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The Resolution Trust Corporation: Historical Analysis

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Summary

In a 1989 legislative response to financial troubles in the thrift industry, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA, P.L. 101-73) was enacted: FIRREA's principal mission was to conduct a partially tax-payer funded program to address the troubles of the nation's many insolvent thrifts. To do so, it established a new entity, the Resolution Trust Corporation (RTC), whose mission was to address troubled thrifts by arranging their sale to other institutions or shuttering them and disposing of their assets. The RTC would eventually obtain \$105 billion in funding but a major part of its principal funding came from an off-budget entity, the Resolution Funding Corporation (REFCORP). REFCORP was created by FIRREA as a public-private partnership, which acquired the funds that it would provide to the RTC through proceeds from its sale of U.S. Treasury bonds. During its years of operation, 1989 to 1995, the RTC was alternately criticized for dumping thrift assets and for taking too much time to dispose of them. It subsequently began selling block assets, it partnered with private entities in the joint ownership of some assets, and it issued securities backed by commercial mortgages. When shut down in 1995, the RTC had closed 747 insolvent thrifts and recovered about 85% of the value of the assets it had seized. Estimates vary but several observers cite direct and indirect governmental costs totaling about \$150 billion for the undertaking.

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Introduction

Between the late 1970s and the mid-1980s, savings and loan institutions (thrifts) faced a constellation of developments that would challenge their financial viability. The developments included (1) high and volatile interest rates in the late 1970s and early 1980s, which increased the thrifts' interest rate risk;¹ (2) the phase out and elimination of the Federal Reserve's Regulation Q (a regulation that had placed limits on the interest rates that banks and thrifts could pay), which encouraged the emergence of new instruments such as money market funds that hurt thrift industry profitability; (3) state and federal deregulation of depository institutions, which enabled thrifts to get involved in new but potentially riskier markets; and (4) reductions in regulatory capital requirements, which allowed thrifts to use alternative accounting procedures that increased their reported levels of capital.

Collectively, the developments had negative impact on the thrift industry: by 1986, 441 thrifts with \$113 billion in assets were found to be insolvent.²

The Enactment of FIRREA and the Beginnings of the RTC

To help remedy the thrift industry's problems and restore the public's flagging confidence, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA, P.L. 101-73). Enacted in August 1989, FIRREA's principal thrust was the creation of a program to close and clean up insolvent thrifts who collectively held billions of dollars in deposits insured at the time by the Federal Savings and Loan Insurance Corporation (FSLIC).³

The vehicle created by FIRREA to conduct the cleanup was the Resolution Trust Corporation (RTC). Principal funding for the RTC came from an off-budget entity, the Resolution Funding Corporation (REFCORP), a FIRREA-created public-private partnership, which was apart from but was operated by the Federal Home Loan Bank (FHLB) System, a federal entity that supplies credit reserves to thrift institutions (similar to what the Federal Reserve does for commercial banks). REFCORP issued about \$30 billion in noncallable, zero coupon, 30 and 40 year U.S. Treasury bonds to fund the RTC. The interest payments on those bonds were largely funded by a FIRREA-directed annual payment of \$300 million from the member banks of the FHLB and taxpayer dollars.⁴

In addition to the \$30 billion from REFCORP, the RTC received \$18.8 billion from the U.S. Treasury, and \$1.2 billion from Federal Home Loan member banks, giving it a total of about \$50

¹ Interest rate risk is the risk that an investment's value will change due to a change in the absolute level of the interest rates.

² Timothy Curry and Lynn Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," *FDIC Banking Review*, December 2000, pp. 26-28.

³ Abolished by FIRREA, the Federal Savings and Loan Insurance Corporation formerly administered deposit insurance for savings and loan institutions, which FIRREA transferred to the Federal Deposit Insurance Corporation.

⁴ "Proposed Rule," *Federal Register*, vol. 65, no. 24, February 4, 2000, p. 5448; and Carl Horowitz, "The Continuing Thrift Bailout," *Investor's Business Daily*, February 1, 1996.

billion in initial funding. Subsequent legislation increased RTC's funding, which would eventually total about \$105.1 billion.⁵

The Structure of the RTC

As directed by FIRREA, the board of directors of the Federal Deposit Insurance Corporation (FDIC) also assumed the role of the RTC's board. FIRREA also established an RTC Oversight Board whose mandate was to oversee the development of RTC policy. The Oversight Board also oversaw the RTC's budget, and monitored its use of taxpayer funds. The board, however, was not to be involved in detailed RTC operational issues, such as matters pertaining to individual transactions.

As specified by FIRREA, the Oversight Board had five members, three of whom were federal officials: the Secretary of the Treasury (who served as the board's chairman), the Chairman of the Federal Reserve Board, and the Secretary of Housing and Urban Development. The two remaining members were nominated by the President and confirmed by the Senate.

In 1991, motivated by a number of issues, including the RTC's need for interim funding and concerns that its dual board structure was cumbersome and inefficient (for example, the Oversight Board had to approve policies recommended by the RTC/FDIC board), Congress passed the RTC Refinancing, Restructuring, and Improvement Act of 1991 (P.L. 102-233). Among other things, the law replaced the Oversight Board with what has been described as a more limited and less intrusive Thrift Depositor Protection Oversight Board (TDPO), which included the Secretary of the Treasury and the Chairman of the Federal Reserve Board but not the Secretary of Housing and Urban Development. The law also removed the FDIC's board from its role as the RTC's board; and it replaced the FDIC as the RTC's manager with the RTC's Chief Executive Officer (also was also a member of the TDPO).⁶

The process of closing or resolving individual thrifts involved one of three alternatives: (1) some thrifts were sold to a healthy acquirer, which involved the RTC paying another institution to buy the insolvent thrift, with most of its assets intact; (2) some thrifts were to be shut down with their depositors being paid off and with the RTC retaining all of its assets for later sale; and (3) some thrifts were shut down with their deposits being transferred to another institution. Because deposits are liabilities (they represent claims on the institution by depositors), the RTC was required to pay the institution receiving the deposits. But because the expected value to the new firms of the customers who owned the deposits often exceeded the face value of the deposits, the RTC frequently paid less than face value for the depository accounts.

⁵ For example, the RTC Completion Act of 1993 (P.L. 103-204) enabled the RTC to continue to fund its operations. In its first few years, a number of members of Congress grew disenchanted with the RTC's performance and recommended that it be significantly overhauled. For example, in 1991, the Hon. Frank Annunzio recommended completely eliminating the RTC and replacing it with a private sector program. Lee Davison, "The Resolution Trust Corporation and Congress: 1989-1993, Part II," *Federal Deposit Insurance Corporation's Banking Review*, vol. 18, no. 3, 2006.

⁶ David S. Holland, *When Regulation was Too Successful—the Sixth Decade of Deposit Insurance: A History of the Troubles of the U.S. Banking Industry in the 1980s and Early 1990s*, New York: Greenwood Publishing Group, 1998, p. 81.

The assets that the RTC controlled for thrifts in conservatorship or for thrifts in the later receivership phase took a variety of forms, including cash, mortgages, loans, securities (including some below-investment grade securities known as junk bonds), land, commercial properties, and houses. FIRREA required the RTC to utilize the services of private-sector companies in managing and disposing of assets whenever possible.

Initially, the agency faced significant criticism that it was not resolving failed thrifts at a rate that kept pace with the growing number of thrifts in conservatorship. The RTC responded to the criticism with a concerted effort to resolve troubled thrifts at a faster rate. That effort, however, added greatly to the agency's collection of assets, especially problem assets. Soon, concerns over the pitfalls of dumping assets with often little regard for the low values they fetched were superseded by concerns, including some from members of Congress, that a faster approach to asset disposal was needed if the agency was going to complete its mission.⁷

In mid-1990, the agency began conducting bulk sales of packaged assets, a contrast to its initial approach of selling assets one by one. Although the bulk sale strategy was criticized for fostering a lack of competition among bidders (including the provision of "sweetheart deals" to some large investors), possibly lowering asset sale prices due to discounts and thus undermining some real estate markets, the criticism was overshadowed by the agency's need to rid itself of assets.⁸

In some of its auctions⁹ of non-performing loans, the RTC packaged assets by product, geographic location and collateral type, some packages being as small as a few thousand dollars, others in the tens of millions, with average packages running between \$3 million and \$4 million.¹⁰ Other bulk packages were less diversified and very asset-specific, consisting of single-property types such as hotels or motels.¹¹

Equity Partnerships. At times, however, the bulk asset sales faced market pricing that was considerably less than the agency desired. To help address such shortcomings, the agency pioneered "equity partnerships" to help liquidate some of the packages of its real estate and financial assets. While the strategy employed a number of different structures, all of the equity partnerships involved a private sector partner acquiring a partial interest in a pool of assets, controlling the management and sale of the assets in the pool, and making distributions to the RTC based on the RTC's retained equity interest.¹²

Commercial Mortgages and Securitization. The RTC is widely regarded as a pioneer in the securitization of complex securitized instruments backed by commercial and multi-family loans,

⁷ Lee Davison, "The Resolution Trust Corporation and Congress, 1989-1993 Part I: 1989-1990," *FDIC Banking Review*, vol. 18, no. 2, 2006, pp. 38-42.

⁸ *Ibid.*, pp. 38-39.

⁹ The RTC made widespread use of auctions, both sealed-bid auctions, in which bidders proffer bids sealed in an envelope and "open-outcry" auctions using auctioneers who set up auction sites that were often near the location of the assets. Some observers suggest that the agency lent groundbreaking legitimacy to the notion of asset auctions.

¹⁰ Jeffrey Marshall, "Learning from the RTC," *United States Banker*, vol. 103, iss. 9, pp. 28-32.

¹¹ *Ibid.*, pp. 29-30.

¹² An example was the RTC's partnership with Colony Capital of Los Angeles, which invested in the RTC's National Land Fund and became a joint-venture partner. The Colony pool had 119 assets with a book value of \$480 million largely in finished residential lots. Colony put up 25% of the purchase price and became the managing general partner; the RTC was a passive limited partner getting 75% of the cash flow as the assets were sold to a point when the total reached the agency's "original imputed contribution." After that point, Colony's equity share rose to 50%.

commercial mortgage-backed securities (CMBS), which constituted a significant share of the agency's assets. Initially, the CMBS were reportedly difficult to sell due in part to the fact that the huge losses that had occurred in the value of commercial mortgages was a major factor in the thrifts' troubles. Eventually, however, sales of the CMBS reportedly became quite healthy, and the innovative approach to asset disposal would later earn the RTC praise.¹³

Conclusion

The RTC Completion Act of 1993 (P.L. 103-204) terminated the RTC as of December 31, 1995. All of its remaining assets, liabilities, and duties were transferred to the FDIC.

In the end, the RTC orchestrated the closing of 747 thrifts, more than 25% of the industry. It was also responsible for selling more than \$450 billion of their real estate and disposing of 95% of their overall assets with a recovery rate of more than 85%.¹⁴

Estimates of the direct and indirect cost of the entire RTC thrift resolution process have ranged from \$100 billion to as high as \$500 billion, with the most widely and recently reported estimate in the area of \$150 billion (the majority being taxpayer financed),¹⁵ an amount said to be below original estimates.¹⁶

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¹³ George Alexander and Tom Rayburn, "FDIC Closes the Books on RTC Securitization Program," *CMBS World*, Winter 2005, pp. 50-52.

¹⁴ Frederick Mishkin and Stanley Eakins, *Financial Markets and Institutions*, Addison Wesley Longman, 2000, p. 498.

¹⁵ For example, see Curry and Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," p. 26, and Mishkin and Stanley Eakins, *Financial Markets and Institutions*, p. 498.

¹⁶ Jerry W. Markham, *A Financial History of the United States*, M.E. Sharpe, 2002, p. 173.

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