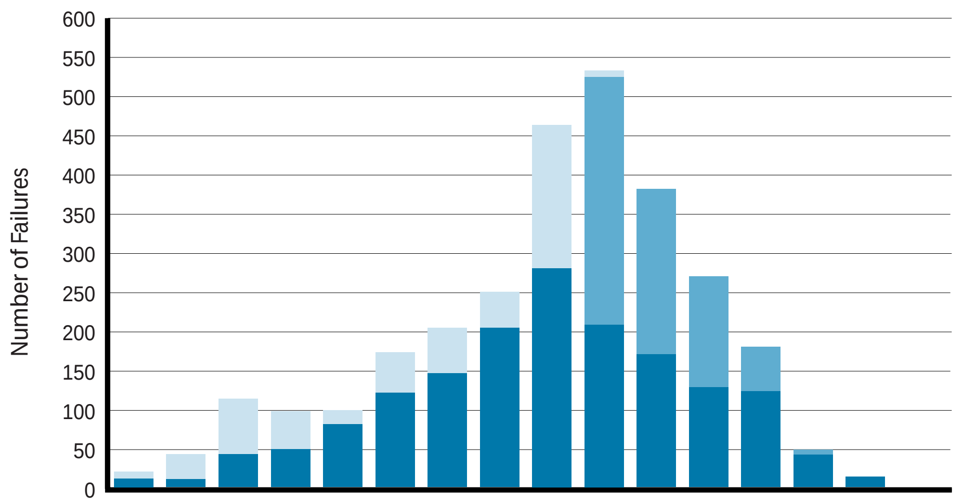
The RTC sold a relatively smaller percentage of assets at the time of resolution, and instead disposed of the assets either during conservatorship (before closing) or after completion of the resolution transaction. Of the $402.6 billion in assets from failed thrifts handled by the RTC, $75.3 billion, or 18.7 percent, were handled at the time of resolution. Of the remaining $327.3 billion in assets, $157.7 billion, or 39 percent, were disposed of while the institutions were in conservatorship, and $169.6 billion, or 42.3 percent, were retained by the RTC for disposal after resolution. The more liquid or easier-to-sell assets often were the ones sold during conservatorship, while the harder-to-sell assets usually were sold after completion of the resolution process.

The volume of bank and thrift assets in liquidation rose steadily in the 1980s and peaked in the early 1990s. The rise corresponded with the dramatic surge in bank and thrift failures discussed in chapters 2 through 7. The FDIC's asset portfolio peaked at $43.3 billion in 1991 and the RTC's at $83.1 billion in 1991. Combined bank and thrift assets in liquidation peaked in 1991 at $126.4 billion. (See chart I.12-2.) To put that number in the proper context in terms of assets, the FDIC/RTC would have been the second largest financial institution in the country at that time.

The disposition methods discussed in this chapter (and in chapters 13 through 17) relate to the liquidation of approximately $410 billion in assets that the FDIC and RTC did not sell to an assuming bank during the resolution process. After resolution, the FDIC needed to liquidate $72 billion in assets from failed banks, along with an

Chart I.12-1

Combined Number of Failures (Banks and S&Ls) 1980–1994



	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	Totals
FSLIC	11	34	73	51	26	54	60	48	185	8						550
RTC										318	213	144	59	9	2	745
FDIC	11	10	42	48	80	120	145	203	279	207	169	127	122	41	13	1,617
Totals	22	44	115	99	106	174	205	251	464	533	382	271	181	50	15	2,912

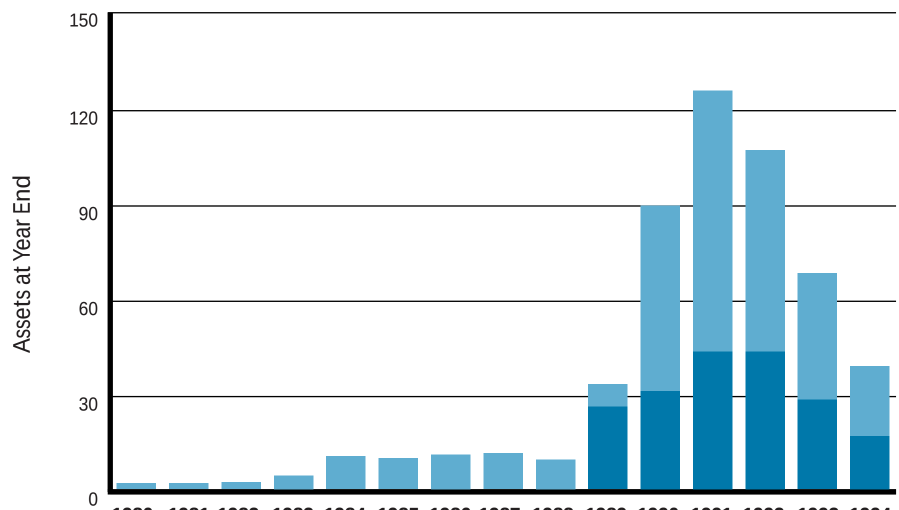
Figures include FDIC and FSLIC open bank assistance transactions.

Source: Reports from FDIC Division of Research and Statistics.

Chart I.12-2

Combined Bank and S&L Assets in Receivership 1980–1994

($ in Billions)



	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
FDIC	$1.8	1.8	2.2	4.3	10.3	9.7	10.9	11.3	9.3	25.9	30.9	43.3	43.3	28.1	16.7
RTC*										$8.0	59.3	83.1	64.3	40.7	22.9

*Does not include $47.3 billion of assets in conservatorship.

Source: FDIC Division of Resolutions and Receiverships and RTC Statistical Abstract.

additional $11 billion in assets received from the FSLIC. The RTC needed to liquidate $327 billion in assets not sold to assuming banks.

Generally, all three agencies had two basic policy goals for disposing of the assets of failed financial institutions: (1) to dispose of the assets as soon as possible without upsetting local markets, and (2) to maximize the return to receiverships. The factors and methods used to decide when to hold versus when to sell assets, or when to litigate versus when to compromise, evolved in response to the circumstances of the times. At the beginning of the crisis years (1980 to 1994), the FDIC used in-house staff to liquidate assets one at a time. By the end of the crisis years, more sophisticated methods had evolved, including securitized sales of assets and equity partnerships with private-sector firms.

Asset Disposition at the FDIC Before 1980

Between the Great Depression and the 1980s, few banks failed, and those that did were relatively small. Between 1934 and 1979, a total of 566 banks failed, or, on average, about 12 per year.[1] Those banks had total assets of about $9.2 billion, or an average of $16.3 million per bank. Excluding three larger bank failures in the 1970s, the average asset size of the banks that failed during that period was only about $3.7 million.

Although there were not many bank failures or failed bank assets before the 1980s, the majority of the assets in the banks that did fail were retained by the FDIC for liquidation. Of the 566 bank failures between 1934 and 1979, 315, or 55.7 percent, were deposit payoffs, and 251, or 44.3 percent, were purchase and assumption (P&A) transactions. In a deposit payoff, the FDIC retained all of the failed bank's assets. In a P&A transaction, a large portion, usually at least 50 percent, of the assets was retained.

Even though the FDIC retained most failed bank assets for liquidation, the pre-1980 asset disposition workload was not significant. Because of the large number of failures in the early to mid-1930s, assets in liquidation peaked at $136 million in 1940 (the value in current dollars is $1.6 billion). Over the next three decades, however, the number of failures decreased, and the volume of assets in liquidation, which was only $2 million in 1952, did not reach the 1940 level again until 1971. The FDIC liquidation activity did escalate in the 1970s, as several large banks failed in 1974, and the volume of assets in liquidation reached $2.6 billion. By the end of the decade, the volume had decreased somewhat to a total of $1.9 billion, but was well above the pre-1970 totals.

During the FDIC's early years, when few banks failed, a team of career FDIC employees, perhaps no more than two or three people, depending on the bank's size, was sent to manage the receivership. The FDIC team hired failed bank employees on a temporary basis to assist the career staff in the liquidation process. After several years, when the workload decreased sufficiently, the FDIC would shut down the receivership, close the office, and dismiss the temporary employees. After a receivership closed, the career employees would move to the site of another failed bank to set up receivership operations. Thus, the FDIC employees lived a fairly nomadic lifestyle, never staying in one place for more than a few years at a time.

Early procedures for disposing of assets were relatively straightforward. In a P&A transaction, the first step was to see if any additional assets could be sold to the acquiring bank. The acquiring bank would look at its list of new depositors to see if those depositors had loans held by the receivership. If they looked like good customers, the acquiring bank would purchase and rewrite the customer's loan and pay off the debt held by the FDIC as receiver. Usually, the FDIC offered no discounts. This process would go on for several weeks as the bank figured out which assets it wanted and which ones it would leave behind. The process worked well during periods of stable or

1. If one excludes the failures in the 1930s, the average number drops to 6.2 per year.

decreasing interest rates because borrowers were not at risk of a significantly higher interest rate on their new loans. In addition, the acquiring bank was not at risk of holding a new loan with a below-market rate of interest if it renewed the loan at or near the existing rate. However, during periods of increasing interest rates, it was not to the borrower's advantage to pay off existing loans that had more favorable rates of interest. In those instances, if the loans were not in default, the FDIC would have to hold them to maturity, a situation that sometimes resulted in the FDIC's retaining a larger portion of the failed bank's assets than it was accustomed to owning.

After the assuming bank completed its activity, the FDIC would focus on liquidating the remaining assets. Although few written policies and procedures were in place at the time, the FDIC preferred that borrowers find refinancing and pay their loans off in full. If borrowers could not obtain refinancing from the assuming bank, the FDIC asked them to look elsewhere. If refinancing was not available, the FDIC expected borrowers to meet the terms of their loans and pay them off in full at maturity. The FDIC's field staff had little flexibility in offering discounts or compromises at reduced value. While not done on a widespread basis, the staff would receive authority from Washington to settle for reduced amounts to the extent necessary.

During the 1950s and 1960s, the FDIC would "offset" the amount a borrower owed on all delinquent loans against that person's deposit balance, thereby reducing the overall payment to the depositor and ensuring that the FDIC collected a higher, if not full, amount on the loan. For performing loans, the FDIC often withheld offsetting deposits pending individual negotiations. Usually, the result was that deposits and loans were "netted" against one another so that only the remaining balance was paid by or owed to the FDIC.

That approach reduced the FDIC's initial outlay of funds for payoff cases. From 1934 to 1965, 8 percent of the deposit accounts and 5.3 percent of the total deposits in resolutions handled as deposit payoffs were paid by offsets.[2] The FDIC did not keep similar records on withheld deposits because they were negotiated and ultimately resolved.

The offsets and withholding method of collection, however, had an adverse effect on local communities. Depositors could not use their funds until decisions could be made about offsets. In addition, once decisions were made, the failed bank's customers often had less liquidity than they had before. The issue received considerable attention in 1963 when the Chatham Bank of Chicago, Chicago, Illinois, failed, and the payoff had significant repercussions for the local community. As a result of that failure, the FDIC changed its policy so that it offset only delinquent loans or officers' and directors' funds against potential liability, and it stopped the practice of offsetting or withholding all mutual loans and deposits. Depositors with funds over the insurance limit retained the right to offset those amounts against loans to the failed bank. That strategy usually

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2. FDIC, *1965 Annual Report*, table 124.

worked to the depositors' advantage because, although they owed the full amount of their loans, they would probably collect less than full value on uninsured funds in the absence of the offset or netting arrangement.

In the 1970s, three notable bank failures signaled a new era for the FDIC's asset disposition activities. Those failures included the United States National Bank, San Diego, California, in 1973, with assets of $1.3 billion; the Franklin National Bank, New York, New York, in 1974, with assets of $3.6 billion; and the Banco Credito y de Ahorro Ponceno (Banco Credito), Ponce, Puerto Rico, in 1978, with assets of $712 million. Those three large bank failures caused a substantial increase in assets in liquidation, which in turn prompted the FDIC to begin re-evaluating its asset disposition practices.

During the late 1970s, with rising interest rates, prospective purchasers would not pay full book value for loans. In 1976, to facilitate sales in that environment, the FDIC issued a directive that stated that loans (especially mortgage loans) could be priced according to their current market value and sold. The directive suggested that the FDIC would not hold such loans, nor collect payments for their future value, but would instead sell them for their present value. As a result, in 1976, the FDIC conducted a mortgage loan sale at a small liquidation office in New Jersey and from 1976 to 1979 conducted approximately 10 competitive residential and commercial mortgage loan portfolio sales (known as bulk sales) totaling approximately $50 million.

During that period, P&A agreements also gave assuming banks exclusive rights to purchase mortgage loans at a discount within 60 days after a bank failure. As a result, in 1978, the FDIC sold about 5,000 mortgage loans in one transaction and a $100 million mortgage loan portfolio in another transaction after the Banco Credito failure.[3]

Asset Disposition Activities After 1980

In the early 1980s, bank closing activities began a steady rise that peaked in the early 1990s. As a result, bank assets in receivership also increased dramatically. The FDIC faced many new challenges, as bank closing activities were directly affected by regional economic factors. The Midwest and Plains states experienced an agriculture crisis that led to the closing of many farm banks and the acquisition of a large volume of agriculture-related loans. Real estate values declined in California, resulting in an increase in bank closings and assets in receivership on the West Coast. In the Southwest, problematic energy loans led to the closure of many banks, the most infamous being Penn Square Bank, N.A., Oklahoma City, Oklahoma. In the Northeast, the FDIC dealt with the savings bank crisis. Recognizing that the volume of bank closings and assets in liquidation could no longer be administered efficiently from Washington, D.C., the FDIC

3. Stephen Douglas, on-site FDIC liquidator, excerpt from an interview.

expanded and decentralized its organizational structure. It also began exploring new and creative ways of disposing of the rapidly increasing volume of assets.

Regionalized Liquidation Activities

Beginning in November 1982, in response to the rapidly accelerating number of "problem banks," the FDIC began to expand its liquidation and claims presence by organizing its operations into regions. It opened regional offices in Atlanta, Chicago, Dallas, Kansas City, New York City, and San Francisco, making those offices responsible for all liquidation activities occurring within their geographical territory.

Later, each region became responsible for several consolidated offices that the FDIC established at different locations within the region's territory. As banks were closed, the assets retained would be brought into the nearest consolidated office for liquidation, generally within three months. That new approach provided economies of scale and improved asset marketing techniques by presenting opportunities for packaging similar loan products from different failed banks for sale to private investors.

One of the key monitoring methods the FDIC used to measure consolidated office performance was the cost-to-collect ratio. FDIC management estimated that, based on historical experience, it would cost an average of $.10 to collect $1.00 from the assets held in inventory at each consolidated office. It used the 10 percent rule as an informal gauge of consolidated office performance. National competition among consolidated offices for the lowest cost-to-collect ratio also affected asset disposition strategies. Consolidated offices were quick to get on board with bulk sale initiatives because of the low cost and high return of disposing of assets in bulk.

Reorganization of liquidation operations provided the FDIC with the flexibility to adapt its operations to meet the expanding workload of the crisis years. Such regionalization was accompanied by delegations of authority and additional field responsibility. The regional and consolidated offices also provided a firm base of operations that contributed to the orderly absorption of the FSLIC in 1989, the start-up of the RTC that same year, and the transition of the RTC into the FDIC in 1995.

The Energy Crisis

The fall of crude oil prices in 1981 had a severe effect on banks in energy-producing southwestern states. The gasoline shortage in the 1970s had convinced the public that crude oil supplies were limited, and projections made by experts at that time indicated that crude oil prices could increase to $100 per barrel. The price of crude oil did increase rapidly to more than $40 per barrel, thus validating the projections and causing the valuation of estimated reserves in the ground to increase exponentially. Almost any loan amount was considered reasonable, based on those leveraged values. That sense of security created a frenzy to lease acreage, drill discovery wells, estimate reserves from the preliminary production, and rush to lease more land. The increasing demand drove up the prices of leases, supplies, and all services. Even though the income from production still took months or years to recoup the cost of drilling, loan volume continued to increase. As interest rates rose during that period, banks continued to lend, and the projected profits enticed borrowers to agree to the higher rates. When the bottom fell out of crude oil prices, energy loan losses increased and many banks fell into insolvency.

As a result, the FDIC acquired a large portfolio of energy loans and related assets and, at one time, became the largest owner of drilling rigs in the world. The FDIC hired employees from the local regions with the knowledge and skills to resolve those specialized assets. Over time, FDIC staff became more knowledgeable in energy lending as well. They were required to identify the exact type of ownership interest in a gas or oil well held as collateral and interpret the attendant legal instruments. They also had to understand reserve estimations and the values assigned from cash flow projections.

Because of the collapse of the energy market and poor loan documentation, collection of loans was difficult. The FDIC relied on secondary sources of recovery such as calling letters of credit and selling collateral equipment.

Agricultural Crisis

In the early 1980s a severe downturn in the agriculture sector began to take its toll on agricultural banks. By 1985, agricultural bank failures had peaked at 62 for the year, accounting for more than 51 percent of total bank failures. The FDIC as receiver was then in the business of working out distressed farm credits.

The disposition of agricultural loans acquired from failed banks started off poorly. The majority of field liquidation staff and regional management had little knowledge of agricultural operations and lending practices. Farm or livestock operations are usually seasonal, with cash flow occurring at different times from year to year, depending on when the crops or livestock are sold. Farm borrowers were accustomed to borrowing funds for living expenses or paying at the time of sales. At the time, releasing proceeds from the sale of collateral or advancing money to borrowers for such expenses were uncommon practices for the FDIC. Compounding the problem was the fact that the FDIC's field staff had limited delegated authority. Typically, requests for advances or releases of proceeds to borrowers had to go to the regional office. Delays in processing such requests impaired the farmers' ability to pay their bills, make critical purchases, and develop business plans.

Smaller community banks had maintained the practice of repeatedly renewing their farm loans. Such renewals were usually done on a quarterly basis, depending on the needs of the farmer. The FDIC told farmers to refinance their loans at other banks, but in most cases there were few good banks from which to borrow. Thus, one of the FDIC's basic collection practices of moving good customers to good banks did not work in the agriculture crisis, and entire communities were affected.

In response to complaints that the FDIC's collection policy was harsh and demanding, the FDIC held town meetings immediately after farm bank failures to explain its policies and procedures to local communities. In addition, the FDIC provided its staff and management with training and written agricultural guidelines to help them handle this crisis. Furthermore, the FDIC put programs in place to keep agricultural loans within the banking system or to sell them immediately after a bank's failure. To encourage sales to the private sector, the FDIC offered discounts on the portfolios.

By early 1986, the FDIC had entered into an agreement with the Farmers Home Administration (FmHA), under which the FmHA and the FDIC would provide personnel at bank closings, make direct loans, and help farmers restructure their debt. That program helped the FDIC verify collateral values and compromise debt. It also provided on-the-job training for less experienced liquidators. Up to that time, the FDIC's collection efforts had been geared toward "stemming" the losses and not increasing outstanding debts. In response to the agricultural crisis, the FDIC adapted its techniques to acknowledge that in rural lending it may be necessary to advance funds to ensure that the value of collateral, such as crops and livestock, would be maintained.

Moreover, as a result of the farm crisis, the FDIC learned to be more sensitive to the public's perception of its actions and to be more flexible in applying collection techniques according to the type of loan and borrower. Those lessons proved invaluable as the 1980s progressed.

Creation of the Resolution Trust Corporation

In August 1989, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) and provided for the establishment of the Resolution Trust Corporation to resolve the savings and loan (S&L) crisis. The RTC immediately inherited 262 conservatorships from the FDIC, which had acted in the place of the FSLIC as conservator for the insolvent institutions. Headquartered in Washington, the RTC opened regional offices in Atlanta, Dallas, Denver, and Kansas City. It also established 14 consolidated offices and 14 sales centers. Initially staffed with FDIC employees, the RTC hired additional employees from the private sector and, in 1991, reached its staffing peak at 8,614 employees.

Although the resolution of insolvent institutions was the initial priority of the RTC, disposition of assets retained from those institutions would become the RTC's biggest challenge. The 262 conservatorships initially acquired by the RTC contained assets of $115 billion. Shrinking those institutions by curtailing new lending activity and selling assets was a high priority.

For the most part, the RTC also continued to place institutions into conservatorship before resolution. During its lifetime, the RTC disposed of $157.7 billion in assets from institutions while they were in conservatorship. It retained an additional $169.6 billion in assets, which it disposed of after resolution.

The asset disposition methods the RTC used were driven mostly by the legislative mandate of FIRREA. FIRREA required that assets be disposed of in a manner that (1) maximized return and minimized loss, (2) minimized the impact on local real estate and financial markets, and (3) maximized the preservation of the availability and affordability of residential property for low- and moderate-income individuals. FIRREA further required that the RTC hire private-sector contractors for asset disposition if such services were available in the private sector and if the use of those services were practicable and efficient.

One of the RTC's biggest challenges was balancing the requirement to sell assets quickly while obtaining the highest possible price without being accused of "dumping." The challenge was especially difficult when the RTC was attempting to dispose of hard-to-sell real estate properties. The RTC also had to face criticism for packaging assets only for institutional investors. That criticism resulted in the RTC's development of small investor programs designed to include a wider range of potential investors.

About one-half of the RTC's assets were commercial and residential mortgages. The other half consisted of owned real estate, other loans, other assets (including subsidiaries), and securities. The RTC placed nonperforming loans, owned real estate, and some of the other assets with contractors and usually placed performing loans with conventional loan servicers. Those assets were then disposed of through various initiatives, such as loan sales, auctions, securitizations, and partnerships with private-sector firms. Those methods of disposition are discussed below and in chapters 13 through 17.

Developing Asset Marketing Activities

As bank resolutions and assets in liquidation began increasing in the 1980s, the FDIC could no longer effectively and efficiently dispose of assets without changing its methods. Several factors influenced the FDIC to move toward selling loans rather than holding them to maturity.

At that time, high interest rates had caused rapid deterioration in the value of the FDIC's relatively large commercial and residential mortgage portfolio. Because of the rising rates, the FDIC had to retain the loans rather than sell them, as it had done in the past. The growing cost to the receiverships caused by the reduction in value prompted a review of existing policies.

In addition, consolidated offices were strained by continuously hiring more staff, leasing more space, and expanding their operations as assets from failed banks continued to mount. It was no longer practical to assign all assets to account officers and work them individually in house. A $1,000 asset required an account officer, an asset file, booking of the asset to an asset management system, and the same labor-intensive support activities required for a $1,000,000 asset. By selling smaller assets, the FDIC would be able to maximize the efforts of its account officers by allowing them to focus on the larger, more complex assets.

Before 1980, asset marketing in the FDIC had been fairly limited. Early attempts focused primarily on pricing and selling assets, such as performing or residential mortgages and installment loans for which established markets were already in place.

From 1982 through 1984, as asset inventories increased and bank closing activity accelerated, FDIC policies began to emphasize bulk sales for broader classes of assets, including delinquent and charged-off loans. In 1984, the FDIC formalized the loan sales program and officially labeled it "bulk sales," which later was called "asset marketing." The program's purpose was to accelerate the disposition of assets acquired from failed banks. Implementation of the program occurred within the various regional offices, consolidated offices, and field sites, with policy oversight coming from Washington, D.C. Consolidated offices set up specialized staff to work exclusively on loan sales. Because no established markets existed at that time, the intent was to build those markets with small (less than $25,000 in book value) delinquent loans. The FDIC began by offering a pipeline of small products in the market. The total book value of each package ranged from $1 million to $2.5 million. Over time, FDIC offices created substantial lists of potential buyers, which led in 1987 to a computerized national database accessible by all offices. After potential buyers were included on the database, they would receive announcements of sales that met their interests.

FDIC management held the position that all assets were potential candidates for sale. Yet, it also was a time of experimentation. Although the FDIC marketed large nonperforming commercial mortgages together, they generally were bid for individually, with mixed results. During that time, before the sealed bid approach became the accepted bidding method, the FDIC tested several different bidding mechanisms. It was not until the 1990s that large portfolio sales (upward of $100 million and more in book value) became a significant part of the FDIC's marketing program.

In 1990, the FDIC contracted with a national mortgage servicer to handle the increasing volume of performing commercial and residential mortgage loans. An FDIC sales force, assisted by an adviser and due diligence firms, sold the serviced mortgages.

The focus on the sale of assets was a major milestone in the evolution of asset disposition methods within the FDIC. From 1986 to 1994, the FDIC sold more than 800,000 loans with a total book value of more than $20 billion.

RTC asset marketing occurred in several ways. Initially, loan sales were conducted from conservatorships using that institution's staff. As the RTC formalized its operations, regional sales centers became involved in packaging and selling assets. In September 1990, the RTC established a national sales center in Washington, D.C., that assumed direct responsibility for overseeing the sale of assets. A capital markets group in Washington, D.C., also put together securitized sales of residential and commercial mortgages.

In the field, as institutions failed, the RTC contracted out nonperforming assets to asset managers, while using conventional loan servicers to service performing loans. The various asset marketing vehicles of the RTC would then package assets from contractors and servicers for sale.

By 1990, the RTC was relying predominantly on private-sector firms to evaluate, package, and market loan portfolios. The use of private firms, particularly those with established reputations, lent more credibility to the RTC's valuation methodology, due diligence work, and marketing techniques. Furthermore, FIRREA required the agency to use the private sector whenever that strategy was deemed efficient and cost-effective.

The RTC used seller financing as a marketing tool for portfolio sales on a much larger scale than did the FDIC. The RTC's use of seller financing came about after a nationwide decline in real estate markets and a credit crunch that forced the agency to adopt more aggressive marketing tools.

The RTC also differed from the FDIC in its asset valuation procedures. With the exception of its handling of performing loans, the FDIC generally relied on in-house staff to value assets for bulk sale purposes. To arrive at values, account officers estimated projected collections from all sources of recovery, subtracted anticipated expenses, and applied a present value to the cash flows.

The RTC, however, relied on an asset valuation methodology developed in coordination with a real estate and financial consulting firm. That methodology attempted to value individual assets as investors would perceive their value. The RTC relied predominantly on actual net cash flows, and gave less weight to other more subjective sources of recovery. In general, RTC procedures resulted in lower estimates of value, thus enhancing its ability to find acceptable bids and sell assets more rapidly.

Both agencies used reserves to set base prices for portfolio sales and required wide marketing to ensure maximum competition. The RTC, however, tended to be more market oriented and more inclined to let the market "speak" concerning the acceptability of bids. In contrast, the FDIC was driven more by appraisals and relied more on internal reserves to set guideposts for determining the acceptability of bids.

Representations and Warranties

Representations and warranties are a set of legally binding statements by the seller intended to assure buyers that the assets being sold meet certain qualitative expectations. They are accompanied by obligations to "cure" conditions that are breaches of the original representations, as well as remedies available to the investor if the condition cannot be cured. Such remedies may require a repurchase or substitution of an obligation.

Consistent with an ongoing effort to be more market oriented and generate maximum competition and sales results, the RTC initially gave more representations and warranties associated with loan sale packages than did the FDIC. The majority of the FDIC loan sales were small, nonperforming loan sales that required only limited representations and warranties to market successfully. The warranties stated that there (1) had been no discharge in bankruptcy of debt represented by the loan(s), (2) was no "voidance" of the debt obligation by any court, and (3) had been no release of the debtor by the seller or the failed institution. The representations and warranties generally had a life of 120 days. Beginning in 1993, the FDIC offered more extensive warranties that were generally consistent with RTC and industry standards on two large sales of nonperforming commercial real estate loans.

FDIC sales of performing residential mortgage loans carried more comprehensive representations and warranties consistent with the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) guidelines and had a longer life of five years.

In May 1990, after consulting with Fannie Mae and Freddie Mac, the RTC began to provide "market-standard representations and warranties" with most of its whole loan sale programs, excluding auctions, for single-family loan assets and mortgage servicing rights. The representations were identical to those required by Fannie Mae and Freddie Mac in sales to them and were recognized as the customary, or market-standard, representations in the secondary mortgage market. The RTC offered the representations and warranties directly in its corporate capacity. Coverage for loan documentation deficiencies was limited to a maximum of a five-year discovery period. Compensation for any breach of representation discovered during that period would be provided for the life of the loan, but only to the extent that actual losses were incurred as a result of such a breach.

In August 1990, the RTC broadened the scope of the representations and warranties it provided to conform with those customarily given in the secondary mortgage market. The RTC increased the duration of coverage for loan documentation deficiencies from five years to the life of the loan and authorized the repurchase or substitution of another qualified loan if a defect was found that would be adverse to the buyer. The RTC also established the policy that it would provide the representations and warranties in its capacity as receiver of the failed institution, with a guarantee by the RTC in its corporate capacity.

In July 1991, the RTC extended the customary secondary market representations and warranties to sales of whole consumer, multi-family, and commercial loans. The market-standard representations and warranties for multi-family and commercial mortgage loans included environmental representations. Depending on the quality of the loan, the dollar amount of the outstanding principal balance, and the type of underlying real property, the RTC offered one or more of the following environmental representations and warranties:

- "Where is, as is" sale;
- Environmental inspection before bidding;
- Six-month indemnification for large balance assets (with a book value equal to or greater than $500,000) with monetary cure or repurchase if material contamination was demonstrated; or
- Life of loan indemnification for small balance assets (with a book value less than $500,000), with monetary cure or repurchase if material contamination was demonstrated.

By 1994, the RTC and the FDIC offered generally comparable representations and warranties for sales of similar loan products, partly because in some instances, such as the bulk sale of performing and nonperforming commercial real estate mortgages (including securitization), the RTC set the market standards. In other instances, the secondary market had already set the acceptable level of representations and warranties, and the RTC and the FDIC then adopted those standards.

Securitizations

The FDIC usually sold performing residential mortgage loans through whole loan sales. In 1986, the FDIC conducted an experimental securitized sale, but it did not use securitized loan sales as a major asset disposition method. The RTC, however, used securitized sales as a means to meet its FIRREA mandate of maximizing return on assets while also liquidating assets expeditiously.

In October 1990, the RTC established a securitization program to facilitate the sale of mortgage loans, which were the largest single category of assets in the RTC inventory. From June 1991 to June 1997, 72 RTC and 2 FDIC securitized transactions closed, representing loans with a book value of $42 billion for the RTC and $2 billion for the FDIC. Almost 500,000 residential, multi-family, commercial, mobile home, and home equity loans were securitized. RTC and FDIC securities are traded in capital markets worldwide.

The ultimate analysis of the securitization versus the whole loan sales disposition methods will not be determined until the actual losses realized by the reserve funds are known. Generally, the greater the "seasoning" of the security, the less the default and loss experience caused by principal paydown and equity buildup in the underlying properties. In retrospect, securitization allowed the RTC and, to a lesser extent, the FDIC to dispose of a large quantity of loans under severe time constraints at prices that might not have been realized if subjected to a market of whole loan buyers.[4]

Partnership Programs

The RTC and, to a much more limited extent, the FDIC used partnership programs with private-sector partners as an asset disposition method. In response to the FIRREA mandate to maximize recovery, the RTC concluded that for certain types of assets, equity-retaining transactions might yield greater returns than if assets were sold outright.

Joint ventures (equity partnerships) were structured between the RTC, acting as a limited partner (LP), and a private-sector investor, acting as a general partner (GP). The

4. See Chapter 16, Securitizations.

RTC contributed asset pools (usually subperforming loans, nonperforming loans, and owned real estate [ORE]) and arranged for financing to the partnership. The GP invested both equity capital and asset management services. After the debt was paid off, the remaining proceeds were usually split according to the ownership percentage each respective partner held. The RTC believed that the net present value of the residual income stream, when added to the up-front cash receipts, would be greater than the total proceeds that would have been received from a direct asset sale.

Between December 1992 and October 1995, the RTC created a total of 72 equity partnerships, with a total book value of $21.4 billion, which were marketed and consummated by the RTC National Sales Center in Washington, D.C. In total, the RTC structured and offered seven types of equity partnerships.

In 1993, in response to a perception that small investors were being excluded from the equity partnership program, the RTC initiated a special series of partnerships that were grouped geographically so that small investors would be able to more readily participate.

The RTC created Asset Management and Disposition Agreements (AMDAs) in response to FIRREA, which mandated the review, analysis, and possible renegotiation of the FSLIC assistance agreements. The AMDA partnership structure required that both the acquirer (GP) and the FDIC (LP) would have equity at risk. The GP's private investors, in addition to contributing to the partnership's capital, accepted responsibility for the management and disposition of the partnership's assets. In return, the GP received distributions from the net recovery on the partnership's assets, but received no management fee.

Although the RTC created only two partnerships using the AMDA structure, their portfolios were sizable because the assets were from two of the largest thrift failures ever resolved by the FSLIC. The AMDA partnerships generated $2.4 billion in cash, of which $2.1 billion was paid to the FDIC as manager of the FSLIC Resolution Fund (FRF).

In general, the RTC's and the FDIC's experiences with the partnership programs have proven to be a viable alternative to conventional methods of asset disposition.[5]

Use of Outside Contractors

During the 1980s, another major asset disposition method, in addition to asset marketing, evolved when the FDIC began to use outside contractors to handle large bank failures.

In September 1984, the FDIC entered into a five-year assistance agreement with Continental Illinois National Bank and Trust Company (Continental), Chicago,

5. See Chapter 17, Partnership Programs.

Illinois. Under the agreement, the FDIC acquired approximately $5.2 billion of the bank's problem loans and other assets and assigned them to "Continental Bank as Administrator." Continental liquidated the assets under the supervision of the FDIC.[6] The contracting method continued to be used for several subsequent large failures in the mid-1980s. In those cases, the FDIC contracted the asset disposition work with affiliates of acquiring banks.

Those early contracts evolved into the use of Asset Liquidation Agreements (ALAs) and Regional Asset Liquidation Agreements (RALAs). Initially, ALAs were asset management and disposition agreements between the FDIC and asset management organizations that were affiliates of the acquiring bank. ALAs later developed into contracts between the FDIC and private-sector contractors that were not necessarily affiliated with the acquiring bank. The ALA program was designed to facilitate the disposition of distressed assets, primarily nonperforming loans and owned real estate. However, the pools sometimes contained performing loans and failed bank subsidiaries. Ten asset management contracts were issued from 1988 to 1993 that handled assets with a book value totaling $32 billion.

Because those agreements provided for "cost plus" reimbursement (costs plus incentive fees), the FDIC reimbursed all of the contractors' operating expenses and overhead, which insulated servicers from risk and did not provide incentive to control overhead. In early transactions, incentive fees were a fixed percentage of gross collections, and a deferred incentive fee was provided, depending on the assuming bank's ability to increase the value of the pool over the life of the agreement. Later contracts used more complicated formulas, such as basing incentive fees on the ratio of cumulative net collections to gross pool value. The goal was to maximize the net present value of cash flows generated from liquidation of the pool.

After favorable experiences with ALA contracts in connection with large bank failures, the FDIC created RALAs for asset pools generally below $500 million in book value. From November 1992 to June 1993, the FDIC issued four RALA contracts to four private-sector contractors, which handled assets with a book value of $1.2 billion. RALA contracts, which were not cost-plus arrangements, contained a three-tier fee structure composed of management, disposition, and incentive fees. The actual fees on the four contracts were less than 5 percent of gross collections. The RALAs were designed to be monitored by an oversight committee of FDIC personnel to ensure that assets were liquidated, managed, and converted to the highest net present value cash equivalent.

The RTC used private-sector contractors as a matter of practical necessity, as well as in response to the legal mandate to employ the private sector. FIRREA required the

6. See Part II, Case Studies of Significant Bank Resolutions, Chapter 4, Continental Illinois National Bank and Trust Company.

RTC to hire private-sector contractors for asset disposition if such services were available in the private sector and if such services were practicable and efficient.

The Standard Asset Management and Disposition Agreement (SAMDA), first issued in August 1990, was a contract between the RTC and a private-sector contractor for the purpose of managing, collecting, and disposing of distressed assets in a portfolio of any size. The Standard Asset Management Amendment (SAMA) amended a SAMDA contract, reducing the scope of work from asset management and disposition to asset management only. During the course of the SAMDA program, the RTC issued 199 SAMDA contracts, including SAMDA contracts that contained SAMAs, to 91 different contractors. SAMDA contracts paid management, disposition, and incentive fees. In addition, all asset-specific expenses were passed through the contracts, except for the contractor's overhead.

FIRREA also mandated that the RTC would include minority- or women-owned businesses (MWOBs) among its contractors. In the early 1990s, the FDIC also established an MWOB program for contracting.

Contractors played a major role in the crisis years. At the FDIC, the $33.2 billion in assets disposed of by ALAs and RALAs represented 46 percent of the $72 billion in assets the FDIC acquired for disposition between 1980 and 1994. Almost all of RTC's assets were placed with asset managers or loan servicers.[7]

Real Estate Sales

Financial institutions that failed usually had significant inventories of owned real estate that they had acquired as a result of deteriorating loan portfolios. As a result of the failure of financial institutions, the FDIC also acquired main bank office buildings and branch office buildings. After resolution, during the asset disposition process, the FDIC also acquired ORE. It acquired properties by foreclosure, deeds-in-lieu of foreclosure, and acceptance of properties in settlement of loan obligations.

Although ORE properties represented a small percentage of total assets for both the FDIC and the RTC, their disposition was highly visible and attracted much public attention. The FDIC and the RTC were criticized for holding properties too long or selling below market value and adversely affecting real estate markets. In the late 1980s, to promote sales and to respond to the criticism, the FDIC introduced policies and procedures to begin auctioning the properties in a manner that was more consistent with private industry standards. The concern for mitigating the effects of large blocks of properties coming onto an already-depressed real estate market carried over to the operation of the RTC. FIRREA included language requiring the RTC to sell real estate for no less than 95 percent of appraised (market) value. In 1991, to facilitate lagging

7. See Chapter 14, Asset Management Contracting.

sales and burgeoning inventories, that language was amended to reduce the minimum sales price to no less than 70 percent of appraised value.

The FDIC primarily used broker listings to sell ORE. Properties would be appraised and listed for sale with a broker, and any offers would be passed on to the FDIC account officer. The account officer would then counteroffer or accept the offer; either action was subject to the approval of the appropriate delegated authority.

The RTC used its SAMDA contractors to dispose of ORE. Contractors would list with brokers and approve sales under their own delegated authority or under RTC-delegated authority.

The FDIC and RTC also disposed of ORE through the auction process. The FDIC began holding ORE auctions in the late 1980s. Those sales consisted primarily of large inventories of small, hard-to-sell properties. The RTC initially prohibited auctions because of the perception that they would adversely affect real estate markets. By 1990, the RTC's ORE portfolio had grown so dramatically that the traditional method of using brokers was insufficient to dispose of large volumes of properties. By March 1991, the RTC had procedures in place for auctions, resulting in regional, national, and in some cases, international marketing. The FDIC and RTC national and regional auctions of non-distressed properties in the late 1980s and into the 1990s met with considerable success; average sales prices ranged from the high 80th percentile to the mid 90th percentile of the appraised values. The 1996 year-end aggregate average FDIC ORE sales-price-to-appraised value ratio was 94.7 percent.

The FDIC had also conducted national auctions for large commercial properties, the first of which was held in New York City in March 1989. Other national auctions followed, with satellite hookups in multiple cities.[8]

The Affordable Housing Program

Marketing and sales of owned real estate were affected in both the FDIC and the RTC by legally mandated affordable housing programs. FIRREA established the framework for such programs and required that the RTC implement an affordable housing program. The purpose was to provide home ownership and rental housing opportunities for families with very-low-, low-, to moderate incomes. Section 40 of the FDIC Improvement Act (FDICIA) of 1991 required that the FDIC establish an affordable housing program for the same purpose. FDICIA anticipated federal funding through congressional appropriations, but funding did not take place until fiscal year 1993. During 1992, the FDIC implemented the affordable housing program without appropriated funds and focused on the sale of single-family properties to income-eligible buyers.

8. See Chapter 13, Auctions and Sealed Bids.

With appropriated funds came credits and grants of up to 10 percent of a negotiated sales price for eligible buyers of single-family properties. Fiscal year 1994 saw increased funding and the broadening of restricted sales to include multi-family properties to nonprofit entities and governmental agencies.

The year 1995 also saw the merger of the RTC and the FDIC's affordable housing management and staff, as set forth in the Resolution Trust Corporation Completion Act (Completion Act) of 1993. The FDIC continues to operate an affordable housing program, but its nature is limited because appropriated funds are no longer available.[9]

Environmental Problems and Issues

In the early 1990s, the FDIC and the RTC developed environmental programs to prepare and train staff to oversee implementation of federal and state environmental statutory provisions, as well as internal policies and procedures. Environmental specialists provide technical advice and recommendations on assets that have highly complex environmental problems or are controversial for environmental reasons. Environmental laws, issues, and risks are significant to the FDIC because they affect asset marketability, valuation, and liability, and they potentially expose insurance funds to losses.

The environmental programs were premised on identifying hazardous environmental conditions or substances, such as underground storage tanks; lead-based paint; damaged, friable asbestos; and special environmental resources, including wetlands, habitats of endangered species, and nationally significant historic sites. The FDIC uses information on environmental hazards to evaluate its potential legal and financial liabilities associated with an asset and how those liabilities would affect foreclosure, purchase, sale, loan workout, or seller financing. Information on special environmental resources assists the FDIC in identifying applicable laws that affect an asset's development potential and in evaluating legally permissible uses that affect its appraised value, as well as the marketing strategy that yields the highest potential return.

To help identify assets with environmental conditions during the S&L crisis, the RTC engaged national contractors with expertise in resource identification and deployed a series of contracting instruments for environmental site assessments. The RTC contracted with The Nature Conservatory, a national nonprofit conservation organization, to identify natural resources, including endangered species, property covered by the Coastal Barrier Improvement Act, and rare natural communities.

Because of the volume of failed S&L assets with environmental conditions, the RTC executed various disposition strategies for those assets, including the use of national sales. The RTC completed two national sales of assets with environmental hazards and one national sale of assets with special resources. In addition, field offices conducted

9. See Chapter 15, Affordable Housing Programs.

sales of environmentally distressed properties. The RTC also adopted environmental representations and warranties for loans collateralized by real estate that were securitized or sold into trust arrangements to maximize its returns while allowing assets that may be found to breach environmental provisions at some point in the future to be repurchased.

Because its portfolio of properties with environmental hazards had grown, the FDIC conducted a nationally marketed sale. When marketing and selling real estate properties "as is," both the FDIC and the RTC took into account the cost of hazard remediation or corrective action to be done by the purchaser. Consequently, the price of the property was reduced by the estimated cost to remediate.

A primary difference between the RTC's and the FDIC's sales of real estate with environmental hazards was the RTC's use of "buyer remediation agreements." The RTC, as part of its standard sales documents, established requirements for buyer remediation, including an asset-specific statement and schedule of work, an escrow account for funding such remediation from the sale proceeds, and a system for determining when remediation had been completed.

The FDIC also prefers to have the buyer remediate properties with environmental conditions, but it sells such properties "as is" without formally requiring that the buyer take any corrective action. The FDIC predominantly sells properties with environmental conditions through standard broker listing agreements, and sales documents usually have disclosure and buyer indemnification provisions. Unlike the RTC, however, the FDIC generally discloses only factual information about a property, not the recommendations of an environmental professional or the costs to remediate.

Disposition of Subsidiaries and Other Assets

Liberalization of banking and savings and loan regulations in the late 1970s and early 1980s allowed financial institutions in the United States to use the corporate structure to establish subsidiary companies that were used to engage in what were hoped to be profitable nonbank activities. Through those vehicles, the S&Ls, and the banks to a lesser degree, either conducted real estate development projects directly or used the corporate structures to make partnership investments in real estate–related activities. Partnership structures were either general or limited, and in many cases the financial institution's role was that of managing general partner (MGP), with all attendant responsibilities and liabilities. Many S&Ls, in addition to conducting real estate activities, created finance subsidiaries to take advantage of interest rate spreads between the institution's cost of funds and rates available on various collateralized mortgage obligations or mortgage-backed securities. The banks also established subsidiaries to handle trust work for their parent bank or S&L. Insurance subsidiaries were also prevalent and often proved to be quite profitable for the bank or S&L.

Liquidating those corporate and partnership entities proved to be an expensive and challenging activity for the FDIC and the RTC. Some corporate entities were sold as whole companies, usually for the tax benefits that belonged to the corporate corpus. In most cases, however, individual assets of the subsidiary were sold through normal FDIC and RTC marketing channels. Liabilities of the companies were satisfied, and then the corporation was legally dissolved.

When capital market assets such as mortgage-backed securities, stock portfolios, bond portfolios, and specialized hedge fund–type investments were encountered, the RTC responded by creating a capital markets branch that had the expertise needed to dispose of those specialized assets. Dissolving partnership interests usually involved the same asset disposition activity; however, less formality was encountered in the legal dissolution of the general partnership form.

Treatment of Unfunded Commitments

Up until the mid-1980s, FDIC liquidators operated under the direction that they had the right to disaffirm all executory contracts, such as outstanding loan commitments, made before a bank failed. Such commitments included construction loans with construction activity in process, land development loans, bridge loans, revolving lines of credit, and letters of credit.

During this period, the liquidators had very little written guidance about unfunded loan commitments other than that, as a receiver of a failed bank, the FDIC had the authority to disaffirm such commitments. Lacking such guidance and without much analysis, liquidators routinely notified borrowers that their loan commitments were no longer in effect. Because the majority of borrowers tended to be small- to medium-sized companies, they usually were forced to make other financial arrangements so that their companies would not fail.

Eventually, the FDIC realized that a more reasonable approach would both benefit the borrowers and help the FDIC maximize its return on assets. For example, at a bank closing in 1984, the FDIC agreed to continue funding revolving lines of credit secured by accounts receivables. The portfolio was then quickly marketed for sale. That approach saved many of the individual customers from going out of business while also maintaining the value and marketability of the portfolio. A sale was then consummated shortly after the bank closing, thus benefiting all concerned.

By the 1990s, the FDIC had formalized a policy that considered the significant impact of funding commitments on the borrower's business, employees, and community. It stated that every reasonable effort should be made to lessen the effect of bank failure on borrowers by providing or facilitating interim relief whenever possible. It also stated that account officers should explore all possible avenues of assistance for the borrower. The FDIC wanted borrowers and the public to understand its willingness to consider funding loan or credit commitments, as well as its desire to help receivership borrowers make a smooth transition to a permanent source of funding. In accordance with that new philosophy, the FDIC conducted borrower seminars to discuss how the

FDIC would proceed concerning outstanding loan commitments and provided representatives to answer any related questions.

Conclusion

During the crisis years, the FDIC and RTC acquired approximately $410 billion in assets that were targeted for asset disposition. By the end of 1997, less than $5 billion of those assets remained with the FDIC. The liquidation of this enormous volume of assets was accomplished in a timely and efficient manner.

In the early and mid-1980s, the FDIC began a gradual shift to asset marketing and the use of private-sector contractors to handle the increasing volume of bank assets. By the 1990s the FDIC and RTC had built on those early methods and were using sophisticated methods to dispose of assets. Those methods evolved in response to legislative mandates, changing marketplaces, public perception, and the volume of assets that were acquired. Markets were created that had not existed before as asset disposition methods were finely honed to create the greatest returns for financial institution receiverships.

Both agencies displayed an ability to adapt to the rapidly changing economic environment and markets, as well as to explosive asset growth. They faced severe challenges, such as the volatility of workload, fluctuating staffing levels, extensive travel, and multiple office relocations, while having to operate in a "fishbowl" of public and governmental scrutiny. Post-crisis challenges for the agencies' staff have been equally difficult because of the merger of the RTC into the FDIC and the subsequent downsizing of the FDIC that followed a decreasing workload.

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The banking and thrift crisis caused an unprecedented volume of assets to be transferred to the FDIC and the RTC. In response to an overwhelming workload, both the FDIC and the RTC experimented with disposition strategies to facilitate disposition at prices that maximized the overall return.