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Statement of the Shadow Financial Regulatory Committee on RTC Thrift Resolution Policies

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The initial approach of the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) to resolving thrift insolvencies has been to sell institutions net of assets whose values are hard to determine. In these so-called "clean bank" deals, the RTC retains the deleted assets of the thrift and gives the acquiror cash (less any acquisition premium) to cover the cost of assuming the thrift's liabilities.

Alternatively, especially in the case of large institutions, the RTC sells the whole institution but

permits the new owner to "put" to the RTC (return) any asset the owner later determines it does not wish to retain. Exercise of this put provision turns the transaction into a clean bank deal in the end, but subjects the RTC to the additional risk of interim declines in value. Moreover, in holding problem assets under either approach, the RTC is taking title to hundreds of thousands of individual properties, trying to account for them, manage them, and ultimately dispose of them.

The Committee believes that the RTC should revise its procedures. The cost of S&L resolutions consists primarily of losses in institutions' assets. To minimize aggregate losses (present and future), the management and ownership of the assets should be transferred to the private sector as rapidly as possible. Only a private owner who bears the costs and gains has the correct incentives to make judgments on maintenance, further investment and terms of sale.

The principle is to privatize risks as soon and as far as possible. "Clean bank" deals and "whole bank" deals with "puts" violate this principle by leaving all the problem assets in the hands of the RTC. The institution's liabilities and readily marketable assets are transferred to the buyer, but so are its personnel which means their knowledge of the problem assets

becomes lost to the RTC. Transactions of these types have an unfortunate attraction to the RTC, in that they avoid immediate recognition of the full extent of the losses imbedded in assets. This creates a misleading impression of the unfolding cost of the resolutions. The hidden cost is that huge asset holdings remain in the hands of the RTC and are subject to further deterioration. The taxpayers' interest would be better served by outright sales of institutions ("final bank" deals) and assets, under terms designed to maximize the transfer of investment risk.

The Committee recognizes that the primary difficulty in effecting final sales of problem assets is uncertainty of valuation. When uncertainty is so great that "final bank" deals do not seem feasible, the RTC should use thrift and asset management agreements. The acquirors of thrifts would thus carry the properties and dispose of them (without risk of loss), with the "workout" compensation established by a widely competitive auction process.

The details of yield-maintenance and loan-guarantee agreements must be structured to maintain optimal incentives for property disposition. In structuring management contracts, the RTC should examine in a more constructive manner the performance history of agreements used in the past by FSLIC and the FDIC.