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Principal-Agent Problems in S&L Salvage

EDWARD J. KANE*

ABSTRACT

New legislation and traditional FDIC insolvency-resolution procedures transform and intensify the principal-agent problems most responsible for the FSLIC mess. These problems explain counterproductive constraints on the governance and operating policies of the agency responsible for rescuing and salvaging assets in insolvent thrifts: the RTC. The constraints slow insolvency resolution, increase interim financing costs, and undermine RTC recovery of asset value. Operationalizing its task as preserving evanescent and economically misconceived "franchise values," the RTC allows insolvents to seek financing on an unconsolidated basis, initiates bidding for one institution at a time, holds back seriously troubled assets, and recruits an overly narrow range of bidders.

ALTHOUGH THE FEDERAL SAVINGS and Loan Insurance Corporation (FSLIC) is officially defunct, its corporate corpse lives on in two successor institutions. Its deposit-insurance business has been taken over by the Savings Association Insurance Fund (SAIF), while its liquidation or "salvage" business has been assigned to the Resolution Trust Corporation (RTC). Both SAIF and RTC have the same stockholder principals: federal taxpayers. Also, both are operated by the Federal Deposit Insurance Corporation (FDIC). Nevertheless, their governing structures differ markedly and in a perverse way.

To maximize net returns from salvage, experience suggests the theory that a salvage or value-recovery operation requires the aggressive operating flexibility of an automobile junkyard. In a junkyard, essentially everything in the salvor's inventory is open for inspection, stripping, and sale to anyone at any time. Hard-to-market hulks are compacted into scrap metal (i.e., pooled) and shipped out on what can be compared to a bulk-sales or auction basis on a strict timetable. The yard either owns or transacts with a fleet of tow trucks and has enough operating capital to bring in new wrecks as they appear.

This paper argues that, unlike a private salvor, the RTC is saddled with the additional objective of slowing down official recognition of the full size of FSLIC's losses. To this end, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) underfunds the RTC, requires delayed sales of residential properties ostensibly to promote the availability of "affordable housing," and creates a superfluous five-person RTC Oversight Board whose incentives are to deprive RTC decisionmakers of desirable operating flexibility.

The RTC Oversight Board creates an appearance of improved accountability to taxpayers that runs exactly opposite to its true economic effects. Three of the

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Oversight Board's members are highly visible public officials: the Chairman of the Federal Reserve Board and the Secretaries of the Treasury and HUD. Their public visibility casts them along with the head of the FDIC as potential scapegoats that politicians may conveniently plan to blame for any scandals or apparent cost overruns that emerge. These officials have an understandable desire to promulgate simple rules and procedures that tightly protect their reputations and postgovernment employability from being damaged by the actions of the RTC. This Board has little incentive to press the FDIC to innovate away from its traditional, one-institution-at-a-time dealmaking practices merely to save taxpayers' unrecognized (i.e., off-budget) expenditures. The Board's idea of innovation (RTC Oversight Board, 1989, p. 11) is for the RTC to continue to select institutions for resolution one at a time but "to allow bidders to bid on a variety of resolution structures (e.g., whole-thrift, clean-thrift, and individual branches)." In effect, Congress has used this Board to reinforce the FDIC bureaucracy's natural lack of adaptive capacity to wrap the RTC salvage operation in counterproductive layers of go-slow administrative restraints.

As devices for political scapegoating, the genius of these arrangements is that estimates of their opportunity cost do not have to be openly reviewed and accepted by either Congress or the Bush Administration. The result may be described as a clever transformation and intensification of the fundamental principal-agent conflicts among taxpayers, politicians, and financial regulators that produced the FSLIC mess in the first place. (See Kane, 1989a,b.)

I. The RTC as an Inefficient Salvage Scheme

Society long ago developed a solution to the salvage problem. Gerathewohl (1982, pp. 657-658) notes that the oldest known insurance contract in Italian, which dates from 1379, carries a specific recovery and salvage clause. Maritime law encourages rescue operations by requiring the owner of a vessel to pay for having his ship or cargo saved from peril, such as shipwreck, fire, or capture by an enemy. The scheme of salvage compensation is designed to create incentives for private-sector volunteers to assist public officials in averting and overcoming maritime disasters. To encourage rescuers, this compensation is designed to exceed the value of the particular rescue services themselves. In setting this compensation, courts attempt to recognize the expense and hazard of the rescue as well as the value of the ship or goods saved.

As this analogy would suggest, it is instructive to envision taxpayers as the effective insurers of assets that are at sea in troubled thrifts. These assets include many damaged and perishable goods of varying degrees of marketability (e.g., partially completed and perilously financed real-estate projects). The ships need to be rescued (taken over), and their cargo needs to be landed and salvaged at minimum cost. However, far from maximizing opportunities for private salvors to participate in the process, RTC procedures severely limit when and how private participants can inspect, strip, or submit bids for imperiled assets.

In principle, an insurance fund's salvage arm should be operated in tandem with the insurance enterprise to maximize the net reserves of the fund. A fund's

net-reserve position roughly measures the market value of the underlying insurance enterprise. It is calculated as the difference between the fund's gross financial resources and the appraised value of the losses to which the fund is exposed.

Salvage personnel seek to generate a reflow of value that lessens the net loss experienced in client claims. To do this effectively, a salvor must operate aggressively. The key is to take timely control of *damaged* or *imperiled* goods when this is necessary to protect them from further deterioration. This is because insured current owners typically have imperfect incentives to undertake expenditures necessary to guard against additional damage. Insureds' claims need to be paid as required, and the damaged goods need to be landed, prudently reconditioned, and repackaged efficiently for sale to whatever parties see themselves as best able to manage them.

Any salvor fulfills four essential functions (Thomas and Reed, 1977):

1. rescue (peril reduction);
2. appraisal (damage evaluation): documenting and valuing inventories of damaged goods;
3. property management (protecting and enhancing existing value efficiently);
4. sales (searching out potential buyers, communicating appraisal information to them, and running auctions or bargaining for the best price).

A top-notch salvor has expertise in all four functions and experience in salvaging a range of diverse goods. Nevertheless, for assistance and advice, it draws freely on two kinds of outside experts:

1. specialists in each of the four functions;
2. specialists in maintaining and disposing of each particular type of good that happens to land in its care.

The guiding principle is to enlist the self-interest of these specialists to value, manage, and move these goods promptly and economically out of the insurer's warehouse.

The Samuelson-Le Chatelier Principle (Samuelson, 1947) tells us that placing arbitrary constraints on how managers may seek to maximize value reduces the value of the enterprise under their control. This means that each inflexible constraint placed on how the RTC pursues its salvage functions threatens to increase the present discounted value of taxpayer's bill for the FSLIC disaster. This paper only loosely costs out the effect of the constraints it identifies. However, had Congress held federal taxpayers' economic interest to be paramount, it would have made the RTC Oversight Board firmly accountable for prosecuting taxpayers' interests by directing it to cost out carefully the opportunity cost of every decision it makes.

II. RTC Startup Performance

When the RTC is understood to be operating in tandem with SAIF, it should be assigned three goals:

1. *Rescue*: to optimize the order and speed of pulling troubled institutions into RTC conservatorships;
2. *Inventory Finance*: to minimize the cost of financing the assets held in or destined for RTC conservatorship;
3. *Insolvency Resolution*: to minimize the costs of asset management and disposition.

To achieve these goals within a reasonable time frame, the RTC must rescue, finance, and dispose of imperiled assets at optimal rates of speed. Tables I and II provide some perspective on how rapidly the RTC has promoted these goals during its startup phase. Table I tells us that, during their first 13 months, the RTC and its predecessor authority put into conservatorship roughly 51 percent of what—using figures from Ely (1989)—Table II identifies as the 685 “sickest” S&Ls. However, by March 21, 1990, only 35 percent of the imperiled assets in these zombie and near-zombie firms had been put into conservatorship. This indicates that on average smaller institutions have been targeted for takeover more rapidly than larger ones.

Table I
Startup Performance of Resolution Trust Corporation

	Through October 18, 1989	Through January 10, 1990	Through March 21, 1990
RTC Conservatorships			
Number	252	285	350
Total Assets (in bil.)	\$93.6	\$105.2	\$163.5
Total Deposits (in bil.)	\$84.2	\$97.1	\$141.1
RTC Insolvency			
Resolutions			
Number	32	37	52
Purchases and	4	7	18
Assumptions			
Deposit Transfers	24	26	30
Deposit Payoffs	4	4	4
Total Assets (in bil.)	\$8.3	\$8.9	\$18.5
Total Deposits (in bil.)	\$9.4	\$10.0	\$18.1
RTC Conservatorships			
Added Since			
August 9, 1989			
Number	22	60	137
Number per Week ^a	2.2	2.9	4.3
Total Assets (in bil.)	\$5.3	\$26.0	\$96.7
Total Deposits (in bil.)	\$4.3	\$21.6	\$72.1
RTC Funding of S&L			
Assets			
Total Placements	\$9.1	\$10.9	\$10.2
(in bil.)			
No. of Institutions	159	168	180
Average Interest Rate	8.14%	8.15%	8.05%

Source: *Resolution Trust Reporter* and telephone calls to RTC Corporate Communications.

^a During the 26 weeks prior to the enactment of FIRREA, 264 institutions were put into conservatorship, a rate of 10.1 per week.

Table II
Analysis of the RTC's Potential Caseload

Category of S&Ls	Number	Ratio of Tangible Net Worth to Assets (in Percent)	Tangible Assets (in \$bil.)
1. Ely's "sickest" S&Ls	685	-5.9	469.1
a. S&Ls already resolved by RTC	32	-46.6	8.8
b. Others in RTC conservatorships	251	-21.2	91.7
c. Other tangible-insolvent S&Ls	255	-3.0	207.3
d. Other very weak S&Ls	147	1.4	161.2
2. Other Weak S&Ls	205	2.4	172.2
3. S&Ls in Fair Condition	340	3.1	217.2
4. Rest of Industry	1,704	6.6	456.8
5. Industry as a Whole	2,934	1.0	1,315.3

Source: Ely (1989), based on June 30, 1989 reports of condition.

Definition: Tangible assets may be viewed as "liquidatable" assets. They are defined as reported total assets less deferred losses and intangible assets.

However, for taxpayers, the key questions are the rate at which the insolvencies of troubled institutions are being *resolved* and the interest rates at which their assets are financed in the interim. As long as insolvent thrifts are operated as unconsolidated enterprises, replacing the particular managers responsible for exhausting their firms' capital with a collection of RTC-appointed executives threatens to start a new round of incentive conflict, resulting in a renewed striving for resurrection. Barth, Bartholomew, and Bradley (1990) show that the principal determinant of the average loss rate experienced in unwinding thrift insolvencies has been the length of time that an institution is permitted to operate after it becomes insolvent.

After 13 months of takeovers, only \$18.5 billion of assets has been reprivatized and only \$10.2 billion is being financed by RTC borrowings. These actions leave 94 percent of imperiled assets financed in unconsolidated forms. As much as \$200 million of this financing is in hot-money certificates of deposit. Clearly, consolidating whatever portion of conservatorship liabilities carries yields in excess of corresponding RTC yields would reduce taxpayer interest costs. Since the RTC paid 21 basis points over Treasuries in its inaugural debt issue, even more could be saved if RTC assets could be financed directly by U.S. Treasury debt and if the rate of conservatorship rescue could be accelerated. However, until the RTC exercises its potential for borrowing through the Federal Financing Bank, FIRREA limits RTC's capacity to fund losses and conservatorship assets to \$50 billion. In its first 37 resolutions, RTC spokespersons acknowledge taking roughly \$5 billion in losses to effect the reprivatization of \$8.9 billion in assets. Assuming that it lost another \$5 billion in reprivatizing the next \$9.6 billion in conservatorship assets, the RTC has only about \$30 billion in funding authority left. Committing these funds to finance inventories of conservatorship assets with currently high funding costs would leave RTC's balance sheet unable to absorb the asset markdowns necessary to dispose of other assets on which potential acquirers might bid.

Table I clarifies that, calculated on a per-week basis, asset rescue and disposal have not only been relatively slow but, since FIRREA, have been moving even

slower. As comforting as it may be to believe that the RTC's disappointing post-FIRREA slowdown is merely a temporary startup problem, it is also Pollyannaish. Funding and bureaucratic constraints on the efficiency and speed with which RTC salvors can operate are preventing RTC from rescuing, refinancing, and disposing of imperiled assets at anything approaching the speed that taxpayers' interests require.

Some politicians and lobbyists promote the view that the RTC *ought* to be slowed down because efficient salvage would ruin viable financial firms and real-estate markets in economically distressed regions. This argument fails to confront three points. First, the value of troubled assets in these regions is fully recognized by informed market participants. Holding these assets in undercapitalized institutions or in government hands does not eliminate them from the stock of assets being priced (although it may through inefficient management destroy their value eventually). It mainly makes the management and disposition of these assets less predictable to other market participants. Second, more than a few of the firms that now claim to be threatened but "viable" are in fact economically insolvent. Not forcing these firms to recapitalize or wind up their affairs places long-run burdens on competing institutions, local real economies, and federal taxpayers. Third, an efficient salvor preserves rather than undermines asset values and completes markets by locating, informing, and servicing parties who might not otherwise submit a bid for the assets in question.

III. The Role of Agency Costs in the FSLIC Mess and in RTC Salvage Operations

At nationally televised sporting events, TV cameras inevitably encounter a banner bearing the legend "John 3:16." This verse proclaims God's love of humanity. Discussions of the FSLIC mess ought to take place under the banner "Luke 16:13." This verse draws a timeless lesson about incentive conflict from the parable of the unjust steward:

No man can serve two masters: either he will hate the one and love the other, or he will devote himself to the one and despise the other. One cannot serve both God and Mammon.

Over the last 25 years, elected and appointed officials responsible for managing the S&L insurance fund faced as short timers essentially the same career problems as the about-to-be-discharged Biblical steward did and chose to resolve these problems in much the same way: at their principals' expense. The policy of guaranteeing the deposit debt of economically insolvent zombie institutions in exchange for a steady flow of grateful industry tribute to politicians and top regulators skewed client risk-taking in ways that created secularly escalating losses for federal taxpayers. Rather than facing up to these losses and cleaning them up efficiently, a succession of top federal officials repeatedly took a coward's way out. They labored to hide as much of the red-ink spill as they could and pushed the growing spill down the timestream for their successors to resolve. Reinforcing a lament featured in the Rolling Stones' "Salt of the Earth," although taxpayers have needed leaders, they have been recruiting gamblers instead.

In signing the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) on August 9, 1989, President Bush claimed that he and Congress were establishing funding and bureaucratic machinery sufficient to pay off FSLIC's bills once and for all. However, economic analysis can clearly show that the salvage problem facing the RTC far exceeds the funding and administrative machinery contemplated in FIRREA. FIRREA is in fact merely another, more concentrated dose of the medicines of coverup and procrastination that fatally poisoned FSLIC.

The economic costs that RTC ought to minimize can be partitioned and subpartitioned in instructive ways. The previous analysis implicitly identified four categories of cost: rescue costs, financing costs, asset-management costs, and disposition costs.

Incentive conflicts imply that each cost category must be envisaged as including a poorly controlled agency-cost component. In this context, agency costs are defined as resource losses that occur because of conflicts between the interest of taxpayer principals and government officials that representative democracy appoints to act as their agents. Agency costs have two components: 1) the explicit costs of monitoring, bonding, and other arrangements aimed at lessening principal-agent conflicts and 2) further implicit losses that develop from whatever residual elements of conflict the conflict-controlling arrangements leave unresolved.

The agency cost of rescue is the cost to taxpayers of suboptimally slow and inappropriately ordered absorption of troubled thrifts into RTC conservatorships. The agency cost of financing troubled assets is the extent to which the interest rates at which assets are funded exceed corresponding Treasury yields. The agency cost of RTC asset management is the suboptimal return on RTC conservatorship assets that is occasioned by their being managed for bureaucratic convenience rather than by market principles. Finally, the agency cost of asset disposition comes from three sources: excessively costly and inaccurate appraisals, poorly configured asset disposal practices, and inappropriate procedures for searching out and communicating with potential bidders for conservatorship assets.

IV. Costly Restraints on RTC Salvage

The RTC's maximal capacity to rescue, refinance, and dispose of imperiled assets, A , are first and foremost a function of the RTC's *explicit* net worth and borrowing authority, N , and its *implicit* or off-budget borrowing authority, B . Congress directly sets parameter N and indirectly controls B . Two other important parameters reflect the interaction of market forces with the efficiency of RTC procedures:

1. the "markdown ratio" or loss rate that develops in salvaging the imperiled assets, R_m . This is one minus the ratio of the market value of A to its book or accounting value.
2. the "turnback ratio," R_T , which under operative RTC procedures measures the percentage of imperiled assets that in case-by-case resolutions private buyers refuse to acquire.

FIRREA sets N at \$50 billion. In November 1989, the Ways and Means Committee threatened to pass legislation setting B at zero to convince FDIC officials to treat B as equalling zero until a compromise could be developed. These constraints do not directly limit the amount of imperiled assets that RTC can rescue, although budget and staffing restrictions have such an effect. However, RTC's underfunding and limited borrowing authority do set up a tradeoff between the amount of assets that the RTC can efficiently refinance or dispose of.

If we relax the RTC-imposed constraint that assets can be disposed of only by completely winding up the affairs of a rescued institution, the maximum book value of conservatorship assets that could be disposed of, A_M , would obey the following equation:

$$A_M = \frac{N}{R_m}. \quad (1)$$

For example, if R_m is 50 percent and $N = \$50$ bil., $A_M = \$100$ bil.; \$100 bil. is only 21.3 percent of imperiled assets.

Moreover, if we impose the procedure that RTC has adopted so far of disposing of a whole institution at a time, A_M becomes smaller. This is because assets that are turned back by the acquirer of the institution's customer base must be explicitly financed by the RTC. In this case, the maximum book value of imperiled assets that can be moved out of conservatorships may be found by solving:

$$R_M A_M + R_T R_M A_M = N. \quad (2)$$

Adding the assumption that $R_T = .40$ to our numerical example reduces A_M to \$71.4 billion.

Bureaucratic constraints on RTC salvage operations aim not at maximizing net returns from salvage but at slowing recognition of the size of the S&L mess and at maximizing the ease with which politicians, top FDIC officials, and the RTC Oversight Board can monitor RTC insolvency resolutions for loose or corrupt dealing. Tradeoffs between the costs of other ways of controlling the risk of RTC corruption (e.g., disclosure requirements and special sanctions for RTC-related self-dealing) and the overall efficiency of the salvage process are not being explicitly explored.

Imperiled assets and the RTC's markdown and turnback ratios are not constants that are fixed once and for all by the mistakes made in running FSLIC prior to FIRREA. These parameters may be improved or worsened by movements in the market environments in which these assets currently float. This possibility encourages authorities to defer action, in hopes of benefiting from a favorable movement in the relevant market environment. This is sad because—unless these markets are extraordinarily inefficient—weaknesses in the RTC salvage process impose burdens on expected cash flows that make these gambles into negative net-present-value projects for federal taxpayers.

Delays in rescue increase imperiled assets and increase the markdown and turnback ratios. They do this by permitting managers of weak institutions to

search out loopholes in the controls on risk-taking imposed by the FDIC and Office of Thrift Supervision (OTS). Delays and weaknesses in appraisals and marketing increase the turnback ratio and lead to inefficient asset management. Weaknesses in property management increase the markdown ratio.

As Ely (1989) complains, bureaucratic constraints are keeping many potentially helpful salvors from being enlisted to move assets expeditiously into and out of the RTC warehouse. First, the RTC Oversight Board has expressed its preference for selling properties in "as is condition (exclusive of minor cosmetic repairs)." Forbidding entrepreneurial activity is an overly expensive way to limit opportunities for corrupt dealing. It reduces the complexity of Board oversight but exposes SAIF and taxpayers to great loss. Contracting arrangements must be developed to allow salvage experts to determine when completions of incomplete properties or major rehabilitations of completed structures would reduce the RTC's markdown ratio by speeding resale or broadening the market by reducing bidder uncertainty.

Second, the RTC has so far refused to let bidders take the bidding initiative. It is slowly parceling out assets on an institution-by-institution basis, tightly controlling the universe of effective bidders, and greatly restricting bid formats. As Table I indicates, the RTC has formulated the problem as one of resolving specific institutional insolvencies, *not* as minimizing taxpayer costs. Bidders are not allowed to submit bids on the specific branch offices or other assets they might most covet until and unless the RTC chooses to resolve the insolvency of the particular institutions that own them. The implicit justification for this approach is an unstated theory of the sensitivity of individual institutions' "franchise values" to portfolio stripping of any sort. It is unlikely that the residual loyalty of a long-insolvent firm's client base would long survive its operation under an RTC conservatorship. My own research on the determinants of the accounting goodwill recognized in a series of bank acquisitions suggests that a high percentage of what accountants designate to be intangible goodwill is from an economic point of view the capitalized value of inefficiently priced deposit-insurance guarantees that are conveyed to the acquirer.

Third, asset-appraisal information is not being developed and shared in the ways that might minimize the costs of bidder "due diligence." If all assets were up for bid at the bidder's option, incentives would exist for the formation of competitive information syndicates. Such syndicates would help RTC to routinize the paperwork process and could for a fee offer to warrant various aspects of their baseline appraisals or otherwise assist bidders to underwrite different classes of information risk.

V. Summary and Conclusions

The size of the S&L insurance mess is not fixed. The present discounted value of the *expected* costs of cleaning it up are growing every day. If the cost of inefficiently funding \$469.1 billion in imperiled assets in an unconsolidated fashion at hot-money and other private deposit rates averages only 43 basis

points, the cost of inefficient patterns of finance is \$2 billion per year. However, this cost is dwarfed by the potential cost of inefficient salvage. With the RTC moving slowly and formally unable to resolve (in the aggregate) losses on more than between 15 percent and 45 percent of imperiled assets, the rate of further market-value deterioration in the base of \$469.1 billion of imperiled assets and \$172.1 billion of assets in other weak thrifts could exceed \$50 billion in the RTC's first year of operation alone.

The RTC is not being operated as a faithful agent for federal taxpayers. FIRREA-imposed restraints on RTC funding opportunities and governance and bureaucratically imposed inflexibilities in its appraisal, management, and sales practices prevent the RTC from managing its affairs at minimum taxpayer cost. Congressional hearings need to refocus away from merely developing gossipy evidence of chicanery in the past regulation of S&Ls and toward straightening out the perverse incentives that feed what remains a growing mess.

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