The Loss Share Loophole: 
Abuse and Manipulation of Examination Criteria and Prudent Banking Practices to 
Maximize Recovery under a Shared Loss Agreement rather than Maximizing Recovery 
under Loans.

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Introduction: The Federal Deposit Insurance Corporation (“FDIC”) has relied heavily upon the 
use of Shared-Loss Agreements (“SLA”) as a vehicle to maximize the liquidation value of failed 
banks.1 When an Acquiring Institution (“AI”) executes its duties under an SLA in good faith, the 
SLA is a creative financial tool that not only minimizes losses to the deposit insurance fund, thus 
reducing the cost of deposit insurance for all insured banks; but also minimizes the systemic and 
systematic impact of bank failures on the overall real estate and banking markets.

Unfortunately, like many well-intentioned regulatory initiatives, private enterprise is rarely 
outdone in its quest to find a loophole that creates a financial windfall, even if the loophole violates 
the spirit and intent of the initiative. In the case of SLA’s, the opportunity for abuse is manifested 
in an unfortunate conflict between the desired behavior under the SLA and the potential financial 
rewards afforded to an unscrupulous practitioner under Generally Accepted Accounting Principles 
(“GAAP”).

The Intent and Purpose of Loss Share: The use of SLA’s by the FDIC has been common since 
1991 as a preferred method of liquidating assets of failed banks. According to the FDIC’s website:

Loss share saves the Deposit Insurance Fund money. In today's markets, 
asset prices are low, and the prices frequently include steep liquidity and 
risk discounts. These agreements enable the FDIC to sell the assets today, 
but without requiring that the FDIC accept today's low prices. Instead, the 
FDIC sells to assuming banks in a way that aligns their incentives with the 
FDIC and reduces the liquidity and risk discounts. The assuming banks 
have the capacity and incentive to service the assets effectively and 
minimize losses.2

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1 See White Paper: The Impact of Shared Loss Agreements on the Purchase Price of assets sold by the FDIC
2 http://www.fdic.gov/bank/individual/failed/lossshare/
Critical to this comment is that the intent of an SLA to align the incentives of the AI and the FDIC. The FDIC is required under the Financial Institutions Reform Recovery and Enforcement Act ("FIRREA") to conduct its operations in a manner which (i) maximizes the net present return from the sale or disposition of such assets; and (ii) minimizes the amount of any loss realized in the resolution of cases.³

The theory behind Loss Sharing is that, properly executed, it allows the FDIC to maximize the liquidation value of failed bank assets. The SLA mitigates the systematic risk⁴ associated with the failed bank’s loan portfolio through the provision of an 80% (at a minimum) payment guaranty that is backed by the full faith and credit of the U.S. government. In exchange for this risk mitigation, AIs are required to employ prudent resolution strategies that maximize the recovery under the Loss Share assets,⁵ thus reducing reliance upon the SLA as a source of repayment.

To insure that the AI is aligned with the FDIC’s obligations under FIRREA, the SLA contains language in Articles 2.2 and 3.2(a)⁶ which outline the responsibilities and duties of the assuming institution. Article 2.1(c) of the SLA provides that the FDIC as Receiver shall not be required to make any payments to BB&T if the Receiver or the FDIC determines that the associated write down is not in accordance with Examination Criteria.⁷

3.2(a) (i) manage, administer, collect and effect Charge-Offs and Recoveries with respect to each Shared-Loss Asset in a manner consistent with:
(A) usual and prudent business and banking practices;
(ii) exercise its best business judgment in managing, administering, collecting and effecting charge-offs with respect to Shared-Loss Assets;
(iii) use its best efforts to maximize collections with respect to Shared-Loss Assets and, if applicable for a particular Shared-Loss Asset, without regard to the effect of maximizing collections on assets held by the Assuming Bank or any of its affiliates that are not Shared-Loss Assets;

⁴ This term refers to the risk inherent to the entire market or an entire market segment. Systematic risk, also known as “undiversifiable risk,” “volatility” or “market risk,” affects the overall market, not just a particular stock or industry. This type of risk is both unpredictable and impossible to completely avoid. It cannot be mitigated through diversification, only through hedging or by using the right asset allocation strategy.
⁵ See White Paper – The Impact of Shared Loss Agreements on the purchase price of assets sold by the FDIC.
⁶ The terms of SLAs change periodically. The reference to specific articles herein are based on the SLA between the FDIC as receiver for Colonial Bank and Branch Banking and Trust Company dated August 14, 2009. While specific terminology may have changed in subsequent agreements, the intent of the language remains unchanged.
⁷ The SLA defines Examination Criteria as the loan classification criteria employed by, or any applicable regulations of, the Assuming Bank’s Chartering Authority at the time the action is taken, as such criteria may be amended from time to time. The primary regulator of BB&T is the Office of the Comptroller of the Currency ("OCC").
These provisions, being subjective in nature, provide wide latitude for interpretation and potential abuse. The subjective terms of the SLA, combined with the mechanics of purchase accounting, create an incentive for the AI to create credit losses as quickly as possible. In doing so, the AI gets the benefit of immediately shifting the credit risk onto the FDIC while simultaneously accelerating the timing of cash flow to maximize its yield. The FDIC’s Office of the Inspector General issued a Report to Congress chronicling the potential for AIs to abuse the loss share program by improperly forcing a loan into default (e.g. not working to keep a loan performing) for the AI’s own profit:

An important feature of SLAs that is intended to control AI behavior is the loss-sharing percentage—typically an 80- to 20-percent split for most agreements. The FDIC and proponents of SLAs maintain that the AI loss percentage aligns the AI’s interests with the FDIC’s requiring the AI to have “skin in the game,” which incentivizes the AI to minimize losses and manage the covered SLA assets consistent with how AIs manage their own non-covered, legacy assets. Critics of SLAs maintain that the AI loss percentage is not enough to curb behavior and that the FDIC loss guarantee incentivizes the AIs to foreclose on an asset or not work to keep an asset performing in order to collect the loss-share guarantee.8

Under loss share, the FDIC reimburses the AI for loss incurred on an asset.9 In fact, an AI may recover – essentially immediately from the FDIC– for losses10 claimed with respect to a defaulting loan that is subject to the SLA. This collection mechanism stands in sharp contrast to those of a conventional agreement between lender and borrower where a performing loan is paid over time and is subject to ordinary and customary business expenses and risks.

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9 Generally, loss share agreements can provide for multiple tranches for loss reimbursement. In most cases prior to mid-2010, the first loss tranche provides that losses are reimbursed at 80 percent of the actual loss until aggregate losses exceed a stated threshold. Losses in excess of the stated threshold, if any, are reimbursed at 95 percent.
10 The fact that a loss is recognized and reimbursed under the SLA does not mean that the loss is unrecoverable. Rather, losses are defined as Charge-Offs and expenses that the AI would normally recognize in accordance with its “Examination Criteria.” The SLA defines Examination Criteria as the loan classification criteria employed by, or any applicable regulations of, the Assuming Bank’s Chartering Authority at the time the action is taken, and as such criteria may be amended from time to time. The primary regulator of BB&T is the Office of the Comptroller of the Currency.
The intent of the SLA is to provide the AI with a backstop to losses that allow it to accept a reasonable risk adjusted yield in exchange for seeking to maximize recovery under the loan (as opposed to reimbursement under the SLA); however, if the AI views loss share reimbursements as a source of cash flow, rather than a backstop to losses, the SLA becomes a tool to facilitate unscrupulous behavior that harms borrowers and the FDIC.

Because the AI’s risk is substantially hedged by the reimbursement provisions of the SLA, it is expected to take affirmative steps to responsibly place the asset back into service and maximize its recovery value. This expectation is communicated in a regulatory guidance:11

> An additional benefit of loss sharing is that the structure softens the effect of the bank failure on the local market by keeping more of the failed bank’s borrowers in a banking environment. The acquiring bank can more easily work with the borrowers to restructure problem credits or to advance additional funding where prudent. This “anti-credit crunch” benefit avoids the exacerbation of declining collateral values that could be precipitated by having a significant amount of local failed bank assets falling into a liquidation mode.12

This paper will demonstrate how an unscrupulous AI is able to guarantee itself a substantially higher investment yield by (i) ignoring its legal and contractual obligations and duties to the FDIC and the borrowers; (ii) the improper characterization of loans as non-performing; and (iii) premature triggering of the reimbursement provisions of the SLA to obtain reimbursement from the FDIC allegedly on account of the “declining” value of the acquired assets. The following sections provide discussion of the nuances of purchase accounting and SLA’s that, in combination, suborn the abuse and manipulation of the SLA.

**Accounting for the Acquisition of Purchased Impaired Loans:**


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11 Risk Sharing Asset Management Guidance RSAM-2010-009
Value\textsuperscript{13} as of the date of acquisition. The acquisition of a failed bank falls within the definition of a Business Combination and is accounted for under the provisions of Topic 805.

For the purposes of Topic 805, the determination of the Fair Value of Purchased Impaired Loans\textsuperscript{14} is governed by FASB ASC 310-30: Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality (“Topic 310-30”). Topic 310-30 provides that expected cash flows in excess of the consideration paid for a loan\textsuperscript{15} represent “accretable yield” that is recognized as income on a level-yield basis over the life of the loan. In other words, if a loan is acquired for $8 and is expected to return $10 over a two year period, the bank would expect to “accrete” income of $1 per year and realize an accretable yield of 13\% per year.

If the actual cash flows occur over a shorter timeframe the accretable yield will increase. For example, in the scenario described above, if the acquired loan generated actual cash flows of $10 over a one year period rather than the originally forecasted two year period, the bank would accrete income of $2 in the first year and realize an accretable yield of 25\%. As shown, the use of Topic 310-30 to account for Purchased Impaired Loans creates a strong incentive for the acquirer to compress the timing of recovery to maximize its yield on the investment.

In contrast, Topic 310-30 penalizes the acquirer if the actual cash flows are slower than originally forecasted. If we assume, in the same scenario, that the Purchased Impaired Loan is instead collected over a three year timeframe, the basis in the loan would have to be reduced, through a charge to the allowance for loan losses (“ALLL”), in the amount required to maintain the originally forecasted accretable yield of 13\%. To demonstrate, assume that at the end of year one the expected cash flow for the loan was revised to reflect the expectation of an additional 12 months to complete the recovery of $10. In order to maintain the original income accretion of 13\%, the

\textsuperscript{13} Fair Value, as used in GAAP accounting is defined by ASC 820, Fair Value Measurements (FASB Statement 157, Fair Value Measurements).

\textsuperscript{14} Purchased Impaired Loans are Loans that, at the time of acquisition, demonstrate evidence of deterioration of credit quality and it is probable that the acquirer will not unable to collect all contractually required payments.

\textsuperscript{15} For purposes of demonstration, throughout this paper reference is made to a single loan as the shared loss asset. Topic 310-30 provides that assets having similar risk characteristics may be combined into pools for purposes of fair value calculation and accounting administration, and in fact most AI’s do account for Purchased Impaired Loans in one or more pools of loans. This distinction does not change the analysis and in fact often enhances the AI’s ability to accomplish the task of manipulating the timing of recoveries under an SLA.
acquirer would have to reduce the basis of the asset to $6.93, resulting in a loss in year one of $1.07.

Topic 310-30 places a burden upon the AI to closely control both the timing and amount of future recoveries. The failure to meet these forecasts will have a negative impact on the earnings of the institution. Likewise, if the expected cash flows can be compressed without significant change in the amount of the expected recovery, the AI is rewarded with a significant increase in its investment yield and profitability. The accurate estimation of future cash flows is critical if the AI wishes to avoid the earnings volatility that results from inaccurate estimates.

Unfortunately, in the acquisition of failed banks, potential buyers are rarely provided with sufficient time to conduct a complete evaluation of the loan portfolio and must rely on estimates based on a sampling of the portfolio. The use of SLA’s provides some degree of hedge against inaccurate forecasting of the amount of actual collections since the indemnification features will significantly limit the amount of credit loss that an acquirer would face if the initial estimates prove overly optimistic. Since, generally, 80% of any credit loss would be reimbursed under the SLA, any adjustment to the fair value of the Purchased Impaired Loans that is attributable to credit losses is divided between a charge to the ALLL of 20% and an increase to the FDIC receivable of 80% of the loss.

Equally unfortunate, and the primary cause of the abuse perpetrated by many AI’s, is the fact that if the timing of cash flows is extended beyond the original forecast the indemnification features of the SLA provide no backstop to the accretion adjustments, and the AI must absorb the entire amount of any adjustment as a charge to the ALLL. This is the cause of the frequent scenario in which AI’s make the seemingly illogical announcement during earnings releases that due to “better than expected performance” of acquired loan portfolios, the bank is recognizing a one-time charge to earnings. These comments are attributed to the scenario in which the Purchased Impaired Loans are not defaulting as quickly as originally forecasted and the recovery is no longer expected to be completed within the forecasted timeframe.

To avoid losses that are attributed to “better than expected loan performance”, many AI’s have adopted loan management strategies that provide assurance that this otherwise favorable scenario does not arise. To achieve this, the AI needs three things to occur: 1) cause as many Purchased
Impaired Loans to default as possible; 2) once defaulted, rely on broadly defined Examination Criteria to create reimbursable losses; and 3) cause the losses to occur as quickly as possible.

While directly in conflict with the spirit of the SLA, these three steps favorably impact the AI’s accretive yield through the manipulation of both the timing and amount of recovery. By treating the loan and the reimbursement rights as interchangeable sources of cash flow, an AI can mitigate the risk of future losses due to delays in recovery timing. Since the prudent execution of loan workout strategies and working with borrowers who have the ability and inclination to pay typically consumes more time than the creation of a default and the liquidation of collateral, an AI who is willing to ignore its contractual and fiduciary duties can increase its accretion yield at the expense of the FDIC and its borrowers.

This seemingly illogical scenario becomes self-evident once one has an understanding of purchase accounting for Purchased Impaired Loans and the interplay between the accounting rules and the SLA rules.

When SLA’s are introduced to a transaction accounted for under Topic 805, the reimbursement rights that accompany the Purchased Impaired Loans provide an unscrupulous AI with a separate source of recovery that is integrated with, and correlated to, the accounting for the Purchased Impaired Loans. This integration provides the AI the ability to, through the improper reliance on SLA reimbursements, significantly reduce the timing of recovery without a significant increase in risk or a decrease in total expected recovery. Taking advantage of this loophole can provide a significantly higher risk free return on investment. To better understand the dynamics of the interplay between purchase accounting and the SLA, an understanding of the mechanics of loss-sharing is necessary.

**Loss-Share Mechanics:**

Purchased Impaired Loans are recognized on the books of the AI at the fair value that reflects the net present value of future cash flow expected from the loan. However, since the SLA looks to the failed bank’s book value for purposes of tracking losses and recoveries, the total consideration for the acquisition of loans and associated reimbursement rights is not segregated within the SLA. Instead, the AI calculates the fair value of the Purchase Impaired Loans, and from that estimate of
value determines the expected recovery under the reimbursement rights of the SLA. These expected recoveries under the SLA are then reported as a separate asset typically referred to as the “Indemnification Asset.” Table 1 demonstrates the accounting for an acquisition of a loan having a book value of $100 in which the AI determined that the fair value of the loan was $65, then, calculating that the expected recovery under the reimbursement rights would equal $28, the AI agreed to acquire the loan and reimbursement rights for combined consideration of $92.5.

Table 1

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Selling Institution</th>
<th>Acquiring Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Book Balance</td>
<td>100.0</td>
<td>-</td>
</tr>
<tr>
<td>- Purchase Discount</td>
<td>(7.5)</td>
<td>-</td>
</tr>
<tr>
<td>- Fair Value of Indemnification Asset</td>
<td>-</td>
<td>(27.5)</td>
</tr>
<tr>
<td>- Fair Value of Loan</td>
<td>-</td>
<td>(65.0)</td>
</tr>
<tr>
<td>Total</td>
<td>92.5</td>
<td>(92.5)</td>
</tr>
</tbody>
</table>

If the resolution of the loan occurs as planned, the cash transactions shown in Table 2 would reduce the asset balances of the loan and the associated indemnification asset to $-0- and yield accretion income of 5% on the average outstanding asset value.

Table 2

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Timing (Months)</th>
<th>Transaction Amount</th>
<th>Book Value</th>
<th>Income Accretion (assume 5% IRR)</th>
<th>Loan Asset Value</th>
<th>Indemnification Asset Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Balance</td>
<td>0</td>
<td>N/A</td>
<td>100</td>
<td>-</td>
<td>65</td>
<td>27.5</td>
</tr>
<tr>
<td>Charge-Off under Examination Criteria</td>
<td>1</td>
<td>(35.0)</td>
<td>35</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Loss Share Recovery (80% of Charge-off)</td>
<td>4</td>
<td>(28.0)</td>
<td>-</td>
<td>(0.5)</td>
<td>-</td>
<td>(27.5)</td>
</tr>
<tr>
<td>Collateral Liquidation</td>
<td>36</td>
<td>(74.8)</td>
<td>65</td>
<td>(9.8)</td>
<td>(65)</td>
<td>(65)</td>
</tr>
<tr>
<td>Ending Balance</td>
<td>36</td>
<td></td>
<td>(10.2)</td>
<td>-</td>
<td>-</td>
<td>(0.0)</td>
</tr>
<tr>
<td>Investment yield</td>
<td></td>
<td></td>
<td></td>
<td>5.00%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- The initial purchase price is allocated to the loan asset at $65 and the indemnification asset at $27.5;
- Immediately upon acquisition of the Loan, the AI would recognize a charge off under the provisions of the SLA of $35 and;
- Within 3 months of the charge off, the AI would be reimbursed $28 under the reimbursement provisions of the SLA. Since the indemnification asset was originally
discounted to fair value, the reimbursement of $28 would reduce the balance of the indemnification asset to 0- leaving $0.50 of accretion income.

- When the collateral is subsequently sold at the end on the 36th month, the estimated proceeds of $74.8 will likewise reduce the book value of the loan to 0- and result in accretion income of $9.8.
- In the end, the return on investment is $10.2 reflecting the projected 5% IRR.

If we next consider the effect of accelerating these cash flows, assuming all other factors remain unchanged, the impact of loss-share manipulation through collateral devaluation can be demonstrated. Table 3 lists the transactions that would occur if the AI elects to aggressively devalue the loan to accelerate payments under the SLA rather than maximizing recovery under the loan.

Table 3

<table>
<thead>
<tr>
<th>Transaction</th>
<th>Timing (Months)</th>
<th>Transaction Amount</th>
<th>Book Value</th>
<th>Income Accretion</th>
<th>Loan Asset Value</th>
<th>Indemnification Asset Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Balance</td>
<td>0</td>
<td>N/A</td>
<td>100</td>
<td>-</td>
<td>65.0</td>
<td>27.5</td>
</tr>
<tr>
<td>Charge-Off under Examination Criteria</td>
<td>1</td>
<td>(80.0)</td>
<td>(80)</td>
<td>-</td>
<td>(45.0)</td>
<td>36.0</td>
</tr>
<tr>
<td>Loss Share Recovery (80% of Charge-off)</td>
<td>4</td>
<td>(64.0)</td>
<td>-</td>
<td>(0.5)</td>
<td>-</td>
<td>(63.5)</td>
</tr>
<tr>
<td>Collateral Liquidation</td>
<td>36</td>
<td>(74.8)</td>
<td>(65)</td>
<td>(9.8)</td>
<td>(20.0)</td>
<td>-</td>
</tr>
<tr>
<td>Loss Share Reimbursement (80% or Recovery)</td>
<td>39</td>
<td>36.0</td>
<td>45</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Ending Balance</td>
<td>39</td>
<td></td>
<td>-</td>
<td>(10.2)</td>
<td>-</td>
<td>(0)</td>
</tr>
<tr>
<td>Investment yield</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>12.48%</td>
</tr>
</tbody>
</table>

- The AI obtains an appraisal that implies collateral impairment of 80% rather than the originally forecasted 35%.
- In reliance on the depressed appraised value, the AI recognizes an $80 charge off under the provisions of the SLA, resulting in an increase in the indemnification asset to $63.5;
- Within 3 months of the charge off, the AI is paid $64 under the reimbursement provisions of the SLA. Since the indemnification asset was originally discounted to fair value, the reimbursement of $64 would reduce the balance of the indemnification asset to 0- leaving $0.50 of accretion income.
- When the collateral is subsequently sold at the end of the 36th month, the estimated proceeds of $74.8 will reduce the book value of the loan to 0-, produce a recovery of $45 against the prior charge-off, and yield accretion income of $9.8.
- Within three months of the collateral sale, the AI will refund $36 to the FDIC reflecting 80% of the recovery realized upon collateral liquidation.
- The yield on the combined cash flows will increase to 12.48% from the originally forecasted 5% due to the AI’s ability to secure payments from the FDIC based on aggressive charge off taken at inception of the SLA.

**Accelerating the Timing of Recovery through Reimbursements:**

To insure that a Purchased Impaired Loan falls into the latter scenario rather than the former, the AI must focus on maximizing recovery under the SLA, rather than maximizing recovery under the loan.

To dissuade AI’s from taking steps that are contrary to their duties under the SLA, the FDIC provides periodic guidance in the form of *Interagency Policy Statements; Risk Sharing Asset Management Guidance* (“RSAM”); and *Letters to Assuming Institutions*16 (“AI Letters”) (collectively, the “Guidance”). The Guidance provides clarification and interpretation of various aspects of SLA management and reporting. Much of the Guidance is focused on avoiding exactly the type of abuse that allows an AI to manipulate the SLA provisions for its own economic gain. These include:

**Interagency Policy Statements:**

- The Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts (October 2009)

**Letters to Assuming Institutions:**

- October 7, 2011: Environmental Issues and Expenses under Shared-Loss Agreements
- December 14, 2011: Assuming Institutions with Non-Single Family/ Commercial and Other Asset/ Commercial Shared-Loss Agreements (Modification to the definition of Permitted Amendments to encourage sustainable loan restructurings)
- October 9, 2012: Assuming Institutions with Shared-Loss Agreements (Portfolio Sales)

**RSAMS:**

- Guidance RSAM-2010-009 Commercial Loss Mitigation Guidance

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16 Copies of existing RSAM’s and Letters to Assuming Institutions can be found at: http://www.fdic.gov/bank/individual/failed/lossshare/RSAM_guidance.html
On October 30, 2009, the OCC and FDIC jointly issued a Policy Statement on Prudent Commercial Real Estate Loan Workouts (the “Policy Statement”). This policy was intended to update and replace existing supervisory guidance to assist examiners in evaluating an institution’s efforts to renew or restructure loans to creditworthy commercial real estate borrowers. As such, the Policy Statement, coupled with the guidance provided in the OCC Comptroller’s Handbook, establish the Examination Criteria by which an AI’s compliance with the terms of the SLA are measured. The following excerpts from the Policy Statement demonstrate a clear willingness, if not encouragement, on the part of regulators to facilitate meaningful and reasonable workout strategies that focus on maximizing recovery, even if doing so delays the resolution of the debt.

1. Renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.

2. The primary focus of an examiner’s review of a commercial loan, including binding commitments, is an assessment of the borrower’s ability to repay the loan. The major factors that influence this analysis are the borrower’s willingness and capacity to repay the loan under reasonable terms and the cash flow potential of the underlying collateral or business.

18 Comptrollers Handbook A-CRE Dated November 1995 and A-RCR dated April 2001. The A-CRE Handbook was updated in August 2013, but the 1995 version was in effect during much of the term of most existing SLA’s. Likewise, banks that are regulated by the FDIC or various state agencies have similar documentation which constitute Examination Criteria.
3. The presence of a guarantee from a financially responsible guarantor may improve the prospects for repayment of the debt obligation and may be sufficient to preclude classification or reduce the severity of classification.

4. Loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not adversely classified.

5. The loan’s record of performance to date should be considered when determining whether a loan should be classified. As a general principle, examiners should not adversely classify or require the recognition of a partial charge-off on a performing commercial loan solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.

6. Many borrowers whose loans mature in the midst of an economic crisis have difficulty obtaining short-term financing or adequate sources of long-term credit due to deterioration in collateral values despite their current ability to service the debt. In such cases, institutions may determine that the most appropriate and prudent course is to restructure or renew loans to existing borrowers who have demonstrated an ability to pay their debts, but who may not be in a position, at the time of the loan’s maturity, to obtain long-term financing. The regulators recognize that prudent loan workout agreements or restructurings are generally in the best interest of both the institution and the borrower.

7. The institution is responsible for reviewing current collateral valuations (i.e., an appraisal or evaluation) to ensure that their assumptions and conclusions are reasonable.

This Policy Statement provides detailed guidance as to what the regulators define as prudent banking practices and sound business judgment in the management of commercial real estate loans. However, as demonstrated, following this guidance, while required by the SLA and in the best interest of the FDIC and the borrower, places the AI at risk of not meeting its originally forecasted liquidation timeline.
The Guidance, in general, advocates for longer term resolution in cases in which the debtor and/or collateral demonstrate some ability to enhance the eventual recovery. This often conflicts with the AI’s expectations the initial cash flow assumptions. As noted earlier, the failure to achieve the dollar amount of expected recovery is 80% to 95% hedged by the SLA reimbursement rights, but the failure to meet the timing expectations of recovery result in the AI absorbing 100% of the loss associated with such delays.19 Faced with following the Guidance which would maximize recovery under the loan and minimize reliance on the SLA reimbursements, but result in charges to the ALLL due to fair value adjustments for longer than expected recovery timeframes; many AI’s opt to ignore or mask a loan’s eligibility for restructure.

As referenced herein, the shifting of expected cash flow from recovery under the loan to recovery under the SLA requires three steps:

1) **Place the loan in default:** Examination Guidelines as well as the Guidance generally prohibits the recognition on loans that are performing. As such, before any loss can be reimbursed, a loan must be considered to be in default and placed in a non-performing status.

2) **Identify and realize reimbursable credit losses:** Once the loan is deemed to be defaulted and in a non-performing status, credit losses can be recognized and reimbursed;

3) **Recognizing losses quickly will enhance accretive yield:** Because of the correlation between the Purchased Impaired Loans and the corresponding Indemnification Asset, the recognition of a loan loss results in an immediate and largely offsetting increase in the Indemnification Asset. Effectively converting a loan asset, valued based on the long term discounted cash flow from the borrower and collateral, to a short term receivable due from a government sponsored entity. By realizing credit losses quickly, the AI quickly reduces the outstanding fair value of the Purchased Impaired Loans and likewise reduces the likelihood that timing of recovery will become an issue that causes charges to the ALLL.20

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19 Notably, we find that in SLA’s with a very high First Loss Tranche, or in which a “Donut Hole” tranche is employed, the AI is more likely to adopt the Guidance since the benefit of the reimbursement hedge is severely if not completely diminished.

20 In early SLA’s which provided for a 95% reimbursement tranche, many institutions were able to achieve the 95% reimbursement tranche within two quarters of the acquisition date. Once this threshold is reached, the credit loss component of fair value calculation becomes di-minimis and the AI’s accretion risk is limited solely to the timing of liquidation.
How to recognize abuse of an SLA:

Identification of the abuses referenced herein can be difficult since, in most cases, the decision processes that facilitate the abuse are subjective in nature and will undoubtedly be defended as demonstrative of the AI’s “best business judgment”. Moreover, I have found that in many cases, the strategic decisions directing an AI’s general attitude toward resolution alternatives are made at higher management levels and that the account officers implementing these strategies are merely responding to management directives. In fact, at some AI’s the account officers actually managing loans are not provided with training in regard to Guidance, or worse, are not aware that the Guidance exists.

Regardless of the AI’s defense or objections, the FDIC has diligently provided Guidance that demonstrates what, in the opinion of the FDIC and other financial regulators, constitutes “usual and prudent banking practices”. As such, the process of identifying and seeking remedies for AI abuse is best executed through testing of the AI’s actual resolution decisions against the Guidance. Listed below are common areas in which deviation is most readily detectable.

Failure to conduct adequate review of collateral valuations:

The Policy Statement Excerpt #7 listed above references the requirement that the AI conduct a review of all collateral valuations to determine if the assumptions and conclusions are reasonable; however, if a loan is covered by an SLA, finding a low valuation to be unreasonable, could actually delay the recovery of that loan by preventing a charge off. In attempting to maximize recovery under an SLA, the failure to conduct proper review of appraisals often results in the understatement of collateral value. The acceptance of appraisals without adequate review demonstrates a failure to comply with prudent business practices and regulatory standards.

Failure to properly assign risk classifications:

Excerpts 1 – 6 of the Policy Statement focus on prudent decision making in conducting loan workouts. The impetus behind the issuance of this statement was the desire of the regulators to encourage the consistent application of a common sense approach to dealing with the extreme pressures placed on the commercial real estate lending market since 2008. Since the primary tool of regulators is the ability to assess risk ratings that influence the safety and soundness of a given
institution, the Policy Statement provides extensive guidance on prudent determination of risk classifications.

The OCC Comptroller’s Handbook states that “the OCC expects national banks to have credit risk management systems that produce accurate and timely risk ratings. Likewise, the OCC considers accurate classification of credit among its top supervisory priorities.” The proper determination of credit risk ratings is the cornerstone of Examination Criteria. To insure consistency in the risk rating process, the regulatory agencies having oversight of financial institutions have adopted the Classification Definitions listed below:

**Classification Definitions:**

The federal bank and thrift regulatory agencies currently utilize the following definitions for assets classified "substandard, "doubtful," and "loss" for supervisory purposes:

**Substandard Assets:** A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful Assets:** An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

**Loss Assets:** Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

The OCC Comptroller’s Handbook for Rating Credit Risk states that “a loan that is on nonaccrual or about to be placed on nonaccrual has severe problems such that the full collection of interest and principal is highly questionable.” The Handbook further references the Call Report

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21 Comptroller’s Handbook A-RCR dated April 2001  
Instructions for the criteria defining the determination of nonaccrual status. The Call Report Instructions\textsuperscript{23} for Schedule RC-N provide the following:

\textit{Nonaccrual} – For purposes of this schedule, an asset is to be reported as being in nonaccrual status if:

1. It is maintained on a cash basis because of deterioration in the financial condition of the borrower,

2. Payment in full of principal or interest is not expected, or

3. Principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.

An asset is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. An asset is "in the process of collection" if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or, (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

It is in the area of loan classification and accrual status that the regulators clearly define the standards for usual and customary banking practices. Ironically, regulators are accustomed to arguing \textit{for} adverse treatment of loans while the Banks are \textit{opposing} such treatment. In the case of an SLA, the roles are reversed. Unfortunately, since different divisions of the FDIC\textsuperscript{24} are responsible for bank supervision and loss share oversight, the FDIC may in fact be aiding in its own fleecing by not questioning the aggressive loan grading and performance decisions of AI’s.

Generally speaking, upward grading movements are heavily scrutinized by examiners while the documentation supporting downgrades or charge offs is not subject to the same scrutiny. This treatment is logical considering that the mission of the Division of Risk Management Supervision is to examine and supervise financial institutions for safety and soundness rather than to assist the Resolutions Division in maximizing recovery of failed bank assets. As such, it would be highly unusual for a bank regulator to investigate or criticize the realization of a loss.


\textsuperscript{24} Bank safety and soundness examinations are under the Division of Risk Management Supervision while management of SLA’s are under the Division of Resolutions and Receivership
Regardless, the apparent absence of oversight in preventing unwarranted downgrades and losses is the cornerstone on which the entire scheme of SLA manipulation is built. The successful accomplishment of these administrative actions opens the door to abuse of the SLA.

**Failure to conduct thorough resolution planning that would maximize recovery:**

Once the losses are realized and reimbursed, the fate of the borrower is sealed in terms of missing the opportunity to effectuate a prudent workout. Having successfully convinced the FDIC that a loan is partially or completely unrecoverable, and being paid under the SLA reimbursement provisions, the sole remaining task of the AI is to insure that the collateral is liquidated and that the collection efforts have been “maximized”. Since the AI’s financial interest has been significantly reduced and its credit risk fully hedged, the sole purpose of finalizing these final steps is to maintain the impression of compliance with the SLA.

This scenario is different than the typical resolution planning that an AI would conduct on a loan without loss share coverage primarily due to the fact that in insuring timely recovery under the SLA, the AI in all likelihood extinguished many of the viable resolution options that would have otherwise been available.

Normally, when a loan is classified as a distressed debt, it becomes necessary for the AI to conduct thorough resolution planning, taking into consideration its duty to the FDIC to maximize collections. The resolution planning process requires the lender to assess the available resolution alternatives and the risk adjusted cash flows associated with each potential alternative.  

After determining the resolution alternative with the highest risk adjusted recovery, the plan must then identify the milestones events and the expected timing in order properly monitor the execution of the plan as well as establish if or when changes to the resolution plan are warranted.

In many cases, if the AI had conducted a reasonable assessment of resolution alternatives and properly assessed the likely outcome of each available alternative, the resolution analysis would have resulted in extension of the maturity date, either in accordance with the AI’s existing Loan Policy or as suggested in the Policy Guidelines. Instead, due to the potential impact on income

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25 Guidance RSAM-2010-009 Commercial Loss Mitigation Guidance
accretion under Topic 310-30, many AI’s either fail to consider the available resolution alternatives or exercise imprudent and unsound decision making criteria in selecting a resolution alternative that is in direct conflict with the Policy Statement and Examination Criteria, but produces a higher investment yield through improper reliance on SLA reimbursement.

Together, an AI’s failure to define and document an effective resolution plan, or in the alternative, consider a prudent loan workout in accordance with the Policy Statement; coupled with their improper determination of risk classification, acceptance of appraisals that are fundamentally flawed, the designation of nonaccrual status and the recognition of unwarranted losses signal a deliberate and bad faith strategy of de-valuing a loan. While on the surface, this strategy would defy conventional logic, the motive behind this strategy becomes clear when taking into consideration the unique circumstances associated with the combination of loss-sharing and Business Combination accounting.

**Summary:**

If an AI’s manages a Loan in a fashion that **maximizes the AI’s yield under ASC 310-30** rather than **maximizing the recovery with respect to the loan** (as required under the SLA), the FDIC may enforce its remedies under the SLA of refusing to honor the reimbursement provisions. However, through systematic processing of downgrades and losses an AI can conceal the strategy and increase its yield on the acquisition investment.

Unfortunately, a borrower or guarantor becomes collateral damage in a complex financial scheme in which he finds himself “worth more dead than alive” and is denied the opportunity to propose a good faith resolution that would benefit all parties. Too often, in the AI’s efforts to receive premature or unwarranted recovery from the FDIC under an SLA, the borrower loses the valuable negotiation tool of being the least costly resolution alternative, because the SLA provisions coupled with the Topic 310-30 accounting treatment provide a lower risk and more timely alternative to a lender who is willing to ignore contractual and fiduciary duties.

By fabricating losses through understatement of loan performance and collateral value, an AI is able to effectively accelerate the timing of cash flows. This acceleration increases the effective yield on investment in the loan.
Even if the amount of expected recovery amount remains unchanged, the SLA reimbursements essentially become an interest free advance to the AI during the term of the recovery period.\textsuperscript{26} Likewise, it provides a hedge against the usual risk of imprudent lending procedures. If in fact the actions of the AI result in actual losses, the protections provided by the SLA would require the FDIC to absorb 80\% - 95\% of those losses.

In essence, the SLA provides an unintended yield protection to a lender who is willing to manipulate the loan recovery process in contradiction to the intent of the FDIC and FIRREA.

Any purchaser of distressed debt is motivated to shorten the collection timeline to increase their yield. AI’s seeking to maximize investment yield at the expense of the FDIC and borrowers systematically employ a strategy to achieve this goal through complete disregard and violation of the contractual obligations to the Debtor as well as the FDIC. Such action is not typical in the distressed market because the risk of extended litigation, lender liability, and the general market risk associated with collection of distressed debt often outweighs the incremental yield above the yield that could be obtained in a prudent and consensual resolution. However, when factoring in the significant benefit of fabricated and premature reimbursements under the SLA, the yield increase becomes significant enough to tempt any AI. This temptation becomes greater if the AI knows that the cost of any additional loss resulting from such imprudent behavior will be largely borne by the FDIC rather than the AI.

The ultimate objective of the specific resolution steps employed by an unscrupulous AI is to advance the timing of recovery of its investment to yield a greater profit on the loan under the provisions of ASC 310-30 at the expense of the FDIC\textsuperscript{27} and the Debtor.

\textsuperscript{26} In the event losses are eventually recovered, the AI will reimburse the FDIC for loss reimbursements previously received.

\textsuperscript{27} It is significant to note that the FDIC, as a provider of deposit insurance, merely passes these losses along to other member banks, including Plaintiff, in the form of increased deposit insurance premiums. These banks, in turn, must pass these higher insurance premiums along to the consumers of bank services.