FDIC-ASSISTED TRANSACTIONS

Core Analysis Procedures

Examiners are to consider these procedures but are not expected to perform every procedure at every institution. Examiners should complete only the procedures relevant for the institution's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures not included below. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

References

- *Interagency Supervisory Guidance on Bargain Purchases and FDIC-and NCUA-Assisted Acquisitions, June 7, 2010 (FDIC: FIL-30-2010)*

Considerations and Background

The FDIC may use Shared-Loss Agreements (SLAs) to resolve failing insured depository institutions. Under an SLA, the FDIC absorbs a portion of the loss on specific assets acquired by the purchasing institution (covered assets). Asset recoveries are maximized and losses to the Deposit Insurance Fund minimized when loss-share assets are managed by an acquiring institution in accordance with prudent business and banking practices. Further, SLAs keep assets of failed institutions in the private sector, which provides a more seamless transition for customers as opposed to other resolution strategies.

SLAs, when used, often come in two forms, Single Family, generally referred to as Single Family Residential (SFR), and Commercial and Other, generally referred to as Non-Single Family (NSF). Both types cover credit losses and certain expenses associated with troubled assets (such as tax, insurance, and sales expenses; and foreclosure costs). For NSF assets, SLAs typically cover an eight-year period with the first five years for losses and recoveries and the final three years restricted to recoveries only. For SFR assets, the SLAs generally cover losses and recoveries for ten years.

The FDIC typically provides coverage for four basic loss events: modification, short sale, foreclosure, and charge-off. Acquiring institutions may be reimbursed for losses when a mortgage is modified or the real estate or loan is sold, but can only make one claim for each SFR asset. For losses on covered NSF assets, the acquiring institution is paid by the FDIC when the assets are charged off (in accordance with the banking agencies' supervisory standards for the classification of assets), or when the assets are sold. Details on FDIC SLAs can be found at http://www.fdic.gov/bank/individual/failed/lossshare/index.html.

Examinations of institutions that acquire assets of failed institutions under an SLA should include reviews of the implications and benefits of loss sharing. To avoid unnecessary home foreclosures, most SFR SLAs specifically require institutions to engage in loss-mitigation efforts in accordance with the FDIC's Mortgage Loan Modification Program or the national Home Affordable Modification Program. Examiners need to consider the impact of the SLA when performing the asset review, assigning adverse classifications when appropriate, assessing accounting entries, and determining CAMELS ratings and examination conclusions.

Terminology may vary from institution to institution. For purposes of this module, an Indemnification Asset (IA) is initially reported at its acquisition-date fair value and represents the present value of expected cash flows to be received from the FDIC for Loss claims on covered assets. The Recorded Investment of an asset(s) on the acquiring institution's books reflects the fair value of the asset(s) purchased as of the acquisition date without regard to the

indemnification agreement.[1] The Certificate Balance represents the value of an asset on the failed institution's books on the closing date, adjusted for subsequent transactions, generally, charge-offs and payments received. Shared loss protection is based on the certificate balance, which is updated based on monthly reports to FDIC's Division of Resolutions and Receiverships (DRR) for SFR assets and quarterly for NSF assets.

Findings and Conclusions

Summarize findings and conclusions here and include a summary of these findings and conclusions in the appropriate Primary or Supplemental modules.

Preliminary Review

1. **During the examination planning process, contact the DRR Regional Manager or DRR employee assigned to monitor the SLA for the institution. Discuss the status of the SLA and whether any related issues may affect the institution's safety and soundness. Examiners may request Loss-Share Watch Lists and other written evaluations of SLA's from the DRR Regional Manager. Examiners may also contact the FDIC's Division of Risk Management Supervision (RMS) Case Manager to determine whether any supervisory issues involving the SLA have been disclosed.**

2. **Review prior examination reports, notes to audited financial statements, Shared-Loss Agreements, and file correspondence for information concerning FDIC-assisted transactions and related indemnification assets. If applicable, review any termination agreements or proposed termination agreements.**

3. **Determine whether a bargain purchase gain resulted from the acquisition.[2]**
   - **Determine whether management reassessed the pertinent factors, such as estimates in fair value (FV), in determining the amount of the bargain purchase gain.**
   - **Review any retrospective adjustments to the bargain purchase gain.**

4. **Determine whether the banking agencies imposed certain conditions to maintain and protect the safety and soundness of the acquiring institution, particularly if FV estimates may not have been validated at the time of the transaction. Conditions may include, but are not limited to the following:**
   - **Capital preservation**

[1] Determine whether this is required directly by SLAs. For an institution that has adopted ASU 2016-13, the recorded investment would not reflect the fair value of the asset purchased for a PCD financial asset; rather, it would be the amortized cost basis.

[2] When applicable, see Accounting Standards Codification (ASC) Paragraphs 805-30-55-3 through 55-5, Special Considerations in Applying the Acquisition Method to Combinations of Mutual Entities. Given the technical nature of this task, examiners may wish to contact the appropriate Loss Share or Accounting Subject Matter Expert (SME) in their agency with any questions or if significant accounting issues arise.

- **Dividend payment limitations**
- **Independent audits or agreed-upon procedures engagements**
- **Independent valuations**
- **Legal lending limit**

SLA Analysis

5. Assess the adequacy of the acquiring institution's accounting for the acquisition, including required FV measurements and the establishment of an IA.[3, 4]

- **Ensure expected cash flows from covered assets are reassessed at least quarterly. (If expected cash flows from covered assets increase, the risk of loss should decline, so the IA should decline. Likewise, if expected cash flows decline, the risk of loss should increase, so the IA should increase.)**
- **Determine whether all assets acquired and liabilities assumed have been correctly recorded at their acquisition date FV, including assets that would not have been on the books of the failed institution such as the core deposit intangibles and the indemnification asset.**
- **Determine whether assets are pooled for accounting purposes, and if so, that they were correctly pooled. For example, the glossary entry of the Consolidated Reports of Condition and Income Instructions for purchased credit impaired loans states: "The aggregation must be based on common risk characteristics that include similar credit risk or risk ratings, and one or more predominant risk characteristics, such as financial asset type, collateral type, size, interest rate, date of origination, term, and geographic location."**

6. Review the terms and conditions of the SLA and any covered assets.

7. Include a sample of SLA-covered assets in the loan review scope. For classification purposes, examiners should first consider whether the asset should be classified without regard to the protection afforded by the SLA. Evaluate the collectability of the amount at which the covered asset is reported on the balance sheet, not its unpaid principal balance. If adverse classification is warranted, examiners should then consider the SLA protection when determining the amount to be classified. In general, the amount that would otherwise be adversely classified should be reduced by the applicable loss coverage rate provided by the FDIC under the SLA.

[3] Given the technical nature of this task, examiners may wish to contact the appropriate Loss Share or Accounting SME in their agency with any questions or if significant accounting issues arise.

[4] Assets purchased that are accounted under ASC Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality should not be pooled with assets that would be accounted for under other Standards. For banks that have adopted ASU 2016-13, ASC Subtopic 310-30 has been superseded; therefore, this note is no longer applicable for those banks. Consequently the last bullet is no longer a requirement for those adopters.

8. Assess the impact of the SLA expiration or termination on Earnings, Asset Quality, and Capital Adequacy as the five- or ten-year SLA reimbursement period nears (e.g., 3-6 months from expiration). If the SLA is going to be, or has been terminated, any associated IA and true up liability should be removed from the books at the termination date (depending on the terms of the termination agreement). In addition, a termination payment to or from DRR will likely be made.[5]
9. Determine whether the allowance for loan and lease losses (ALLL) is appropriately established for shared-loss loans, but only for loss exposure due to credit deterioration *after* acquisition. Determine whether the institution is accounting for the ALLL and IA separately, in accordance with Consolidated Reports of Condition and Income Instructions.[6]
10. Determine whether the institution's credit administration policies and procedures are consistently applied for loans originated by the institution (i.e., the institution's legacy loans) and loans acquired through SLAs.[7] To assist with this determination, examiners should:[8] • **Sample recent large claims to determine whether loss recognition is consistent between SLA assets and non-SLA assets, and reflects consideration of outstanding guidance** • **Contact DRR and review DRR audits and claim reviews** • **Review loan loss recovery efforts for SLA assets and non-SLA assets** • **Compare renewal practices for SLA loans and non-SLA loans for each acquisition. Consider the following:** o **Maturity dates (such as any renewals of SLA loans beyond the SLA expiration date)** o **Amortization periods** o **Interest rates** o **Loan-to-value levels** o **Debt service levels**
11. Review and document IA components by considering the following items: • **Determine the IA balance for each acquisition, distinguishing between agreements for SFR and NSF assets.**

[5] For nonperforming SLA assets, examiners should consider whether the SLA is expected to provide any additional benefit to the institution.

[6] For institutions that have adopted ASU 2016-13, the allowance for credit losses (ACL) for loans and leases is measured for at acquisition and subsequent to acquisition. The ACL for loans and leases is the term used for those institutions that adopted ASU 2016-13, replacing the ALLL used under the incurred loss methodology.

[7] Under typical SLAs, acquiring institutions are not to use the benefits of the SLA to justify or accelerate a decision on foreclosure or loss recognition, and SLA claims are only to be presented to the FDIC when all other loan workout, modification, and loss mitigation efforts have been exhausted.

[8] Examiners are not expected to pull a second sample of acquired loans (beyond those identified in procedure 7) to determine consistency of procedures. However, if examiners become aware of such inconsistency during the examination's credit review process, examiners or an appropriate agency representative should notify the DRR Regional Manager and RMS Case Manager.

- **Determine whether the IA is amortizing due to better than expected cash flows on indemnified assets. Compare the accretion period for improved cash flows with the amortization period on the IA and assess the impact to capital and earnings.[9]**
- **For multi-tranche acquisitions, determine how adjustments are made on the IA for different coverage amounts.**
- **Assess management's strategy for ensuring the IA was eliminated prior to the expiration of the SLA. Determine whether this strategy has been clearly communicated to the board.**
- **Determine the amount of the IA associated with current claims that have been submitted but not yet paid.[10]**
- **Determine the amount of the IA associated with covered expenses that have been incurred but not yet claimed.[11]**
- **Determine the amount of the IA associated with costs to sell.[12]**

12. Document the recorded investment, certificate balances, bargain purchase gains, and true-up liabilities for each SFR and NSF asset.[13]

Internal Controls

13. Determine whether comprehensive internal control procedures are in place to monitor compliance with FDIC reporting requirements and other SLA terms. Ensure internal controls cover accounting issues and compliance with SLA terms.

Audit or Independent Reviews

14. Assess the scope, frequency, and documentation of audit programs relating to SLA activities. Areas to consider include:

- **The accuracy of initial FV accounting, establishment of the IA, and bargain purchase accounting**

[9] The amortization period of the IA associated with improved cash flows should be the lesser of the SLA expiration date or the loan maturity date.

[10] Claims are typically paid within 90 days, so this portion of the IA is relatively liquid.

[11] Certain expenses are reimbursable under the SLA (e.g., appraisal fees, legal fees, and ORE maintenance). This part of the IA is not associated with a discount on the covered assets.

[12] Under accounting rules, institutions must use the FV (less cost to sell, if applicable) to measure credit losses on collateral dependent loans, or to determine the cost basis of property pledged on a loan if it has been transferred into Other Real Estate. Costs to sell are typically not reimbursed under the SLA until the property is sold and costs have been paid. The institution will typically have a portion of IA associated with expected reimbursement on costs to sell. At expiration of the SLA, this portion of the IA may be uncollectable. Some SLAs include a provision that allows cost to be netted against recoveries (reimbursements to DRR) during the recovery phase of the NSF agreement.

[13] If the purchase and assumption agreement includes a true-up clause, the calculation of the true-up liability should be reviewed for accuracy. A true-up clause is typically titled "Payment in the Event Losses Fail to Reach Expected Level" and are due 45 days following expiration of the SLA. The true-up liability should be booked if purchase accounting assumptions indicate losses will fail to reach expected levels.

- **The appropriateness of ongoing accounting practices, including accounting for changes in expected cash flows on covered assets as well as changes to the IA**
- **The adequacy of auditor's qualifications for assessing SLA activities**
- **The adequacy of MIS reporting in keeping management and the board informed**
- **The effectiveness of oversight of third-party service providers**
- **The appropriateness of follow-up activities on internal and external audit exceptions**

15. If recent reviews disclosed any deficiencies, determine whether management's responses and subsequent actions are appropriate and reasonable.

Management Information Systems

16. Consider whether SLA-related items are accurately reported in the Consolidated Reports of Condition and Income. Reporting issues may include:

- **Nonaccrual status of purchased impaired loans, or purchased deteriorated financial assets for those institutions that have adopted ASU 2016-13**
- **Delinquency status of purchased loans**
- **Recognition of goodwill or bargain purchase gains**
- **Risk-weighted assets[14]**
- **Valuation allowances, and the ALLL or ACL for loans and leases**
- **Indemnification assets**
- **Any identified true-up liabilities**

17. Evaluate the institution's use of its MIS reports and resources. Determine whether:

- **Existing reports help management monitor compliance with SLAs**
- **There are data items missing from reports that could enhance management's ability to monitor SLAs**
- **Board reports include sufficient information for the board to provide appropriate oversight**

18. Assess the effectiveness of MIS reports used to evaluate credit risk associated with the SLA portfolio(s).[15]

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[14] Not applicable for institutions that report the community bank leverage ratio.

[15] As SLAs approach expiration (e.g. 12 months), examiners should encourage management to begin producing board reports that include scenarios regarding the collectability of the IA and the potential effect on capital. Informative reports reflect the potential increase in adversely classified assets, including comparisons to tier 1 capital plus the entire ALLL or tier 1 capital plus the ACL for loans and leases.

Managerial Effectiveness
19. Review the institution's strategic or business plans regarding acquisition and expansion activities. Determine whether: • **The plans set forth clear objectives for identifying post-acquisition target markets, customers, and performance benchmarks (i.e., profitability or asset quality)** • **The plans appropriately address risks, including credit, operating, liquidity, compliance, interest rate, legal, and reputation risks** • **The plans detail management's estimate of potential deposit runoff after an acquisition** • **The plan's projections and assumptions appear reasonable in view of economic, market, and competitive conditions; management expertise; technological and operational capacity; and capital support** • **The plans include an assessment of capital needed to support the volume and overall risk characteristics of the organization's acquisitions**
20. Determine whether management periodically evaluates whether acquisitions correspond with long-term strategic plans, acquired assets perform within acceptable risk limits, and acquisitions have positively influenced profitability and performance goals.
21. Analyze management's response to adverse performance trends in SLA assets, such as higher than expected charge-offs, delinquencies, prepayments, customer complaints, or expenses; or lower than expected profits.
22. Determine whether management provides the necessary staffing and training to successfully integrate acquired assets, and consider whether the institution employs accounting professionals capable of handling purchase and assumption transactions that involve shared-loss accounting.
23. Consider whether management prepared for and executed appropriate business strategies for new market areas they have entered resulting from Purchase and Assumption transactions.
24. Determine whether managerial talent and depth was sufficient to successfully integrate acquired assets (or an institution) into existing corporate cultures and practices.
25. Determine whether management has effectively merged acquired data and processing systems and whether plans are in place to add or integrate new systems.

26. Determine whether management has pursued prudent loss recovery and loan modification efforts before presenting a claim for loss under the SLA.[16, 17]
27. If potential noncompliance with an SLA is identified during the examination, the examiner or appropriate agency representative should notify the FDIC's DRR Regional Manager and RMS Case Manager.
End of Core Analysis.

[16] Under typical SLAs, institutions are not to use the benefits of loss share to justify or accelerate a decision on foreclosure or loss recognition. If examiners find that an acquirer is not making a sufficient effort to work out SLA loans, an appropriate agency representative should notify the DRR Regional Manager and RMS Case Manager.

[17] Refer to Procedure 10.