FDIC Loss-Sharing Agreements: A Primer

Through decades of experience acting as the receiver of failed financial institutions, the FDIC has developed a variety of resolution structures designed to reduce the Deposit Insurance Fund's costs and enhance the attractiveness of closed bank franchises. As the current banking crisis has evolved, the Corporation has increasingly used a resolution structure known as a loss-sharing agreement (LSA).

LSAs were first introduced into selected failed institution acquisitions in 1991. The FDIC's goal when using an LSA is to sell the majority of a failed institution's assets to an acquiring institution and have the purchaser manage the assets in a manner that benefits itself and the FDIC. LSAs reduce the FDIC's immediate cash needs, are operationally simpler and more seamless to customers of failed institutions, and move assets quickly into the private sector. Acquirers of failed institutions view the LSA structure as attractive because the FDIC's loss coverage provides substantial downside protection against losses on covered assets. The terms of a loss-sharing transaction are set forth in the LSA, which supplements the FDIC's Purchase and Assumption Agreement with the acquiring institution.

Although the accounting and examination issues concerning LSAs are complex, from a supervisory perspective there is no credit risk arising from the portion of assets covered by the FDIC's protection except as noted below. In the context of rendering a credit risk assessment, covered assets can generally be compared to other federal loan guarantee programs. Accordingly, examiners generally will not subject the portion of assets covered by an LSA to adverse classification or other criticism provided the acquiring institution complies with the terms of the LSA.

This article discusses the key supervisory considerations for LSAs, including a summary of loss-sharing structures, an overview of examination procedures for reviewing assets covered by LSAs, important accounting and loan loss allowance issues, and guidelines for establishing adverse classifications.

Typical Loss-Sharing Agreement Structures

LSAs come in two forms, with both types covering credit losses and reimbursement of certain types of expenses (such as advances for taxes and insurance, sales expenses, and foreclosure costs) associated with troubled assets. The first form is for commercial assets and the second for residential mortgages. For commercial assets, LSAs typically cover an eight-year period with the first five years for losses and recoveries and the final three years for recoveries only. For single-family mortgages, LSAs normally run 10 years. The FDIC provides loss coverage on three primary single-family mortgage loss events: modification, short sale, and foreclosure; for certain second liens, loss coverage is also provided for charge-offs. For losses on covered commercial 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.[1] Under both agreements, losses from bulk sales are allowed only if the FDIC approves the sale ahead of time (i.e., sales are not allowed unless the FDIC provides its consent).

[1] Details on FDIC LSAs can be found at http://www.fdic.gov/bank/individual/failed/lossshare/index.html.

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Although bidding procedures have varied over time, a primary component of each bid is the asset premium (discount) bid. For most transactions, three factors determine the size of the initial FDIC cash payment to the acquirer: the asset premium (discount) bid, the franchise value bid for the failed institution's deposit base, and the difference between the book values of the assets acquired and the liabilities assumed from the failed institution. If the combination of these items is negative, the FDIC makes an offsetting up-front payment to the acquirer. For recent transactions, if the combination of these items is positive, the acquirer makes an up-front payment to the FDIC for that amount. For many earlier transactions, a positive number would result in a "first loss tranche." The first loss tranche is essentially a deductible, where FDIC loss coverage is provided only after losses exceed the amount of the first loss tranche. Due to changes in bidding procedures over time, a few recent transactions have a first loss tranche even though the acquirer received an up-front cash payment from the FDIC.

In most transactions to date, the FDIC reimburses 80 percent of the losses incurred by the acquirer on covered assets, with the acquiring institution absorbing 20 percent (once the first loss tranche, if any, is exhausted). However, there have been a few transactions where the FDIC has provided a lower level of coverage.

For transactions that occurred before April 2010, 80 percent loss coverage is provided up to a stated threshold amount (generally the FDIC's dollar estimate of the total projected losses on covered assets).[2] Once losses exceed the stated threshold amount, the FDIC provides 95 percent loss coverage.

Considerations for Reviewing LSAs During Bank Examinations

Examinations of banks that have acquired assets of failed institutions under an LSA will take into account the implications and benefits of loss sharing. Examiners will consider the impact of LSAs when performing the asset review, assessing accounting entries, assigning adverse classifications, and determining CAMELS ratings and examination conclusions. In many cases, examiners may discuss and review LSA issues with acquiring institutions prior to the next regularly scheduled examination through visitations or other interim supervisory contact points.

During the pre-examination planning phase of on-site reviews, examiners will obtain a copy of any loss-sharing agreement and closely review the terms.[3] The examination asset review will include a sample of commercial assets covered by LSAs, the volume of which will provide the examiner-in-charge with sufficient information to assess whether the acquiring institution applies its loan administration processes, credit risk management policies (including its loan review

[2] On March 26, 2010, the FDIC indicated that it would no longer offer 95 percent loss coverage for losses above a stated threshold, but generally would offer 80 percent reimbursement for all losses, as defined in the LSA, on covered assets. Thus, in some cases, the FDIC may enter into an LSA that provides reimbursement for losses at a percentage other than 80 percent (e.g., 50 percent). These changes do not alter the terms of earlier LSAs that provide for 95 percent loss coverage above a stated threshold.

[3] If a copy of an LSA between the bank being examined and the FDIC has not already been obtained, the LSA can be accessed via the "Failed Bank List" at http://www.fdic.gov/bank/individual/failed/banklist.html. Click on the name of the failed institution acquired by the bank being examined, and the LSA is included as part of the "Purchase and Assumption Agreement" shown on the list of information available for the failed institution.

and credit grading policies), and loss recognition and charge-off standards to covered commercial assets in a manner consistent with its treatment of commercial assets not covered by LSAs.[4] For covered single-family residential mortgages, the scope of asset reviews will be similar to a regular examination of such assets. The LSA and the covered assets are not being examined per se. LSAs are a risk mitigant and will be considered when assigning classifications and determining examination conclusions. However, if nonconformance with the terms of an LSA is apparent during an examination, examiners should contact the appropriate regional office which will advise the FDIC's Division of Resolutions and Receiverships of identified issues.

Assets covered by an LSA can potentially expose an acquiring institution to partial loss (similar to some government-guaranteed loan programs). However, the portion of assets that the FDIC would cover under an LSA generally will not be subject to criticism (unless the contractual terms of the LSA have not been met by the acquirer) because loss sharing represents a conditional guarantee from the FDIC. Acquiring institutions should recognize that examiners will review banks' efforts to implement the homeownership preservation initiatives specified in the LSA and the October 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts.*[5]

Accounting Treatment for Acquisitions with LSAs

The acquisition of a failed institution should be accounted for as a business combination in accordance with generally accepted accounting principles (GAAP).[6] The accounting for acquisitions of such institutions with FDIC assistance in the form of LSAs is complex, particularly because of the fair values that must be estimated (with limited exceptions) for the assets acquired, including an indemnification asset,[7] and liabilities assumed as of the acquisition date of the failed institution. In addition, the acquired covered assets and the indemnification asset, despite the linkage between them, are treated as separate units of account. Because an acquiring institution will have had limited time to perform due diligence with respect to these assets and liabilities before the acquisition, initially it will need to record provisional fair value estimates as of the acquisition date. As a consequence, the acquiring institution will need to retrospectively adjust the provisional amounts booked as of the acquisition date as it obtains the information

[4] Because an LSA subjects an acquiring institution to a number of contractual requirements, the institution must implement effective internal processes over covered assets (including consistency in the treatment of covered and non-covered assets) to maintain the loss-sharing guaranty, which underpins the indemnification asset. An acquiring institution's failure to comply with the contractual requirements of an LSA may lead to the revocation of the agreement, which would necessitate the write-off of the related indemnification asset.

[5] *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, October 30, 2009, http://www.fdic.gov/news/news/financial/2009/fil09061.html.

[6] See Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 805, Business Combinations, which was formerly referred to as FASB Statement No. 141(R), *Business Combinations*. General guidance on the application of the acquisition method of accounting under ASC Topic 805 is presented in "Accounting News: Accounting for Business Combinations" in the Winter 2008 issue of ***Supervisory Insights*** (http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin08/si_win08.pdf).

[7] An "indemnification asset" represents an acquiring institution's right to receive payments from the FDIC for losses on assets covered under an LSA. This indemnification asset is measured at an amount that takes into account the institution's estimate, on a present value basis, of the amount and timing of the expected future cash flows to be received from the FDIC as reimbursable losses occur on the covered assets.

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necessary to appropriately measure the acquisition-date fair values during the accounting measurement period (of not more than one year) after acquisition that is set forth in GAAP.

Under GAAP, no entries to the allowance for loan and lease losses (ALLL) should be recorded for the covered loans as of the acquisition date; however, the ALLL will subsequently be affected by any credit deterioration in covered held-for-investment loans after acquisition. Subsequent (post-acquisition) entries also are needed to reflect the effect of transactions and other events on the covered assets and the indemnification asset.

At the first examination after a failed institution's assets are acquired, examiners will determine the status of the acquiring institution's efforts to complete the accounting for the acquisition, including required fair value measurements. The acquirer's records will be reviewed to determine the appropriateness of the accounting for the acquisition, including whether the fair value measurement process for the covered assets and the related indemnification asset has been completed and, if so, whether these assets have been booked at reasonable fair value estimates that have been properly documented and supported. This review also will include any entry that increased earnings and, hence, capital as a result of a gain on bargain purchase. Examiners also will verify that the acquiring institution has instituted procedures to ensure subsequent LSA-related entries conform to GAAP. Accounting for LSAs will be reviewed during visitations and subsequent examinations to ensure the acquiring institution's financial and regulatory reporting for the covered assets and the indemnification asset remains appropriate. The extent of these reviews of the acquiring institution's accounting will be determined based on the materiality of the acquisition, including any gain on bargain purchase recognized in earnings and capital.

Given the complex nature of accounting for LSAs, acquiring institutions are encouraged to consult with their accountants to ensure that initial and ongoing entries are measured and recorded properly. In addition, examiners may wish to contact internal regulatory accounting resources for support, particularly if significant accounting issues are evident.

Capital Implications from Bargain-Purchase Accounting Rules for Business Combinations

In a failed institution acquisition, the fair value of the identifiable assets acquired less the fair value of the liabilities assumed may exceed the fair value of any consideration that the acquiring institution transferred to the FDIC as receiver to effect the business combination. In this situation, the excess, previously referred to as "negative goodwill," should be recognized immediately as a bargain purchase gain in earnings, thereby resulting in an increase in both GAAP equity capital and regulatory capital.

The FDIC's capital standards do not contain any limitation on the regulatory capital recognition of a gain on a bargain purchase arising from a business combination. However, an acquiring institution's regulatory capital is vulnerable to retrospective adjustments made during the measurement period of up to one year from the acquisition date. During this period, the institution is expected to promptly obtain the information necessary to appropriately measure the acquisition-date fair values of the identifiable assets acquired and liabilities assumed in the failed institution acquisition that give rise to the bargain purchase gain. Accordingly, the FDIC may not fully consider a bargain purchase gain as having the permanence necessary for a tier 1 capital component when making supervisory decisions about an acquiring institution until the measurement period has ended and examiners or external auditors have reviewed the reasonableness of its fair value measurements, including the inputs, assumptions, and valuation techniques used. For example, the FDIC may require an acquiring institution to exclude any gain on bargain purchase from the calculation of its dividend-paying capacity pending the completion of the measurement period and the examiners' or external auditors' review. Therefore, an acquiring institution should be attentive to the initial accounting for the failed bank acquisition and the efforts to be undertaken during the measurement period and seek appropriate advice from their accountants and valuation experts.

Adverse Classification of Assets Covered by an LSA

Importantly, the FDIC's reimbursement for losses on assets covered by an LSA is measured in relation to the asset's book value on the books of the failed institution on the date of its failure, not in relation to the acquisition-date fair value at which the covered asset must be booked by the acquiring bank. When the acquiring bank initially recognizes the indemnification asset at its fair value as of the acquisition date, the fair value estimate will take into account the expected amount of losses on covered assets for which the FDIC will reimburse the bank under the LSA. If the acquiring bank determines there is further credit deterioration on covered assets after acquisition, which will increase the losses on these assets compared to the losses estimated as of the acquisition date, it will increase the carrying amount of the indemnification asset to recognize the effect (on a present value basis) of the increased payments to be received from the FDIC for the percentage of losses for which the acquiring bank will be reimbursed under the LSA. Thus, because of the unique accounting that applies to the indemnification asset, the LSA provides protection from a classification standpoint only for additional losses on covered assets beyond those the acquiring bank already has considered when measuring the carrying amount of the indemnification asset.

When evaluating a covered asset for classification purposes, examiners will assess whether the asset should be classified without regard to the protection afforded by the LSA. Examiners evaluate the collectibility of the amount at which the covered asset is reported on the balance sheet, not its unpaid principal balance. If adverse classification of a covered asset is warranted, examiners then will consider the extent of the protection provided by the LSA when determining the portion of the covered asset to be classified. In general, the amount that would otherwise be adversely classified should be reduced by the currently applicable loss coverage rate (normally 80 percent or 95 percent) provided by the FDIC under the LSA.[8]

In addition, as the end of the five- or ten-year LSA reimbursement period nears, examiners need to consider whether any loss on a covered asset is likely to arise before the end of this period. If not, the LSA would not provide protection and should not affect any adverse classification to be assigned to the covered asset.

[8] In cases where a first loss tranche has not yet been exhausted as of the examination date, examiners should also take into account the remaining amount of losses that the acquiring institution must absorb before FDIC loss coverage is provided.

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Risk Weighting of Assets Subject to LSAs

The FDIC's general risk-based capital rules[9] recognize third-party guarantees provided by central governments, U.S. government-sponsored entities, public-sector entities in OECD countries, multilateral lending institutions and regional development banks, depository institutions, and qualifying securities firms in OECD countries. The general risk-based capital rules allow a bank to apply the risk weight of the guarantor, instead of the underlying obligor, in determining the institution's risk-based capital requirements. If a claim is partially guaranteed, the portion of the claim that is not fully covered by the guarantee is assigned to the risk category appropriate to the obligor or, if relevant, the collateral.

LSAs are unique in terms of structure and guarantor. The guarantee amount is based on the book value of the covered assets on the failed institution's books on the date of failure. By contrast, the risk-based capital rules' treatment of guaranteed assets generally is based on the carrying amount of the assets. As mentioned above, business combination accounting standards under GAAP require that a bank record the identifiable assets acquired at their acquisition-date fair values. In many cases, covered assets such as loans are written down to fair values that are substantially lower than their unpaid principal balances to reflect expected credit losses and current market conditions. In contrast, the LSA is based on the failed institution's book value for these assets (which may be the unpaid principal balance of covered loans); therefore, the LSA may cover most or all of the balance sheet losses to the acquirer.

An LSA typically contains various conditions an acquiring institution must adhere to for a claim submitted to the FDIC to be paid. For example, restrictions may exist on the advancement of funds for an unfunded loan commitment or on how a loan may be modified or restructured. To maintain the loss-sharing guarantee, the acquiring institution must also apply its loan administration processes, credit risk management policies (including its loan review and credit grading policies), and loss recognition and charge-off standards to covered commercial assets in a manner consistent with its treatment of commercial assets not covered by LSAs. Thus, LSAs are considered conditional guarantees for risk-based capital purposes due to the contractual conditions that acquirers must meet.

Accordingly, an acquiring institution may apply a 20 percent risk weight to the guaranteed portion of assets subject to an LSA.[10] Because the structural arrangements for these agreements vary depending on the specific terms of each agreement, institutions should consult with their primary federal regulator to determine the appropriate risk-based capital treatment for specific LSAs.

Determining CAMELS Ratings and Overall Conclusions at Institutions Covered by an LSA

Assigned CAMELS ratings should represent an institution's overall condition, with consideration given to the LSA. Depending on the volume of covered assets relative to the institution's total assets, the indemnification provided by the FDIC may have a favorable impact on its CAMELS ratings, especially on the asset qual-

[9] 12 CFR part 325, appendix A.

[10] 12 CFR part 325, appendix A, section II.C.

ity and capital component ratings. The management component could also be impacted by the effectiveness of LSA-related accounting processes and oversight of acquired assets from a risk management and credit administration standpoint. Compliance with the terms of the LSA may be a consideration for component and composite ratings if management's actions have jeopardized the indemnification's continued coverage.

Examination conclusions at institutions with covered assets should provide a balanced view of the institution and recognize the benefits derived from the FDIC's loss indemnification. Comments regarding asset quality and capital may include a discussion of the FDIC's indemnification depending on the materiality of LSA-related assets, including the indemnification asset. Any deficiencies involving the management and administration of covered assets (such as accounting and credit administration) will be commented on in the Report of Examination.

Conclusion

Supervisory issues involving LSAs will be encountered over the next several years as acquirers of failed institution assets utilize the FDIC's loss protection for existing and prospective bank resolution cases. From a supervisory perspective, LSAs provide significant risk mitigation for acquirers while the agreement remains in force because credit losses on covered assets can result in substantial reimbursements from the FDIC. However, examiners will expect acquiring institutions to employ effective accounting, asset management, financial reporting, and risk-grading processes for LSA-related assets, including indemnification assets, given their complexity and ongoing measurement issues. The existence of these FDIC indemnification agreements should be viewed favorably in the supervisory process as the acquirer's credit risk on covered assets is contained, borrowers have an opportunity to work cooperatively with a new lender, and the Corporation and public benefit from quickly transitioning receivership assets into the private sector.

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