



## Viewpoint: Five Key Tasks to Make FDIC Loss-Sharing Work

American Banker | Tuesday, January 12, 2010

By Charles B. Wendel

Entering into shared-loss transactions appears to be the Federal Deposit Insurance Corp.'s preferred approach for dealing with failed banks. More than 60% of last year's 140 bank failures were resolved using this approach.

Shared-loss transactions let banks build market share or move into new markets with minimal risk. They also let private-equity players (led by a team of bankers) take advantage of current industry discontinuities.

Much of the attractiveness of these transactions centers on the "guarantee" the FDIC offers buyers. Typically, the agency remits 80% of "dollar one" loan losses to buyers and increases its payments to 95% for losses beyond an agreed upon threshold. In turn, the FDIC benefits from recoveries during the 10-year life of these deals.

Though these deals are attractive strategically and economically, they are also complex.

My company's work with banks and private-equity players points to five key elements that should be addressed in order to structure and manage a transaction appropriately.

**Conducting a focused due diligence process and negotiating the FDIC shared-loss deal.** Though many players are experienced in due diligence, the FDIC window is short, with no more than two weeks between reviewing an offer package to bidding. Time with the target is also limited (two to three days), requiring a focused approach. Buyers should assemble a team of internal and external resources and set clear priorities for their review process.

As for negotiating an agreement, the FDIC has standardized the general structure of its purchase-and-assumption and shared-loss agreements. However, no two agreements are alike, given evolving requirements by the FDIC (for example, a "true-up" provision added in the fourth quarter) and buyer-negotiated amendments. Management should view these agreements as a bible that will be revisited many times. Bank buyers should consult the handful of legal, valuation and related advisers with expertise in the shared-loss world, leveraging their knowledge rather than relying solely on internal controllers, general counsels or other internal resources.

**Addressing key accounting-related priorities.** Accounting regulations to be addressed include FAS 141R, SOP 03-3 and IRC Section 593. Many tax and accounting issues stem from the need to determine the tax basis of assets subject to the shared-loss agreement and the rules related to deferred tax gains. A bank's auditor is conflicted out from offering these services, since it would be reviewing and passing judgment on its own work. This requires bank buyers to obtain the services of an independent firm with appropriate accounting and valuation capabilities.

**Ensuring strong portfolio support.** The FDIC expects buyers to make regular claim submissions related to loan losses, usually monthly for residential loans and quarterly for commercial and consumer loans.

Residential submissions are relatively straightforward because of the objective loss criteria outlined by the FDIC, namely, "actual losses incurred due to modifications, foreclosures, short sales, deeds-in-lieu or bulk sales." However, commercial submissions are more subjective and require greater evaluation.

The state of commercial loan files in failed banks is often inadequate for portfolio management or for making "audit-proof" submissions. (After all, there is a reason why these banks failed.) Oftentimes, financial statements are old, appraisals are out of date, and file memos chronicling the loan's current status are missing.

Owners should select a team of internal and/or external resources to triage, in effect, the portfolio, uncovering the low-hanging fruit that can be submitted earliest while establishing a process to assess the entire portfolio. Every loan in the portfolio must be reviewed against the acquirer's risk rating system and managed within policy guidelines.

Commercial bankers at the acquired bank should undergo a sea change in how they look at their loans. Before failure, many banks avoided taking losses because their reserves could not support a realistic view of a borrower's position. Under shared-loss agreements, management wants bankers to accurately assess transaction risk as quickly as possible in order to identify loans subject to FDIC claims.

**Making accurate and complete certificate submissions.** The FDIC has developed a three-page certificate that requires buyers to tap multiple internal databases and in some cases provide manual inputs as well. Systematizing this process is crucial to increased accuracy and productivity.

**Using technology to track and monitor loan submissions and recoveries** during the life of the FDIC agreement. While residential mortgage loans usually involve one submission, both CRE and C&I loans may require multiple submissions based upon declining values and continuing expenses related to asset preservation, legal and appraisal costs.

In addition, recoveries occur across the portfolio. Buyers need to develop an inclusive information management system or "portal" to track these ins-and-outs. Tying the portal to the bank's core systems allows for the "automatic" generation of certificates, eliminating much of the manual activity that dominates bank staffers' time in the early stages of integrating an acquisition.

Shared-loss transactions can be very attractive and beneficial to all stakeholders, including the customer and the FDIC. However, making them work requires senior management focus, clear priorities, and a bankwide understanding of the unique opportunity these transactions offer.

**Charles B. Wendel is the president of Financial Institutions Consulting Inc.**

---