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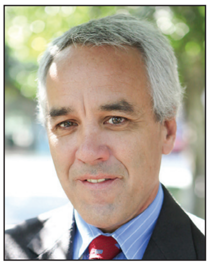
The Loss-Share Loophole



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The loss-share loophole is the result of the abuse of provisions within typical shared-loss agreements (SLAs) used by the Federal Deposit Insurance Corp. (FDIC) to provide purchasers of failed banks with reimbursement rights as a "backstop" for credit losses. Improper manipulation of these reimbursement rights by the acquiring institutions (AIs) can favorably impact the timing of cash flows and profitability of the AI, which is the primary motive for the abuse that has been and continues to be perpetrated by many of these AIs.

The FDIC has relied heavily upon the use of SLAs to maximize the liquidation value of failed banks. When an AI executes its duties in good faith, the SLA is a good tool that can not only serve to minimize losses to the deposit insurance fund, but also minimize the impact of bank failures on the overall real estate market. However, like many well-intentioned regulatory initiatives, private enterprise is rarely outdone in its quest to find a loophole that can create a financial windfall, even if the loophole violates the spirit and intent of the regulatory initiative.

When properly executed in good faith, SLAs can allow the FDIC to maximize the liquidation value of failed bank assets. In exchange for the risk mitigation provided by an SLA, AIs are required to employ prudent resolution strategies that maximize the recovery under the covered assets. However, if the AI views loss-share reimbursements as a *source of cash flow* rather than a *backstop to losses*, the SLA can become a tool to facilitate unscrupulous behavior that can harm borrowers and the FDIC.

SLA provisions governing the duties of the AI provide a wide latitude for interpretation and potential abuse. These subjective terms, combined with the mechanics of purchase accounting, can create a timing incentive for the AI to speed up and create credit losses quickly. This can result in an AI benefiting by immediately shifting the credit risk onto the FDIC while simultaneously accelerating the timing of cash flows to maximize its yield. An unscrupulous AI can have a financial motive and the means to guarantee itself a substantially higher investment yield by ignoring its legal and contractual obligations and duties to the FDIC and the borrowers, while also prematurely triggering the SLA's reimbursement provisions to obtain reimbursement from the FDIC for fallacious credit losses.

The Motive: Purchase Accounting

At acquisition, the fair value of a purchased impaired loan[1] is determined by the net present value of expected cash flows from the loans. The expected cash flow in excess of the consideration paid for a loan represents "accretable yield" that is recognized from an accounting perspective as income over the life of the loan. In other words, accretable yield is the expected rate of return on investment. Any expected cash flows from reimbursement rights payable by the FDIC are separately accounted for at a fair value.

If the actual cash flows occur faster than the projected timeframe, the accretable yield will be adjusted upward to reflect the improved timing. This creates a strong financial incentive for the AI to compress the timing of recovery. In contrast, if a loan is collected over a longer-than-anticipated timeframe, accounting standards require that the basis in the loan be reduced through a charge to the allowance for loan losses, in an amount that is required to maintain the originally forecasted accretable yield.

While the reimbursement provisions of SLAs provide a backstop to credit losses, the SLA provides no backstop for losses that occur as a result of the timing of collection, which is the primary motive for the abuse perpetrated by many AIs. It also dissuades an AI from giving favorable consideration to a prudent workout if doing so results in an extended resolution term.

From the AI's perspective, prudent loan-workout strategies, such as working with borrowers who have the ability and inclination to pay, do not result in immediate reimbursement from the FDIC and typically consume more time than a liquidation strategy, so this otherwise-favorable alternative could result in losses. To avoid losses attributed to "better than expected loan performance," some AIs have adopted resolution strategies to ensure that this scenario does not arise. While directly in conflict with the spirit of the SLA, an AI can favorably impact its yield through the manipulation of both the timing and amount of the recovery by treating the loan and the reimbursement rights as interchangeable sources of cash flow.

An AI desiring to increase its accretable yield at the expense of the borrowers and the FDIC has at times a strong incentive to ignore contractual and fiduciary duties under the SLA. The reim-

1 These are loans that, at the time of acquisition, demonstrate evidence of deterioration of credit quality, and it is probable that the acquirer will be unable to collect all contractually required payments.

bursement rights under the SLA provide the AI with a separate source of recovery that is inversely correlated to the expected recovery under the loans. This integration provides the means, through the subornation of SLA reimbursements, to significantly reduce the timing of recovery by taking advantage of this loophole to provide a significantly higher return on investment.

The Means: Accelerating Reimbursements

To dissuade AIs from pursuing resolution strategies that are contrary to their duties under the SLA, the FDIC provides periodic guidance in the form of interagency policy statements,[2] risk-sharing asset-management guidance (RSAM) and letters to assuming institutions[3] (collectively, the "guidance"). The guidance provides clarification and interpretation of various aspects of SLA management, and much of it is focused on deterring the types of abuses that allow an AI to manipulate the reimbursement provisions for its own economic gain.

The guidance provides detailed information as to what the regulators define as "prudent banking practices" and "sound business judgment" in the management of covered loans. However, following this guidance, even though it is in the best interest of the FDIC and the borrower, could place the AI at risk of not meeting its original liquidation timeline, resulting in adverse accounting treatment.

The guidance generally advocates for longer-term resolution in cases in which the borrower and/or collateral demonstrate some ability to enhance the aggregate recovery. This often conflicts with an AI's expectations in the initial cash-flow assumptions. As previously noted, losses related to the failure to achieve the dollar amount of an expected recovery are 80 to 95 percent hedged by SLA reimbursement rights, but the failure to meet the timing expectations of recovery results in the AI absorbing 100 percent of the loss associated with such delays. Faced with following the guidance to maximize recovery under the loan and minimize reliance on the reimbursements, or risk earnings impairment resulting from longer-than-expected recovery timeframes, many AIs opt to conveniently ignore a loan's eligibility for restructure. The shifting of expected cash flow from recovery under the loan to recovery under the SLA requires the following three steps:

1. *Place the loan in default.* Examination criteria[4] and the guidance generally prohibit the recognition of losses on loans that are performing. As such, before any loss can be reimbursed, a loan must be in default and placed in a nonperforming status.
2. *Identify and realize reimbursable credit losses.* Once the loan is deemed to be defaulted, credit losses can be recognized and reimbursed.
3. *Recognizing losses quickly will enhance accretive yield.* The recognition of a loss results in an immediate and largely offsetting increase in the FDIC reimbursement rights. The result of this loss recognition is to effectively convert a loan asset that is valued based on the long-term discounted cash flow from the borrower and collateral into a short-term receivable due from the FDIC. By quickly realizing credit losses, the AI reduces the outstanding fair value of the purchased impaired loans and likewise reduces the likelihood that timing of recovery will become an issue that will impact the AI's earnings.

How to Recognize Abuse of an SLA

Identification of the aforementioned abuses 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, in many cases, the strategic decisions directing an AI's general attitude toward resolution alternatives are made at higher management levels, and the account officers implementing these strategies are merely responding to management directives. In fact, at some AIs, the account officers actually managing loans are not provided with training in regard to the guidance, or worse, are not aware that the guidance exists or have no approval authority and have to seek higher-level approval for all decisions related to loan management.

Regardless of the AI's defense or objections, the FDIC has diligently provided the guidance that demonstrates what constitutes "usual and prudent banking practices." As such, the process of identifying and seeking remedies for AI abuse is best executed by testing the AI's actual resolution decisions against the guidance. Listed below are common areas that deviation is most readily detectable.

Failure to Conduct Adequate Review of Collateral Valuations

The guidance provides that "[t]he institution is responsible for reviewing current collateral valuations to ensure that their assumptions and conclusions are reasonable."[5] 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.

An Aggressive Downgrade to Risk Classifications

Examination criteria and the guidance clearly define the standards for usual and customary banking practices in terms of risk classifications. In the ordinary situation, regulators argue *for* adverse classification of loans while the banks *oppose* such treatment. In the case of an SLA, however, the roles are reversed. Unfortunately, since different divisions of the FDIC[6] are responsible for bank supervision and SLA oversight, the FDIC may in fact be aiding in its own fleecing by not questioning the forceful downgrades and aggressive write-downs of loans by AIs.

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

2 Policy Statement on Prudent Commercial Real Estate Loan Workouts (2009), www.fdic.gov/news/news/financial/2009/fil09061a1.pdf.

3 Copies of existing RSAMs and letters to assuming institutions can be found at www.fdic.gov/bank/individual/failed/lossshare/RSAM_guidance.html.

4 The SLA cites examination criteria as the standard by which losses under the SLA are recognized.

5 Policy Statement on Prudent Commercial Real Estate Loan Workouts (2009), www.fdic.gov/news/news/financial/2009/fil09061a1.pdf.

6 Bank safety and soundness examinations are under the Division of Risk Management Supervision, while management of SLAs are under the Division of Resolutions and Receivership.

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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.

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 downgrades opens the door to abuse of the SLA.

Failure to Conduct Thorough Resolution Planning that Would Maximize Recovery

Once the losses are realized by the AI and reimbursed by the FDIC, the fate of the borrower is sealed as there is little to no opportunity to effectuate a prudent workout. In many instances, the actions taken to facilitate rapid reimbursement have extinguished many of the viable resolution options that would have otherwise been available.

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 ensure that the collateral is liquidated and 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 these final steps is to maintain the impression of compliance with the SLA.

When a loan is classified as impaired, it normally 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 that are associated with each potential alternative.[7]

In many cases, if the AI had conducted a reasonable assessment of resolution alternatives and properly assessed the likely outcome of each available alternative (without regard for the temptation of immediate recovery under the SLA), the prudent resolution alternative would have been the extension of the maturity date, either in accordance with the AI's existing policies and procedures or as suggested in the guidance. Instead, due to the potential impact on income accretion under purchase accounting, many AIs 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 guidance but produces a higher investment yield through improper reliance on SLA reimbursement.

Conclusion

An AI's failure to define and document an effective resolution plan or consider a prudent loan workout in accordance with the guidance — coupled with improper determination of risk classification, acceptance of appraisals that are fundamentally flawed, and the recognition of unwarranted losses — can signal a deliberate and bad-faith strategy of devaluing a loan to the detriment of the FDIC, borrower and real estate market as a whole. While on the surface this strategy would defy conventional logic, the motive behind this strategy becomes clear when taking into consideration the unique circumstances that are associated with the combination of loss-sharing and purchase accounting.

Any distressed-debt purchaser is motivated to shorten the collection timeline to increase its yield. AIs seeking to maximize investment yield at the expense of the FDIC and borrowers systematically employ a strategy to achieve this goal through a complete disregard and violation of the contractual obligations to the borrower and the FDIC.

If an AI manages a loan in a fashion that *maximizes its yield under purchase-accounting* rather than *maximizing the recovery with respect to the loan*, the FDIC may enforce its remedies under the SLA by 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 investment. Unfortunately, borrowers become collateral damage in a complex financial scheme in which they find themselves "worth more dead than alive" and are denied the opportunity to propose a good-faith resolution that would benefit all parties. abi

7 Guidance RSAM-2010-009 Commercial Loss Mitigation Guidance (2010), https://www.fdic.gov/bank/individual/failed/lossshare/Guidance_RSAM-2010-009_Commercial_Loss_Mitigation_Guidance.pdf.