CBO STAFF MEMORANDUM

THE RTC'S LOAN SECURITIZATION PROCESS

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This staff memorandum responds to a request from Chairman Jim Sasser of the Senate Committee on the Budget to analyze the budgetary treatment of the RTC's securitization program. It was written by Ron Feldman and Marvin Phaup of the Congressional Budget Office's Special Studies Division under the supervision of Robert Hartman. Questions should be directed to the authors at (202) 226-2835.

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SUMMARY

This staff memorandum addresses the economic and budgetary consequences of the Resolution Trust Corporation's (RTC's) securitization program. The following are the memorandum's main findings:

- RTC securitization produces a variety of financial instruments that to varying degrees have characteristics of both debt and equity. By retaining most of the risk of default on the mortgages, the transaction falls well short of terminating the government's equity interest in the loans. By transferring some credit risk on the loans to investors, it defies classification as a pure debt transaction. The RTC has an option to convert the transaction into a pure sale, however, by liquidating its residual interest in the mortgages.

- Viewed as a form of borrowing, RTC securitization is a more costly form of federal finance than Treasury debt, for which these securities substitute. But long-term borrowing by the RTC from the Treasury, which would enable the RTC to hold the mortgages indefinitely, is inconsistent with the agency's mandate to dispose of the federal government's interest in insolvent thrifts.

- Viewed as a form of sale, RTC securitization is inherently no more costly than some alternative means of ridding the government's books of these loans. Yet the RTC goes further and claims that securitization is significantly less costly than whole-loan sales. The agency's evaluation is marred, however, because it assumes that securitization is equivalent to a complete sale of the government's equity interest in the loans. In fact, the reported "savings" result in large part from the RTC's retention of credit risk under securitization.

- Viewed as an explicitly temporary solution to conflicting agency goals, RTC securitization is appealing. Securitization moves the assets off the government's books, gives the RTC time to reestablish a performance track record for the loans, and may leave the government in a position to conduct a complete sale when sufficient data are available to minimize market uncertainty about the value of the loans. The RTC plans to liquidate its interest in the reserve funds eventually.

- In the budget, proceeds from borrowing are classified as a means of financing the deficit, whereas sales of assets by government agencies are treated as offsetting collections, which reduce the

deficit. Because RTC securitization has aspects of both borrowing and an asset sale, the effort to specify the appropriate budgetary treatment is complicated. Currently, the Office of Management and Budget (OMB) distinguishes between those proceeds of a sale that are available to protect investors against loss and those that are not so available. Sale proceeds subject to recourse by the buyer--funds held in a "reserve pool," for example--are treated as borrowing, but proceeds free and clear of potential recourse are offsetting collections. However, OMB has exempted proceeds subject to recourse under "representation and warranties" about the underlying loans from this scoring. As a result, the current treatment of the RTC's loan disposition proceeds is inconsistent. The Budget Committees, therefore, may wish to revisit the question of the appropriate budgetary treatment of asset sales involving representations and warranties.

INTRODUCTION

The Congress created the Resolution Trust Corporation to manage and resolve insolvent thrifts that the government takes over as part of honoring its commitments to insured depositors. In this role, the RTC has assumed the ownership of billions of dollars of mortgages and other assets previously held by thrifts. As an explicitly temporary federal entity, the RTC's objectives have included liquidating these assets at the highest possible net return to the federal government.[1] The more money the RTC realizes from the sale of these assets, the lower the ultimate cost of deposit insurance to the taxpayer.

The objectives of selling loans, doing so quickly, and obtaining the highest possible net return to the government often conflict. The most obvious conflict is between speed of sale and sale price. Up to a point, the faster the RTC attempts to sell, the lower the price. This trade-off arises in part because of the low average quality of and high uncertainty surrounding the loans acquired by the RTC. The loans tend to be substandard in performance and documentation. Because the loans have recently been owned by institutions in financial and managerial disarray, loan documentation and servicing are likely to have received less than the close attention and vigorous oversight necessary to maintain the value of the loans. Time and resources are required to restore the loan files and

1. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989, which established the RTC, does not explicitly include disposing of assets quickly among the objectives set out for the corporation [103 Stat. 369]. The RTC is intended to be a short-lived entity, however, and its Oversight Board has ordered speedy disposition of these assets.

servicing to a level that potential buyers require. Without these time-consuming efforts by the RTC, potential purchasers will buy the loans only at a discount of sufficient depth to compensate for the poor quality of and lack of information about the loans. Thus, the faster the RTC attempts to sell the loans, the less time it has to cure deficiencies, and the lower the price the government can expect in the sale.

A more subtle conflict also exists between the goals of selling loans and receiving the highest expected net return to the government. The government uses a lower discount rate to value expected future loan payments than private investors use. Both the government and private investors discount future loan payments for expected defaults and for the time value of money. Private investors, but not the government, apply a further discount for the pure uncertainty of expectations. The greater the uncertainty with which expectations of future payments are held, the greater the private discount. This difference in the treatment of uncertainty means that selling loans will often appear to give the government a lower net return than not selling them.

The RTC's attempt to reconcile the conflicting goals of selling loans and maximizing the government's net return is at the heart of the questions that have been raised about the RTC's securitization program.

OPTIONS OTHER THAN SECURITIZATION

At the extremes, the RTC faces two simple options once it comes into possession of a mortgage: hold the mortgage, perhaps until the balance due is paid, or sell the mortgage, as is, outright.

Holding the Mortgages

If the RTC holds the mortgages, it receives the revenue they generate minus the costs of holding them. Holding costs include default losses on the mortgages, the fees paid to the mortgage servicers, and the interest paid on the funds used to acquire the mortgages. The RTC's enabling legislation allows it to borrow from the Federal Financing Bank (FFB) at an interest rate just slightly (1/8 percent) above the rate paid to holders of Treasury securities. Since the RTC can borrow just above the Treasury rate, it has the cheapest source of funds available.

Given this uniquely low-cost financing source, it is always more expensive for the RTC to fund its activities by borrowing from any source other than the FFB. But holding mortgages--with maturities of up to 30 years--in its portfolio is inconsistent with the cleanup role for which the RTC was created. In addition,

the RTC's Oversight Board has directed the agency to move its acquired assets off its books as soon as possible.

Selling the Mortgages

The other option available to the RTC is to sell the mortgages outright as whole loans. Indeed, this was the agency's initial strategy for disposing of its financial assets. The RTC has sold mortgages with a face value of at least $20 billion, or about the same as the volume sold through securitization.[2] According to one industry analyst, most of the RTC's whole-loan sales have been made to firms that repackage the mortgages for resale as asset-backed securities.[3]

In a whole-loan sale transaction, the RTC severs its equity interest in the loan, and the investor accepts the credit risks formerly borne by the RTC.[4] Prices received on whole loans will naturally reflect a market uncertainty discount from expected values, as well as market expectations about future collections and servicing costs.

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2. Total sales of mortgages and loans, including sale at the resolution of an institution, exceed $100 billion.

3. Thrift Liquidation Alert, *RTC's Loan-Sale Database* (Newark, N.J.: Thrift Liquidation Alert, March 1992). Lehman Brothers was the largest single buyer of whole loans, paying $4.4 billion for 83 whole-loan portfolios.

4. The RTC does retain some risk in these transactions because it offers guarantees for its representations and warranties made in the sale (see Box 1).

Whole loans held by the RTC usually sell for less than the balance remaining on the mortgage, even when interest rates have not increased since the mortgages were originated. This discount primarily reflects the below-average quality of loans acquired by the RTC. Buyers of these loans must accept the credit risk on these sales because the RTC sells the loans without recourse, except for its representations and warranties (see Box 1).

LOAN SECURITIZATION

In October 1990, the RTC's Oversight Board directed the agency to use a third, intermediate approach--securitization--to dispose of financial assets. The first such transaction was completed in June 1991, and a year later the RTC had completed more than 40 transactions securitizing about $20 billion in mortgages. In the future, the RTC intends to use securitization as its "primary and priority" method of selling all types of performing mortgages.

Box 1.
Representations and Warranties

When selling whole loans or securitizing loans, the Resolution Trust Corporation makes certain representations of fact and law about the characteristics of the loans, including, for example, that the reported principal balance is correct.[1] The agency guarantees the accuracy of these representations at the time of sale. If a breach in these representations, for either whole loans or securitization, is discovered during the life of the mortgage, the owner or trustee may submit a claim to a claims administrator operating under contract to the RTC. If the administrator grants the claim, the RTC must buy back the defective loan, replace it with an equivalent one, or pay the loss incurred as a result of the defect. If the claim is denied, the trustee may pursue the matter through litigation.

Even though the RTC hires private contractors to perform "due diligence" assessments of loan quality for a sample of loans before selling either whole loans or securities, the agency acknowledges that its warranties will be costly. Accordingly, it has reserved $200 million for claims under its warranties for the $20 billion in loans securitized to date. As of May 22, 1992, the RTC had repurchased loans or paid claims for $12.8 million under its representations and warranties.[2]

The significance of these representations and warranties for the federal government is that, although they increase the up-front proceeds from loan sales, they can complicate efforts to terminate completely the government's equity position in the loans.[3] As long as the representations and warranties obligation is outstanding, the government retains a financial interest in the loans. Moreover, the RTC's legal counsel has provided the rating agencies with an opinion that these representations and warranties are backed by the full faith and credit of the U.S. government. Such a guarantee restricts the government's ability to cash out this exposure by reinsuring its losses with a private entity because no private insurer can fully match the financial strength of a sovereign power. If, however, the RTC is able to reinsure its losses with a creditworthy firm and pay for this coverage with a one-time, up-front premium payment, the federal loss for this contingency would essentially be locked in at a fixed amount.

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1. Since each whole-loan sale is negotiated between the RTC and the buyer, the representations and warranties may vary from sale to sale. In general, however, the RTC reports that there are no significant differences between the representations and warranties offered on securitized transactions and those offered on whole-loan sales. In fact, the agency argues that the remedies available to the buyer are somewhat more restrictive under securitization than under whole-loan sales.

2. Other representations include the following: that all monthly payments due as of a specified date have been made; that the seller has good title to each mortgage; that each mortgage loan is covered by title insurance; that, to the seller's knowledge, each mortgaged property is in good repair; that there are no delinquent taxes, assessments, or other outstanding charges affecting the mortgaged properties; and that the properties are not affected by hazardous materials or other environmental risks.

3. Some analysts argue that the trustees have incentives to return virtually all defaulting loans to the RTC under its representations and warranties, rather than to draw against the reserve funds. The RTC argues, to the contrary, that the incentive facing trustees strongly favors recovery of credit losses from the reserve funds, which are in the possession of the trustee. The RTC estimates that it has paid out $2.85 million to honor representations and warranties made under securitization. This estimate is preliminary because it was generated from a newly developed data base. Payouts from the reserve funds have totaled $41 million.

What is Securitization?

Securitization, a significant financing innovation developed for private financial intermediaries in the last two decades, consists of creating and selling standard marketable claims to future payments, when those payments are generated or secured by a pool of illiquid loans.[5] The interest rate paid on the securities is less than the rate on the underlying loans because of the greater ease (compared to a whole loan) with which the investor can resell the securities, and because the risk of default is lower for a claim on a pool of loans than on a single loan.[6]

The securitization process begins when the RTC groups some of its mortgages with common features into pools. For example, the most frequently securitized mortgages consist of performing loans collateralized by one to four family dwellings.[7] Some pools consist of fixed-rate loans; others are made up of adjustable-rate mortgages. Once a pool of mortgages has been formed by the RTC and transferred to a trustee, pass-through certificates can be created for sale to investors. (See Figure 1, which illustrates financial flows.) These certificates can be divided into any number of different classes for purposes of creating

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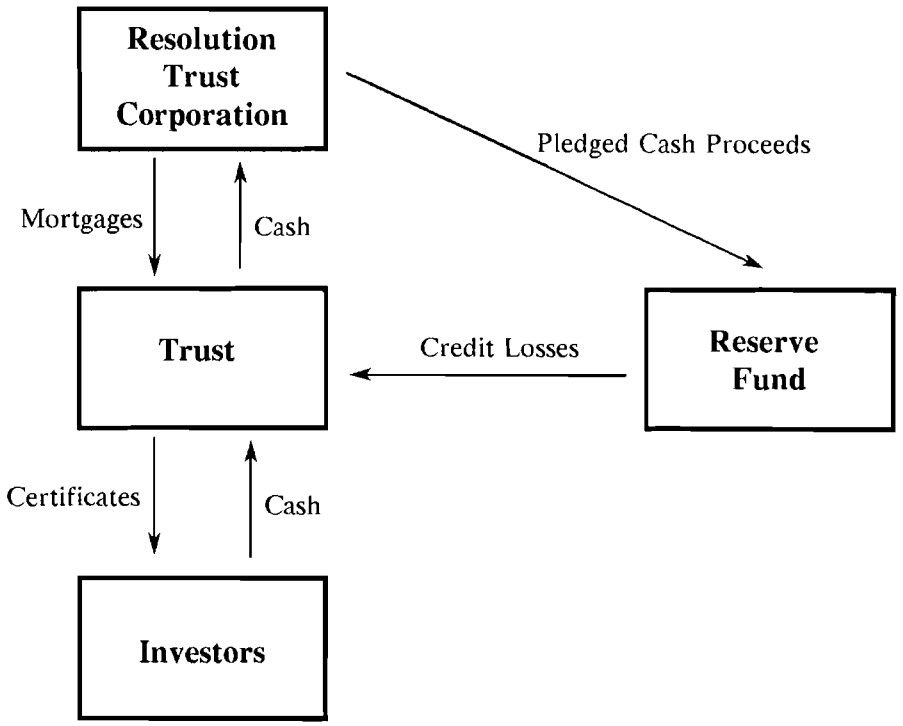
5. Private financial institutions find securitization useful for a variety of purposes: to reduce their cost of funds, to lower their asset-to-capital ratios, and to diversify credit risks. See Charles Carlstrom and Katherine Samolyk, "Securitization: More than Just a Regulatory Artifact," *Economic Commentary*, Federal Reserve Bank of Cleveland (May 1, 1992).

6. If the interest rate on the securities were higher than the rate on the underlying loans, no incentive would exist to incur the transaction costs necessary to create and market the securities.

7. The RTC has also created pools of mortgages secured by multi- (more than four) family properties; manufactured houses, including mobile homes; and commercial properties.

FIGURE 1. ILLUSTRATION OF INITIAL FINANCIAL FLOWS FROM SECURITIZATION



SOURCE: Congressional Budget Office.

securities with different maturities, with fixed or variable interest rates, and with potentially different risk exposures.

An Example of Securitization

Although the contents and terms of RTC transactions vary from issue to issue, it may be helpful to consider a few details of one RTC securitization. Series 1991-3 of RTC mortgage pass-through certificates (rated triple-A, or highest credit quality, by three major rating agencies) was issued in August 1991. The loan pool consisted of one-to-four-family, fixed-rate mortgages with an aggregate face value of $476.2 million.[8] The coupon interest rate on the pass-through certificates was set at 50 basis points (one-half of one percent) less than the rate on the underlying mortgages.[9] This spread of interest rates provides funding for ongoing expenses such as loan servicing (22 basis points) and other trust expenses. Actual yields

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8. The pool was divided into three groups of mortgages on the basis of the contract interest rate. Group 1 consists of all mortgages with an interest rate of 8 percent to 10 percent (about two-thirds of the mortgages in the pool), Group 2 of those mortgages with interest rates above 10 percent, and Group 3 of those with interest rates below 8 percent. Three classes of securities were created corresponding to the three groups of mortgages. The Class 1 securities, which constitute a claim on the Group 1 mortgages, were further subdivided into 12 subclasses (1-A, 1-B, and so on). Principal repayments collected on the Group 1 mortgages are paid in alphabetical order, first to the Class 1-A certificates until all Class 1-A certificates are retired, then to the Class 1-B certificates, and so on. The Class 1-A certificates have the shortest maturity and the Class 1-L the longest. In this manner, certificates are created that have different maturities than the long-term mortgages in the pool. Class 2 and 3 certificate holders all receive pro rata shares of principal as it is received from the underlying mortgages.

9. The interest rate paid on each class of certificates is equal to the weighted average interest rate on the loans in the group less 50 basis points (and in some cases, less a charge for private mortgage insurance). For all subclasses of the Class 1 certificates, this coupon rate is 8.08 percent; for Classes 2 and 3, it is 10.34 percent and 6.70 percent, respectively.

to investors depend on the market price of the securities.[10] On average, the price was just above par, and the effective average yield was close to the coupon yield. It is significant that the yield on these securities was approximately 100 basis points above the yield on Treasury securities of comparable maturity.[11]

The sale of the securities produced gross proceeds of $479.2 million. After printing, underwriting, and other costs of the transaction that totalled $5.6 million, the RTC netted $473.6 million. Consistent with the terms of the security sale, the RTC pledged $128.6 million (27 percent of the face value of the loans) to a reserve fund. The purpose of the reserve fund is to protect the purchasers of the pass-through certificates from losses due to defaults and delinquencies on the underlying loans. In fact, reserve funding at the indicated level was required by the rating agencies as a condition of their awarding a triple-A credit rating to the securities. Given that the securities were rated so highly for investor safety, the reserve fund clearly provides substantial protection against loss by investors in the securities.

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10. When certificates with varying maturities but the same coupon rate of interest are sold, competitive forces set the price of the short-maturity securities higher than the long-term securities. (In fact, the Class 1-A securities sold at a premium, above par, and the Class 1-L securities at a discount, below par.) These price differences translate into differences in effective yields on the securities: Class 1-A, with an estimated maturity of one year, sold at a price to yield 6.9 percent, whereas the Class 1-L certificates, with an estimated maturity of 30 years, sold at a price to yield 9.6 percent annually to maturity.

11. The RTC reports that the spread over comparable Treasury rates was about 130 basis points. Estimates of the spread of certificate interest rates over Treasury securities of "comparable maturity," however, are inexact. This is because the maturity of pass-through certificates depends on the extent to which the mortgages are prepaid--a factor that cannot be known when the certificates are issued. As prepayments occur, the certificates are "called" for redemption. In addition, the comparison is not wholly one of equals because the Treasury does not issue callable debt. Hence, in this memorandum's treatment of Series 1991-3, the estimated spread is rounded down to 100 basis points.

The extent of that protection can be seen by comparing the amount of the reserve fund whose size is specified by the credit rating agencies with the RTC's projection of expected credit losses. The RTC believes that credit losses on the mortgages in the pool will total about 4 percent of loan principal over the life of the loans, or about $19 million. The reserve fund of $128.6 million, therefore, is sufficient to absorb losses that are almost seven times expected losses. This is consistent with the meaning of triple-A-rated securities: investors do not expect credit losses under any economic conditions less severe than those of the Great Depression.

Securitization and Risk Transfer

The RTC, through its pledge of monies that constitute the reserve fund, is liable for almost all credit losses on the underlying mortgages. The proportion of credit risk retained is especially high on the one-to-four-family mortgage securitization.[12] The balances remaining in the reserve fund after credit losses have been

12. Investors in securities backed by commercial mortgages appear to have assumed more risk than those holding one-to-four-family mortgages. See "RTC Bonds Losing Luster as a Model," *American Banker* (July 14, 1992), pp. 1, 6. For a discussion of the special difficulties confronting efforts to convert commercial mortgages into securities, see Hearing on Secondary Market for Commercial Real Estate Loans before the Subcommittee on Policy, Research and Insurance of the House Banking Committee, May 6, 1992.

absorbed and the pass-through securities have been retired belong to the RTC--and ultimately to the U.S. government.[13]

The significance of the reserve fund is the extent to which the government has retained, rather than transferred, the credit risk associated with ownership of the mortgages. Before securitization, the RTC bore all of the risk of default and foreclosure on these mortgages and was entitled to any "gain" from better than expected loan performance. With securitization, the RTC--through its ownership of the reserve fund--retains the risk of loss up to six to seven times the level of expected losses on these mortgages, but it benefits as well from the fruits of unexpectedly low default loss levels. Investors are at risk only if losses exceed the assets of the reserve fund. They are entitled to nothing from a loan performance that is better than expected. The essential point is that investors in the RTC certificates have assumed almost none of the risk associated with the pools of one-to-four-family mortgages. The risk transfer appears to be somewhat greater on the commercial mortgages, but the RTC is also retaining most of the risk on those pools.

13. Reserve fund balances revert gradually to the RTC as the principal amount of outstanding certificates declines.

Securitization as Borrowing

If no significant risk is transferred to investors through the securitization process, then no economically meaningful sale of an equity interest has occurred. This suggests that the securities issued are secured debt, signifying that the RTC has borrowed, replacing its debt to the Treasury with debt to investors in the pass-through certificates. Under this interpretation, securitization merely raises the government's financing cost and reduces its net income from the mortgages. For the Series 1991-3 certificates, the effect was to reduce net earnings by a little more than 1 percent of loan principal per year for the life of the securities.[14]

Securitization as Sale

In reality, however, securitization did more than simply raise the cost of financing the mortgage loans to the government. Securitization gives the government, acting through the RTC and its successors, the legal right to limit its credit losses on the mortgage loans to the amount pledged by the RTC to the reserve funds. For Series 1991-3, the amount pledged to the reserve fund was $128.6 million. If another Great Depression were to occur, the government would be within its

14. The securities have a maximum life of 30 years, but provision has been made for the RTC to repurchase the mortgage loans securing the Series 1991-3 certificates after the principal balance on the loans has been reduced to less than 10 percent of its face value. Assuming a 100-basis-point differential on the outstanding principal over the life of the entire $20 billion in securities issued so far, the present value of the reduction in net income to the government is about $1 billion.

contractual rights to pay holders of RTC securities no more than the balance in the reserve funds. Seen this way, with securitization the government has purchased the right to limit its losses. Although the limit is high, this is not a right that the government had before securitization, and it should therefore be recognized as a component of the transaction.[15]

Securitization as Hybrid

Given that the securitization transaction entails both borrowing and a limited transfer of equity interests, it is neither a pure debt nor a pure asset sale. It is instead a hybrid transaction through which the RTC strips out the near-riskless debt component of a mortgage and sells it outright to investors. The remaining risky component of the loan, whose return is subject to substantial uncertainty (mainly because of default risk), is mostly retained by the RTC. The RTC may decide eventually to sell these retained equity interests when, in its judgment, the market value is close to the agency's estimate of expected value.

The RTC contends that securitization gives the government a higher net price for the loans than it would get with a sale of whole loans. The RTC

15. The RTC's ownership of the reserve fund also retains for the government a right that it had before securitization: the economic benefit of better than expected performance on the underlying mortgages. The RTC also claims that securitization leads to better servicing of the mortgages. The source of this gain, however, is not apparent if the RTC is itself able to structure servicing contracts that provide appropriate incentives to the servicer.

estimates that securitizations completed as of June 23, 1992, provided the government with nearly $1.4 billion more than whole-loan sales. The agency's claim, however, is based on a comparison of a genuine sale with a hybrid transaction in which the RTC retains an equity interest in the loans through the reserve fund.

A direct comparison between the returns to the government from securitization and from whole-loan sales requires that the securitization be structured to transfer credit risk to investors, just as whole-loan sales do. This result could be accomplished if the RTC were to sell--through securitization or otherwise--its claim to the residual balance in the reserve funds and calculate its net proceeds from securitization. In the Series 1991-3 sale, the calculation would be $473.6 million minus $128.6 million plus receipts from sale of ownership of the reserve fund. (The market price of the residual reserve funds is likely to be deeply discounted from $128.6 million because this fund is liable for all credit losses on the mortgages, up to the full amount of the reserve balance.) The resulting amount would be directly comparable to the receipts from a whole-loan sale.

The comparison, assuming that markets are highly competitive and well informed, is likely to show that the net proceeds to the RTC are approximately equal from securitization (without risk retention) and from whole-loan sales.

Inasmuch as many firms have the expert knowledge necessary to securitize loans, competitive bid prices for whole loans should differ from the proceeds of securitization only by the cost of converting loans into securities. If these costs of transformation are the same for the RTC as for private firms, and if both the loan and securities markets are competitive, the RTC should get the same net proceeds from both forms of sale. The RTC can assure itself of such a result over the long term by accumulating and disseminating information on loan quality and by encouraging competition in markets for whole loans and securitized assets.

Was RTC Securitization a Mistake?

Given that the securitization process transfers only a small risk to investors and raises federal financing costs relative to Treasury borrowing, some observers have argued that securitization is an inferior alternative both to holding the loans and to selling them outright. This view needs to be reassessed. Securitization may be the option most consistent with the RTC's conflicting objectives.

Consider the alternatives once again: the RTC could hold the loans; sell the loans outright; securitize, hold ownership of the residual value of the reserve fund, and retain the risk; or securitize, immediately sell the claim to the reserve funds, and transfer the risk to investors. Holding the loans for any extended

period was and still is clearly inconsistent with the RTC's mandate to move the mortgages off the government's books. The first option, therefore, can be rejected as neither desirable nor feasible.

Outright sale of the loans is consistent with the cleanup mandate but has a disadvantage that is especially pertinent to the RTC portfolio--excessive discounting for uncertainty. According to all accounts, the RTC loans are substandard not just in performance but in the information investors need to estimate future cash payments from the mortgages. Projections of future cash for RTC loans are more uncertain--because of missing data--than for other loans offered for sale. This uncertainty will raise the discount for risk that the market will exact from a seller.[16]

One effective way to improve information about the mortgages is to build a favorable record with experience. By retaining the mortgages, the RTC could bring the information content of the files up to standard and establish a verifiable record of performance for the loans. This would reduce the market's uncertainty about the expected cash flows from the loans and lower the market discount for risk. By securitizing the loans, therefore, the RTC deferred a complete sale and gained the time necessary to demonstrate the true value of the loans reliably. Securitization also retains the government's option to sell its claim to the reserve

16. These factors also contribute to the use of representations and warranties in RTC loan transactions.

funds, which if carried out would make the transaction equivalent to the sale of whole loans.[17]

The RTC's use of securitization, therefore, amounts to a fifth option: securitize the loans, hold the reserve fund for a time, and liquidate it after a reasonable period of seasoning the mortgage pool. Viewed as an explicitly temporary solution that allows the RTC time to reduce market uncertainty about the value of the loans prior to sale, securitization is consistent with the agency's objectives.

BUDGETARY TREATMENT OF SECURITIZATION

In the budget, the proceeds of borrowing are classified as a means of financing the deficit rather than as a means of reducing the deficit. Otherwise, the government could eliminate the deficit through borrowing. However, proceeds from sales of equity interests, such as sales of real property and sales of loans without recourse to the government, are treated as offsets to outlays and therefore as deficit reduction.[18] In the past, under a budget scoring convention referred to as the

17. The prospectus for the securities describes the RTC's right to sell its interest in the reserve fund on the condition that such sales be approved by the rating agencies consistent with the maintenance of the initial credit rating on the certificates.

18. Under the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings), only sales mandated by law before September 18, 1987, and routine, ongoing sales were treated as offsetting collections or deficit reduction. See Senate Committee on the Budget, *Budget Process Law Annotated* (April 1991), p. 537.

"binary rule," the proceeds of hybrid transactions, which provided for some investor recourse to the government or other form of federal guarantees, were classified in the budget as a means of financing the deficit rather than as offsetting collections.

More recently, in hybrid transactions in which the government's liability under recourse is limited to some fixed amount, the Office of Management and Budget (OMB) has distinguished the component proceeds for budgetary purposes.[19] Transaction proceeds that are beyond the reach of purchasers or investors are scored as offsetting collections. Proceeds that are potentially at risk--even if that potential is small--through recourse provisions and other guarantees are scored as means of financing.

OMB, however, has not applied this scoring rule to all forms of recourse. In particular, its Circular A-129, "Loan Asset Sales Guidelines," explicitly excludes representation and warranty obligations from the definition of recourse for budgetary purposes. Consistent application of the scoring rule that only those funds no longer subject to recourse are offsetting collections would require all the proceeds from asset sales with representations and warranties to be classified as means of financing, because the entire proceeds of the sale are potentially within reach of investors who can demonstrate a breach of those representations.

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19. For recent developments in accounting for such securities by private firms, see D.W. Thomas and K.F. Sellers, "Dual Classification of Hybrid Securities for Tax Purposes," *Accounting Horizons* (June 1992), pp. 38-46.

Consistency would also require that offsetting collections be recorded only as the principal value of the loans is reduced by repayments. Furthermore, if representations and warranties are viewed as a recourse provision for the RTC, presumably the same interpretation would be applied to all other loan sales, whether whole or through securitization, in which the government offers similar representations and warranties.

Applying this scoring rule consistently is not the only option available to the Congress. The Congress may, like OMB, find that representation and warranties are different from other forms of recourse because they pertain to documentation and reliability of information rather than directly to credit risk. Thus, the Congress might want to keep the current representation and warranty exemption.[20] Or it could require agencies offering representations and warranties to explicitly limit their exposure to a specific dollar amount. However, buyers of securities or loans will discount the value of the securities or loans to compensate for the reduced representations and warranties.

Another option would be to base scorekeeping rules on the economic, rather than legal, exposure of the government when classifying securitization proceeds as borrowing or offsetting collections. Specifically, the estimate of

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20. Under current RTC receivership accounting systems, the RTC does not know which proceeds have been generated by securitization and which by other forms of asset sales. All proceeds that the RTC is free to use, regardless of their origins, are commingled. Requiring the RTC to change this system in accord with new budget scorekeeping norms could have high administrative costs that could outweigh the benefits of the change.

losses under both representations and warranties and the reserve pools could be classified as borrowing, with the remainder of the proceeds treated as offsetting collections. The rationale for this approach is that even though the entire proceeds from the securitization could be returned to investors under the government's representations and warranties, the probability of this occurring is very small. A division based on expected losses, rather than on maximum potential liability, would more accurately reflect the long-term effect RTC securitization will have on the budget deficit. Focusing on the economic and not the legal exposure of the RTC would also allow losses under representation and warranties to be treated the same way as losses from the reserve pool.

Yet another option would be to treat the entire reserve fund and the estimate of losses for representations and warranties as a means of financing and all other proceeds as offsetting collections. This budgetary treatment recognizes that the reserve fund is legally unavailable to the RTC until the mortgages are paid off and that the amount of funds the RTC reserves for its representations and warranties is based on the agency's estimate of future losses.