



Why We Did The Audit

We conducted a performance audit of the FDIC's structured transactions with Rialto Capital Management, LLC (Rialto) in response to a request, dated October 13, 2011, from the Director of the FDIC's Division of Resolutions and Receiverships (DRR). In the request, the DRR Director noted that the FDIC had received a number of inquiries regarding various aspects of the structured transactions. Although DRR had taken steps to address the inquiries, the Director indicated that concerns surrounding these transactions remained at that time and that an independent review of the transactions was warranted.

The objectives of our performance audit were to assess (1) the FDIC's bidding and selection processes, (2) the terms and conditions of the limited liability company (LLC) sales agreements, (3) Rialto's compliance with the LLC sales agreements, and (4) the FDIC's monitoring and oversight of the LLCs. As part of our assessment of the FDIC's monitoring and oversight of the LLCs, we reviewed selected inquiries from the public pertaining to the structured transactions to determine whether the FDIC's responses were timely and supported by documentation. The independent accounting firm of BDO USA, LLP (BDO) provided assistance in the performance of the audit by conducting audit procedures to address objectives 2 and 3. The results of BDO's work are incorporated into this report.

Background

Structured transactions involve the liquidation of assets through public/private partnerships that utilize the asset management expertise of the private sector. The FDIC, as Receiver, uses structured transactions to facilitate the sale of many receivership assets that are difficult to market and sell. Such assets consist largely of distressed and non-performing single-family and commercial real estate loans and real estate owned (REO). The FDIC, as Receiver, had completed 32 structured transactions through June 30, 2012 involving 42,314 assets with a total unpaid principal balance (UPB) of \$25.5 billion. These transactions accounted for 3.8 percent of the \$676.2 billion in assets inherited by the FDIC, as Receiver, from failed institutions from January 1, 2008 through June 30, 2012.

In a structured transaction, the FDIC, as Receiver for one or more failed institutions, pools a group of similar assets, such as single-family, commercial real estate, or construction-type loans, from one or more failed-bank receiverships and transfers the assets into a newly created LLC. In exchange for contributing the assets, the FDIC, as Receiver, obtains the entire ownership interest, or equity, in the LLC. Following a competitive bid process, the FDIC, as Receiver, then sells a portion of the equity in the LLC to pre-qualified, private-sector investors. The FDIC, as Receiver, also engages various outside consultants (or advisors) to provide technical assistance with the transactions.

On February 3, 2010, the FDIC, as Receiver for 22 failed institutions, created Multibank 2009-1 RES-ADC Venture, LLC (Multibank RES) and Multibank 2009-1 CML-ADC Venture, LLC (Multibank CML) and transferred a total of 5,511 sub- and non-performing residential and commercial acquisition, development, and construction loan assets with a combined UPB of \$3.1 billion into the LLCs. The FDIC, as Receiver, held and serviced the assets for an average of 13 months before they were conveyed to the LLCs.

As partial consideration for transferring the assets into Multibank RES and CML, the LLCs executed and delivered to the FDIC, as Receiver, a total of six Purchase Money Notes (PMN) with a combined initial

principal amount of \$626.9 million. The FDIC, in its corporate capacity, guaranteed the PMNs. The FDIC set the interest rates on the PMNs at 0 percent as an incentive for potential investors because the FDIC was concerned about the potential limited recovery on the high number of non-performing assets held by Multibank RES and CML.

On February 9, 2010, following a competitive bid process, the FDIC, as Receiver, sold a 40-percent equity interest in Multibank RES and CML to entities established by Rialto (herein referred to as Rialto because Rialto created and is a 100-percent owner of the entities) for a total of \$243.5 million. The FDIC, as Receiver, retained the remaining 60-percent equity interests in Multibank RES and CML.

Within the FDIC, DRR is responsible for marketing structured transactions and monitoring the private-sector investors that enter into the structured transaction agreements. DRR monitors structured transactions through its staff and third-party contractors. At least annually, a compliance monitoring contractor (CMC), engaged by DRR, conducts on-site compliance reviews of each LLC's operations, including the LLC's obligation to service loans in compliance with the structured transaction agreements, applicable laws, and the terms of the loan documents.

Audit Results

With respect to the bidding and selection processes, we found that the FDIC:

- marketed the assets that comprised the Multibank RES and CML portfolios and approved (i.e., qualified) prospective investors to bid consistent with its then-existing policies, procedures, and guidance; and
- properly determined that Rialto's bids represented the best value offered for the assets and awarded an equity interest in the portfolios to Rialto.

We did note, however, that the FDIC should develop guidance that defines an approach for informing the public about structured transactions as the Corporation enters into such partnerships.

Based on our assessment of the terms and conditions of the LLC sales agreements, we determined that they were generally consistent with customary and usual business practices in the financial services industry. In addition, we reviewed asset files and other information pertaining to a sample of 120 assets and concluded that Rialto was in compliance with the provisions of the structured transaction agreements that we tested. Notably, our review did not identify any questioned costs or violations of the prohibitions in the structured transaction agreements regarding asset sales to affiliates. Further, Rialto was in the process of enhancing its procedures to further mitigate the risk of selling an asset to an affiliate.

However, at the time of our audit, DRR was working with Rialto to (1) ensure that Rialto applies cash proceeds from the sale of REO consistent with the terms of the structured transaction agreements and (2) remove REO deficiency balances from the UPB of assets when deficiencies are not being pursued (even though such action is not required by the structured transaction agreements). Both of these efforts impact Rialto's management fee. DRR was also working with Rialto to (3) separately report REO and loan deficiency balances in financial reports provided to the FDIC (even though such detailed reporting is not required by the structured transaction agreements) and (4) provide the FDIC with required reports on

significant litigation activities and environmental hazards. The FDIC should confirm that Rialto has appropriately documented and effectively implemented procedures to address all of these matters.

With respect to the FDIC's monitoring and oversight of Multibank RES and CML, we found that DRR had limited controls in place when the structured transactions with Rialto were consummated. Since that time, DRR's monitoring controls have improved considerably. Further, the FDIC's responses to inquiries from the public pertaining to the transactions were processed in a timely manner, and the information contained in responses that we sampled was supported by documentation. However, we identified several areas where DRR could improve its monitoring and oversight of Rialto. Specifically, we found that DRR should:

- Confirm that Rialto has fully implemented its enhanced procedures for certifying that REO sales are made only to non-affiliated parties of the company.
- Provide the CMC responsible for monitoring Rialto with relevant information regarding inquiries from the public to facilitate the CMC's oversight efforts.
- Establish written guidance that defines DRR's approach for conducting site inspections of LLC properties and documenting the results of such inspections to enhance the monitoring of LLCs.
- Continue coordinating with Rialto to stay abreast of any risk that cash flows will be insufficient to fully pay off two PMNs totaling \$314 million on schedule. DRR should also obtain and document a consensus among appropriate FDIC management officials on the merits of options available if such an event would occur, including reissuing the PMNs with new maturity dates, as allowed for by the structured transaction agreements.
- Direct the CMC responsible for monitoring Rialto to include an assessment of the company's handling of consumer loans during the CMC's periodic compliance reviews, if appropriate.

Corporation Comments

The report contains seven recommendations intended to strengthen the FDIC's controls and oversight pertaining to the structured transactions with Rialto. The Director, DRR, and the Deputy to the Chairman for Communications provided a joint written response, dated August 31, 2012, to a draft of this report. In the response, FDIC management concurred with all seven of the report's recommendations and described planned corrective actions to address the recommendations. Further, we provided a draft of this report to Rialto for its review and informal comment. In response, Rialto provided clarifications regarding certain matters discussed in the report. We considered the information provided by Rialto in finalizing our report.

Because this report contains sensitive information, we do not intend to make the report available to the public in its entirety. We will, however, post this Executive Summary on our public Web site.