Office of Inspector General

Office of Audits and Evaluations
Report No. EVAL-15-005

Evaluation of Risks Associated with Early Termination of Shared-Loss Agreements

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August 2015

Office of Inspector General

Executive Summary

Evaluation of Risks Associated with Early Termination of Shared-Loss Agreements

Report No. EVAL-15-005
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Why We Did The Evaluation

This report presents the results of our evaluation of the risks and controls associated with the early termination of Shared-Loss Agreements (SLA). The FDIC endeavors to terminate those SLAs that result in estimated savings to the FDIC rather than waiting until the SLA's expiration date as defined in the agreements. However, in executing these transactions, the FDIC must ensure that early termination decisions are not counter to the FDIC's mandate to maximize the value of the receivership estate or harm the FDIC's reputation.

Our evaluation objective was to evaluate whether the FDIC has established controls to mitigate risks associated with SLA early terminations and is complying with its early termination process.

Background

When an institution fails, the FDIC may enter into SLAs to reduce the FDIC's immediate cash needs, provide continuity to failed bank customers, and move assets into the private sector. Under an SLA, the FDIC enters into an agreement with an Assuming Institution (AI) to absorb a portion of the loss on a specified asset pool to maximize asset recoveries and minimize the FDIC's losses. In 2010, the FDIC provided certain AIs participating in SLAs with the option to terminate their SLAs early. In 2012, the FDIC created a pilot program to terminate SLAs before their natural expiration date and later expanded the program. The early termination program objective is to maximize receivership recoveries, as required by the FDIC's statutory mandate to maintain the viability of the Deposit Insurance Fund (DIF). Within the FDIC, the Division of Resolutions and Receiverships (DRR) has overall responsibility for the SLA program.

Evaluation Results

The FDIC has established process controls that collectively mitigate the risk that early termination decisions are counter to the FDIC's mandate to maximize the value of the receivership estate or harm the FDIC's reputation. Specifically, the FDIC's process controls help to ensure that (1) program eligibility requirements are met, (2) the FDIC's underlying financial analysis for early termination is complete and accurate, (3) the AI is in compliance with the SLA agreement, (4) the FDIC assesses risks to the DIF, and (5) a final review and approval of the decision to terminate is performed by the proper delegated authority within DRR. Further, as part of a 2015 DRR performance goal, DRR was developing a plan to further validate a worksheet it uses to identify the breakeven price the FDIC is willing to accept for an early termination.

The FDIC has limited guidance related to early terminations. Since its introduction, the program has evolved and expanded and involves multiple FDIC divisions and groups within DRR. As a result, the FDIC could benefit from an overarching policy that clearly defines the early termination program objectives and explains the responsibilities and authorities of the various organizations involved.

Based on our testing, we determined that the FDIC is properly assessing whether SLAs are eligible for early termination according to DRR's current guidance. To date, many AIs have declined to terminate their SLAs early, but that trend may change as AIs lose loss coverage under the SLAs and covered asset levels decline. For cases included in our sample, we found that the FDIC complied with key early termination process controls. Moreover, we confirmed that the completed transactions we reviewed were cost beneficial to the FDIC, consistent with the FDIC's early termination program objectives.

Recommendation and Corporation Comments

We made one recommendation for the Director, DRR, to establish a policy for the SLA early termination program that defines program objectives, explains the early termination process, and assigns roles and responsibilities of each FDIC division and DRR organizational unit involved in the program. Such a policy would help to ensure program understanding, process compliance, and consistent treatment of early termination transactions. DRR concurred with the recommendation and described a corrective action that was responsive.

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Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, Virginia 22226

Office of Audits and Evaluations
Office of Inspector General

DATE: August 26, 2015

MEMORANDUM TO: Bret D. Edwards, Director
Division of Resolutions and Receiverships

/Signed/

FROM: E. Marshall Gentry
Assistant Inspector General for Evaluations

SUBJECT: *Evaluation of Risks Associated with Early Termination of Shared-Loss Agreements* (Report No. EVAL-15-005)

This report presents the results of our evaluation of the risks and controls associated with the early termination of Shared-Loss Agreements (SLA). The FDIC endeavors to terminate those SLAs that result in estimated savings to the FDIC rather than waiting until the SLA's expiration date as defined in the agreements. However, in executing these transactions, the FDIC must ensure that early termination decisions are not counter to the FDIC's mandate to maximize the value of the receivership estate or harm the FDIC's reputation.

Our evaluation objective was to evaluate whether the FDIC has established controls to mitigate risks associated with SLA early terminations and is complying with its early termination process. To address the first part of our objective, we gained an understanding of the program and related risks by reviewing relevant policies and procedures and interviewing program officials. We then analyzed whether the FDIC had established process controls to mitigate risks to the FDIC. The scope of our evaluation covered relevant policies and procedures in place between November 2010 and December 31, 2014. To address the latter aspect of our objective, we reviewed and analyzed management reports and performed selected testing of completed early termination transactions through December 31, 2014.

We conducted this evaluation in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation*. Appendix 1 of this report includes additional details on our objective, scope, and methodology. Additional appendices include further information on topics covered in this report, a glossary of key terms,[1] a list of acronyms used in the report, and the Corporation's written response to our report.

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[1] Certain terms are underlined when first used in this report and defined in Appendix 5, *Glossary of Terms*.

Background

The FDIC first introduced SLAs as a part of selected Purchase and Assumption (P&A) transactions in 1991 to reduce the FDIC's immediate cash outlays, provide continuity of banking services to failed bank customers, and move assets into the private sector. Under an SLA, the FDIC[2] enters into an agreement with an assuming institution (AI) to absorb a portion of the loss on a specified asset pool to maximize asset recoveries and minimize the FDIC's losses. The FDIC provides shared-loss coverage for single-family (SF) and commercial (non-single-family or NSF)[3] assets and has provisions for legal termination when SLAs naturally expire. SF SLAs typically cover a 10-year period and naturally expire on the tenth anniversary of the agreement commencement date. NSF SLAs typically cover an 8-year period and naturally expire on the eighth anniversary of the agreement commencement date. The first 5 years of an NSF SLA cover losses and recoveries and the final 3 years pertain to recoveries only.

Within the FDIC, the Division of Resolutions and Receiverships (DRR) has overall responsibility for the SLA program. The early termination program objective is to maximize receivership recoveries, as required by the FDIC's statutory mandate to maintain the viability of the Deposit Insurance Fund (DIF).[4] DRR's Strategic Programs Group (SPG), within the Franchise and Asset Marketing Branch (FAMB), has specific responsibility for coordinating the process for the early termination of SLAs. Table 1 provides a summary of the SLA inventory as of April 30, 2015.

Table 1: SLA Statistics at a Glance—as of April 30, 2015 ($ in thousands)

Category	
Number of Failed Institutions Under SLAs	269
Initial Assets Subject to Loss Sharing	$216,454,483
Remaining Assets Subject to Loss Sharing	$43,356,779
FDIC Loss Estimate (FDIC's Share) Over the Full Term of SLAs	$32,494,640
Actual FDIC Losses at this point in time of SLAs (Loss Payments to AIs net of $1.3 billion in recoveries from AIs)	$28,656,026

Source: Deposit Insurance Fund Loss Sharing Summary Report, for the period ending April 30, 2015.

In 2010, the FDIC provided certain AIs participating in SLAs with the option to terminate their SLAs early. In 2012, DRR created a pilot program to terminate SLAs before their natural expiration date and later expanded the program. Table 2 depicts the number of SLAs currently in place and those that are eligible for early termination.[5]

[2] Throughout this report, for ease of reference, we use "FDIC" to refer to the FDIC when acting either in its corporate capacity or its receivership capacity.
[3] While not always offered, shared-loss coverage may also apply to securities and subsidiaries.
[4] See Sections 11(a)(4) and (d)(13)(E) and Section 13(c)(4) of the Federal Deposit Insurance Act, as codified to 12 United States Code (U.S.C.) §§ 1821 and 1823.
5 Appendix 2 provides a description and timeline of the SLA early termination program from its inception in 2010 through March 2015. Appendix 3 includes a flow chart of the current SLA termination process.

Table 2: SLA Early Termination Activity as of December 31, 2014 (SF and NSF Portfolios)

	Number of AIs	SLA Assets	SLA Portfolios
Eligible	94	$5.06 billion	325
SLA Terminations	20	$1.15 billion	51

Source: SPG Shared-Loss Agreement data as of December 31, 2014.

Evaluation Results

The FDIC has established process controls that collectively mitigate the risk that early termination decisions are counter to the FDIC's mandate to maximize the value of the receivership estate or harm the FDIC's reputation. Specifically, the FDIC's process controls help to ensure that (1) program eligibility requirements are met, (2) the FDIC's underlying financial analysis for early termination is complete and accurate, (3) the AI is in compliance with the SLA agreement, (4) the FDIC assesses risks to the DIF, and (5) a final review and approval of the decision to terminate is performed by the proper delegated authority within DRR. Further, as part of a 2015 DRR performance goal, DRR was developing a plan to further validate a worksheet it uses to identify the breakeven price the FDIC is willing to accept for an early termination.

The FDIC has limited guidance related to early terminations. Since its introduction, the program has evolved and expanded and has always involved multiple FDIC divisions and several groups within DRR. As a result, the FDIC could benefit from an overarching policy that clearly defines the early termination program objectives and explains the responsibilities and authorities of the various organizations involved. Such a policy would help to ensure program understanding, process compliance, and consistent treatment of early termination transactions.

Based on our testing, we determined that the FDIC is properly assessing whether SLAs are eligible for early termination according to DRR's current guidance. To date, many AIs have declined to terminate their SLAs early, but that trend may change as commercial SLAs lose loss coverage and covered asset levels decline. For cases included in our sample, we found that the FDIC complied with key early termination process controls. Moreover, we confirmed that the completed transactions we reviewed were cost beneficial to the FDIC, consistent with the FDIC's early termination program objectives.[6]

[6] As we were finalizing this report, we learned that the FDIC was reviewing an early termination proposal that would exceed the existing SLA early termination program asset portfolio size and payout limits. That proposal was outside of the scope of our evaluation.

Program Controls Mitigate Risks but DRR Needs to Establish an Early Termination Policy

According to the United States Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government*,[7] an organization's control environment is the foundation for an internal control system. The control environment provides the discipline and structure, which affect the overall quality of internal control. Management then establishes control activities through policies and procedures to achieve objectives and respond to risks in the internal control system. Management should design appropriate types of control activities for the entity's internal control system.[8]

DRR's Established Controls Mitigate Risks Associated with the SLA Early Termination Program

The FDIC has a number of process controls that collectively mitigate the risk that early termination decisions are counter to the FDIC's mandate to maximize the value of the receivership estate or harm the FDIC's reputation. The figure below provides a description of some of the key risks associated with the SLA early termination program.

Figure: Key Risks Associated with the SLA Early Termination Program

- Reputational/Optic: terminating an SLA that was not financially beneficial to the FDIC or is viewed as a "sweetheart" deal for the AI.
- Pricing/Valuation: asset valuation reviews (AVRs) from Financial Advisors (FA) may be inaccurate and valuation practices may not be consistent among FAs.
- Compliance: the AI is not in compliance with the SLA or owes the FDIC for paid claims that were later disallowed.
- Recovery: The AI does not provide the FDIC with its share of SLA recoveries.
- Safety and Soundness: termination of the SLA will negatively impact the financial condition of the AI and present risks to the DIF.
- Capacity: the inability of DRR to timely process requests for early terminations, especially if such requests substantially increase in number.

Source: Office of Inspector General (OIG) analysis of DRR's 2014 assurance statement,[9] interviews with program officials, review of current events, internal OIG discussions, and prior GAO and OIG reports.

[7] GAO-14-704G, dated September 2014.
[8] Control activity categories include segregation of duties, proper execution of transactions, accurate and timely recording of transactions, and appropriate documentation of transactions.
[9] DRR's assurance statement is an annual statement to the FDIC Chairman describing how well the programs under DRR's supervision and related internal controls are working. According to the 2014 statement, the program areas under DRR's purview were operating in accordance with FDIC guidance and its management control systems, as a whole, provided reasonable assurance that DRR's program objectives were met.

The following section summarizes controls that DRR has established to mitigate risks and achieve program objectives.

Program eligibility requirements. During our evaluation, an AI could have been eligible for an early termination if the SF and NSF portfolios of covered assets were each $50 million or less, the AI was in compliance with SLA terms and conditions, and the AI was willing to terminate both the SF and NSF SLAs in their entirety. The FDIC's total payment to the AI to terminate all of its SLAs affiliated with any one failed institution could not exceed $10 million.[10] There is no limitation on asset portfolio size if the AI offers to pay the FDIC to terminate an SLA.

SPG continuously monitors SLA activity, identifying SLAs eligible for early termination. Generally, SPG monitors the size of AI portfolios, AI performance, and AI capital levels. If it appears that an AI would be a good candidate for an early termination, SPG will suggest that the Risk Share Asset Management (RSAM) loss share specialist (LSS), in the monitoring group, contact the AI to see if it would like to submit an offer to the FDIC to terminate its SLAs early. In some cases, an AI may approach the FDIC with an offer and be willing to make a payment to the FDIC to terminate early. Either way, the FDIC must determine that the transaction is estimated to be financially beneficial to the FDIC.

Once an AI submits an offer to the FDIC, SPG staff conducts a reasonableness assessment to determine whether the AI's buyout offer is expected to produce cost savings to the FDIC. The SPG may consider the AI's compliance and performance under the SLAs, and may also take into account current portfolio performance/delinquency status, the trend of claims/losses paid to date, and call report and other relevant information.[11] SPG will not continue the process unless the early termination assessment demonstrates that the AI's offer appears reasonable; this is done to mitigate the time and expense of a full termination evaluation.

Termination evaluation. SPG performs a financial analysis to determine the minimum acceptable value for terminating an SLA early and estimates cost savings to the FDIC. A key component to assessing financial reasonableness of the early termination is the calculation of the FDIC's "take-out" price. The "take-out" price is essentially the breakeven price the FDIC is willing to accept for an early termination and is primarily comprised of estimated remaining losses, recoveries, and any true-up payment[12] from an independent AVR. Appendix 4 presents a depiction of the "take-out" price calculation.

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[10] On April 23, 2015, the FDIC revised the early termination eligibility ceiling to SLAs with covered assets of $100 million or less**.**

[11] Insured financial institutions are required to submit quarterly Reports of Condition and Income, known as Call Reports. The AI's "FDIC loss-sharing indemnification asset" line item on the Call Report represents the carrying amount of the right to receive payments from the FDIC for losses incurred on specified assets that are covered by SLAs with the FDIC.

[12] A number of SLAs include a true-up payment provision, which requires the AI to reimburse the FDIC when loss-sharing ends if the FDIC's initial estimated losses on covered assets were overstated and actual losses incurred were less than anticipated.

The "take-out" price calculation process begins with the FDIC contracting with an independent FA to perform an AVR. The AVR values the SLA assets and estimates the remaining losses within an AI's SLA portfolio. To do this, the FA stratifies the assets by type and performance status, selects a sample of assets within each subgroup, and reviews a sample of loan files. The FA considers economic, environmental, and geographic factors (e.g., depressed markets, geographic concentrations, etc…) in valuing the portfolio assets. The AVR includes a range of losses and recoveries (low to high) for the remaining life of the loans within the SLA portfolio. Once the AVR is completed, Dallas FAMB uses a standard AVR Loss Share checklist to review and approve the AVR.

To ensure that the FAs perform AVRs consistently, DRR uses a standardized statement of work (SOW) that describes technical details related to the work required and deliverables. Additionally, in June 2012, DRR procured an independent contractor to perform a horizontal review[13] of the FAs that prepare AVRs. During our review, we inquired whether an updated horizontal review would be prudent. DRR officials indicated that they did not believe there was a need for an updated horizontal review for the following reasons:

- DRR has reviewed the FAs' assumptions and methodologies, and
- Dallas FAMB conducts a standard review of each AVR deliverable.

SPG uses the information in the AVR to complete the *Terminations Workbook/Worksheet* (Worksheet) to calculate and document the "take-out" price. The Worksheet includes the FA's cumulative loss estimates and estimated future recoveries on assets charged off prior to the "as of" date of the valuation. The Worksheet also includes estimated recoveries from the true-up provision, estimated administrative expenses, claims settlement estimates (if applicable), adjustments reflecting any additional estimated loss, and other financial information as necessary to determine an appropriate settlement amount. SPG uses an independent contractor to ensure the accuracy of the Worksheet calculations, logic, and outputs.

[--- --*information redacted*--- --] The FDIC may accept an offer from an AI that is equal to or less than the "take-out" price. SPG's Job Aid states that at no time will the FDIC disclose its specific "take-out" price to the acquirer.

As part of a 2015 DRR performance goal, DRR was developing a validation plan to ensure the Worksheet the FDIC uses to calculate the "take-out" price was performing in line with its development specifications. This effort is intended to further validate the accuracy of the calculations performed throughout the Worksheet, as well as the underlying design and assumptions employed.[14] The FDIC's Office of Corporate Risk

[13] A horizontal review evaluates a common process or activity across several groups or entities to assess effectiveness or consistency.
[14] The performance goal is to implement the *FDIC Model Risk Management Policy,* Circular 1170.1, dated October 1, 2014. This policy is intended to ensure that FDIC models are reliable, validated, and sufficient

Management would initially review and approve the plan. SPG would then use contractor staff or FDIC staff who were not directly involved in the development or use of the Worksheet to implement the approved validation plan.

SPG compares the "take-out" price to the AI's offer. SPG uses the lesser of the "take-out" price or AI offer to calculate the final termination amount, which also considers any outstanding loss claim certificates from the AI and compliance review findings. Finally, SPG calculates an estimated all-inclusive cost savings over the remaining life of the agreements, which includes estimated remaining FDIC compliance and monitoring costs.

Compliance with the SLA agreement. While SLAs receive ongoing oversight, the FDIC or compliance monitoring contractors periodically conduct on-site reviews of an AI's covered loss records for overall compliance with the SLA. DRR's RSAM Compliance Group also performs a final compliance review to ensure no outstanding compliance issues or disputed loss claims exist prior to an early termination. Upon completion of its review, RSAM Compliance prepares a memorandum summarizing the work performed and documenting exceptions or adjustments identified for recovery. RSAM Compliance has procedures in place specifically designed for the SLA early termination final review. The procedures outline risks, testing expectations, guidance for summarizing work performed, and guidance for preparing the compliance memorandum that is sent to SPG.

Safety and Soundness Considerations. SPG considers the impact of the SLA on the AI's safety and soundness before agreeing to an early termination. SPG contacts the Division of Risk Management Supervision (RMS) to obtain an assessment of the risk to the AI and DIF from an early termination proposal. Upon completion of the review, RMS provides the SPG a memorandum communicating the RMS Regional Office's recommendation regarding the early termination proposal. The RMS memorandum also addresses the appropriateness of the transaction accounting and loss estimates and any conditions or limitations related to the early termination proposal.

In cases where the FDIC is not the primary federal regulator (PFR),[15] RMS will obtain the PFR's opinion on the early termination proposal.[16] The aforementioned RMS memorandum will document and assess concerns posed by the other regulator, detailing any approval conditions agreed upon with the applicable PFR or state authority. Finally, the memorandum identifies whether the AI is a minority depository institution (MDI). In consideration of the FDIC's ongoing efforts to preserve the ownership and service of MDIs, the Regional Office may offer technical assistance to MDIs on evaluating the early termination proposal and executing the transaction.

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to support quality corporate decision making. The FDIC's Worksheet is the model that will be evaluated as part of this process.

[15] The FDIC is the PFR for state banks that are not members of the Federal Reserve System. The Federal Reserve is the PFR for state banks that are members of the Federal Reserve System. The Office of the Comptroller of the Currency is the PFR for national banks and federal savings associations.

[16] RMS also obtains the views of the applicable state authority on the proposed early termination for state-chartered institutions.

In addition to AI examination and monitoring procedures that RMS has in place, RMS issued Regional Director (RD) Memo, *Early Termination of Shared-Loss Agreements, 2011-011*, dated March 24, 2011, which establishes documentation, review, and approval procedures for RMS' review of SLA early terminations.

Review and Approval of the Early Termination Proposal. DRR has established a multistep review and approval process that involves several organizations within and external to DRR, which creates segregation of duties and multiple reasonableness checks as outlined in Table 3.

Table 3: Separation of Responsibilities

Division/Group	Overall Responsibility
DRR FAMB SPG	Manages the overall early termination program and calculates the "take-out" price.
DRR FAMB – Dallas	Oversees the AVR procurement process and FAs and reviews deliverables.
DRR RSAM SLA Monitoring	Works with the AI on a day-to-day basis; communicates with the AI and the FDIC throughout the early termination process.
DRR RSAM Compliance	Monitors AI compliance with the SLA, tracks SLA certificates, and performs the final compliance review.
RMS	Performs examination and monitoring procedures for state nonmember AIs with SLAs as part of the safety and soundness examination; provides an assessment of the risk to the AI and the DIF for early terminations; contacts the PFR for its opinion of the early termination proposal.
Legal Division	Ensures that the final transaction is legal and binding and coordinates legal questions or concerns with the AI's counsel.

Source: OIG review of FDIC policies, procedures, and organizations.

After the SPG calculates the "take-out" price and considers the information provided by RMS and the PFR, SPG requests a draft termination agreement from the FDIC's Legal Division. If SPG and the AI tentatively agree to the terms of the early termination, SPG evaluates all of the information collected to estimate the early termination cost savings and prepares a case memorandum. The memorandum details the facts of the transaction, including the "take-out" price calculation, difference between the "take-out" price and AI offer, and estimated cost savings of terminating the SLA early, including savings associated with compliance monitoring and SLA administration. DRR terminates SLAs only if the case memorandum indicates that receivership recoveries would be maximized, resulting in a cost savings to the DIF. The case memorandum must be signed by the proper delegated authority within DRR.

Policy Needed to Ensure Program Understanding, Process Compliance, and Consistency

Control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives to achieve program objectives and address related risks. As discussed previously, DRR has developed a number of control activities for the early termination process, including eligibility requirements, worksheets, independent reviews, segregation of duties, and delegated authority levels to help meet early termination program objectives. GAO's *Standards for Internal Control in the Federal Government* provides that management should implement its control activities through policies and procedures that assign responsibility for operational process objectives and related risks and set expectations for control activity design, implementation, and effectiveness.

DRR's current guidance for the early termination of SLAs is limited to a high-level paragraph in the August 20, 2014 RSAM Manual and a Job Aid designed primarily for the SPG to process an early termination. The Job Aid details step-by-step instructions for implementing the early termination process and includes requirements to obtain information from other organizations to assess the early termination proposal.

DRR updated the Job Aid to reflect changes to the process as the early termination program has evolved. However, at the time of our review, the updated Job Aid was not on DRR's SharePoint site and SPG was in the process of further updating its guidance for early terminations. Further, while certain other organizations involved in the early termination process have policies and procedures in place for the work they perform and the information they provide to the SPG, the RSAM Manual and Job Aid do not specifically designate individual responsibility to those organizations.

As discussed in the next section of this report, we found that DRR complied with its established process for those early termination cases that we reviewed. Nonetheless, as the dollar thresholds and early termination activity increase, the FDIC needs to ensure that FDIC officials involved in processing early terminations clearly understand program requirements and process controls to help ensure a consistent early termination process. For example, representatives of one organization were not familiar with the process details or the individuals involved in the early termination process. In addition, contrary to its stated process, DRR disclosed the "take-out" price to AIs associated with about 25 early termination proposals from 2010 through mid-2013.[17] DRR discontinued the practice in 2013 and now keeps the "take-out" price confidential.[18] We also noted that, although SPG's practice is not to negotiate the final termination amount between the FDIC and the AI, one FDIC organization involved in the process perceived that the price was negotiable and another used the term negotiate, for internal purposes, in its guidance. Disclosing the "take-out" price and negotiating with the AI increases the risk that the FDIC may not get the best offer from the AI.

The early termination program has been evolving for several years and the FDIC expects an increase in program activity as SLA loss coverage expires. An SLA early termination program policy would help ensure that: (1) SLA program objectives are defined, (2) the early termination process is designed to support program objectives and effectively

[17] Not all of these proposals were accepted by AIs. A DRR representative indicated that these transactions involved small shared-loss portfolios and the risk of receiving a lower price for terminating the agreement was not material.
[18] DRR did not disclose the "take-out" price to the AI for any of the 10 early termination transactions that we reviewed.

mitigate associated risks, (3) limitations and thresholds for participation are clearly established, (4) roles and responsibilities of various organizations within and outside of DRR are defined and understood, and (5) the basis for decisions regarding early terminations are transparent.

Recommendation

We recommend that the Director, DRR:

1. Establish a policy for the SLA early termination program that defines program objectives, explains the early termination process, and assigns roles and responsibilities of each FDIC division and DRR organizational unit involved in the program.

FDIC Is Complying with Process Controls for Terminating SLAs Early

DRR Is Properly Screening AIs to Determine Whether Agreements Are Eligible for Early Termination

We reviewed the SPG's *Early Terminations Status Report*, as of December 31, 2014, to assess the SPG's AI screening efforts for SLA early termination eligibility. We concluded that DRR's eligibility determination was proper in all cases that we reviewed. The FDIC considered 95 AIs for early termination and completed early terminations associated with 20 of those AIs. According to the SPG's records, the FDIC did not reach agreement to terminate a number of SLAs early for the following reasons:

- The AI was not interested in terminating its agreements,
- The AI was on the RSAM Compliance Monitoring Watchlist,[19]
- The AI declined the FDIC's early termination offer, or
- The SPG determined that the AI's offer was not in the best interest of the DIF.

In September 2014, FDIC management noted that, to date, AIs have generally chosen to retain SLA coverage, and the FDIC has had limited success with the early termination program. However, as previously noted, the FDIC has increased the ceiling for early terminations, which may incentivize AIs to terminate their SLAs before they naturally expire. Further, several SLA portfolios are reaching the 5-year mark when loss coverage ends for NSF portfolios. As a result, AIs will have an additional incentive to terminate SLAs early, and DRR expects several more early terminations to occur in 2015. Moreover, as the economy and local real estate markets improve, AIs may determine that the benefit of SLA coverage outweighs the regulatory compliance costs.

[19] RSAM's Compliance Review Committee maintains and distributes the Watchlist report to communicate RSAMs' monitoring strategy to RMS and DRR management for AIs that require an increased level of scrutiny.

FDIC Is Complying with Established Process Controls When Terminating SLAs Early

Based on our review of SPG records, we confirmed that the agreed-upon termination amount, including costs considered after the calculation of the "take-out" price[20] was cost beneficial to the FDIC for all completed early terminations through December 31, 2014. Our review of SPG management reports showed that SPG actively tracks early termination activity. As of December 31, 2014, the FDIC and 20 AIs completed early terminations of 51 SLAs for a net outlay by the FDIC of about $13.8 million. The FDIC paid AIs $73.1 million to terminate their SLAs early, which involved assets acquired from 22 failed banks. AIs paid the FDIC $59.3 million to terminate SLAs early, which involved assets acquired from six failed banks. The SPG estimated that these early terminations saved the FDIC $59.7 million over the original estimated cost of managing the SLAs to their natural expiration.

We selected a sample of the SPG's files from early termination transactions and management reports to determine whether the FDIC was complying with its early termination process and realizing cost savings. We reviewed 10 completed early termination files, including one from 2013 and nine from 2014, representing all of the early terminations completed during 2014. Of the 10 transactions, the one early termination completed in December 2013 occurred under special circumstances and received approval to deviate from the existing process. We found that DRR followed its early termination process for the nine terminations completed in December 2014.

In our view, although our testing was limited to more recent transactions, the results provide reasonable assurance that risks associated with early termination transactions are being mitigated and that controls are in place to help ensure that program objectives are met.

Corporation Comments and OIG Evaluation

The Director, DRR, provided a written response dated August 13, 2015, to a draft of this report. The response is presented in its entirety in Appendix 7. In its response, DRR concurred with the report's recommendation and stated that a policy would help to ensure program understanding, process compliance, and consistent treatment of early termination transactions. DRR plans to implement the recommendation by May 15, 2016. A summary of the Corporation's corrective action is presented in Appendix 8. We consider management's response sufficient to resolve the recommendation.

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[20] Costs considered after the "take-out" price may include: (1) estimated remaining compliance review costs, (2) estimated remaining monitoring costs, and (3) the difference between the estimated "take-out" price and actual "take-out" costs.

Objective, Scope, and Methodology

Objective

Our evaluation objective was to evaluate whether the FDIC has established controls to mitigate risks associated with SLA early terminations and is complying with its early termination process. We performed our evaluation from January through March 2015 in accordance with the Council of the Inspectors General on Integrity and Efficiency's *Quality Standards for Inspection and Evaluation.*

Scope and Methodology

The scope of this evaluation included reviewing FDIC policies, procedures, and guidance related to the SLA early termination process in place from 2010 through December 31, 2014. The scope of our review also included selected testing of proposed, denied, and completed early termination transactions as of December 31, 2014 as discussed further below.

We performed our work at DRR in Arlington, Virginia, and held phone interviews with officials in RMS and DRR's Dallas Field Operations Branch.

To address our objective, we obtained an understanding of the SLA early termination process and control structure, including decision points, policies, and other factors DRR considers in deciding whether to terminate SLAs early. This included understanding:

- the loss estimation process and controls to ensure that calculations are accurate and
- how the FDIC estimates early termination costs and ensures terminating an SLA is in the best interest of the DIF.

Specifically, we reviewed DRR's RSAM Manual dated August 20, 2014 and the related Job Aid, *Early Terminations of Shared-Loss Agreements*. We also reviewed earlier versions of DRR's Job Aid to understand how the program has evolved. Further, we interviewed officials from DRR RSAM Monitoring, DRR RSAM Compliance, DRR Dallas FAMB, RMS, and the Legal Division.

To identify risks associated with the SLA early termination process, we reviewed DRR's most recent assurance statement, considered relevant news articles, interviewed FDIC officials involved in the process, and held team discussions to identify possible or perceived risks related to the SLA early termination program. For purposes of conducting our evaluation, we categorized risks into two groups: (1) risks that early termination decisions are counter to the FDIC's mandate to maximize the value of the receivership estate and (2) risks that could harm the FDIC's reputation. We then mapped process controls to the key risks identified.

Objective, Scope, and Methodology

We tested compliance with DRR's process for identifying SLAs eligible for early termination by reviewing DRR's *Early Termination of SLAs Status Report – Offers Under Consideration*, as of December 31, 2014, to assess whether SPG was monitoring SLA activity, screening for SLA early termination eligibility, and determining the reasonableness of AI offers.

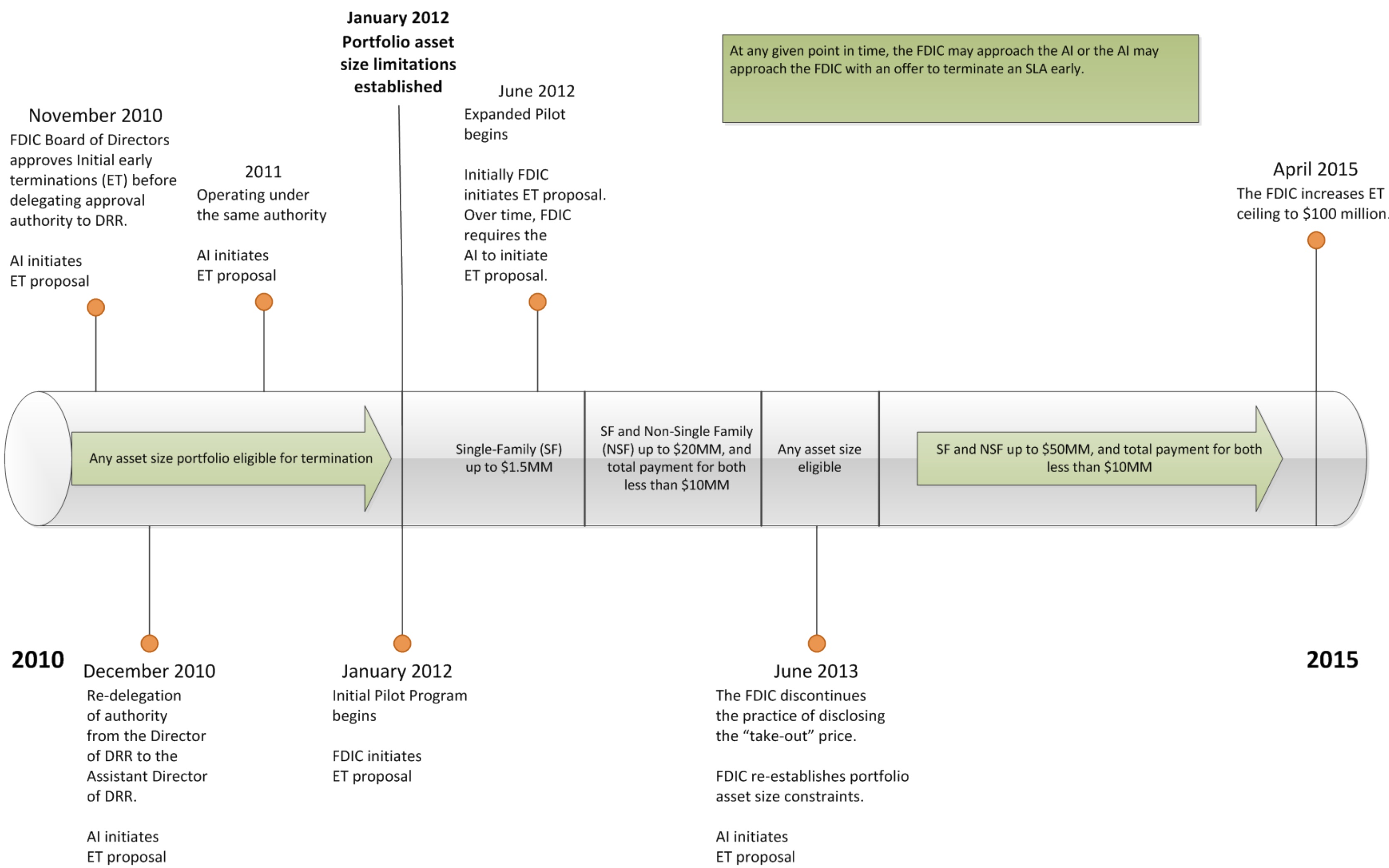
We also reviewed DRR's early termination report to verify that each completed early termination was estimated to be financially beneficial to the FDIC. To ensure we could rely on the report, we traced key data fields to relevant supporting documentation. For example, we reviewed AI offer letters, final termination agreements, and the DRR case memorandum to validate the reported information for 6 of 20 AIs that had terminated their SLAs as of February 18, 2015.

To test whether the FDIC complied with its process for completed transactions, we reviewed a non-statistical sample of 10 of the 51 SLA early terminations completed between January 31, 2012 and December 31, 2014.[21] Specifically, we selected all of the early terminations completed between November 21, 2013 and December 31, 2014 because this allowed us to evaluate the FDIC's compliance with the most recent early termination guidance in place. Using our process map as a template, we reviewed DRR case files and met with officials to ascertain whether DRR followed process controls for each of our sampled items.

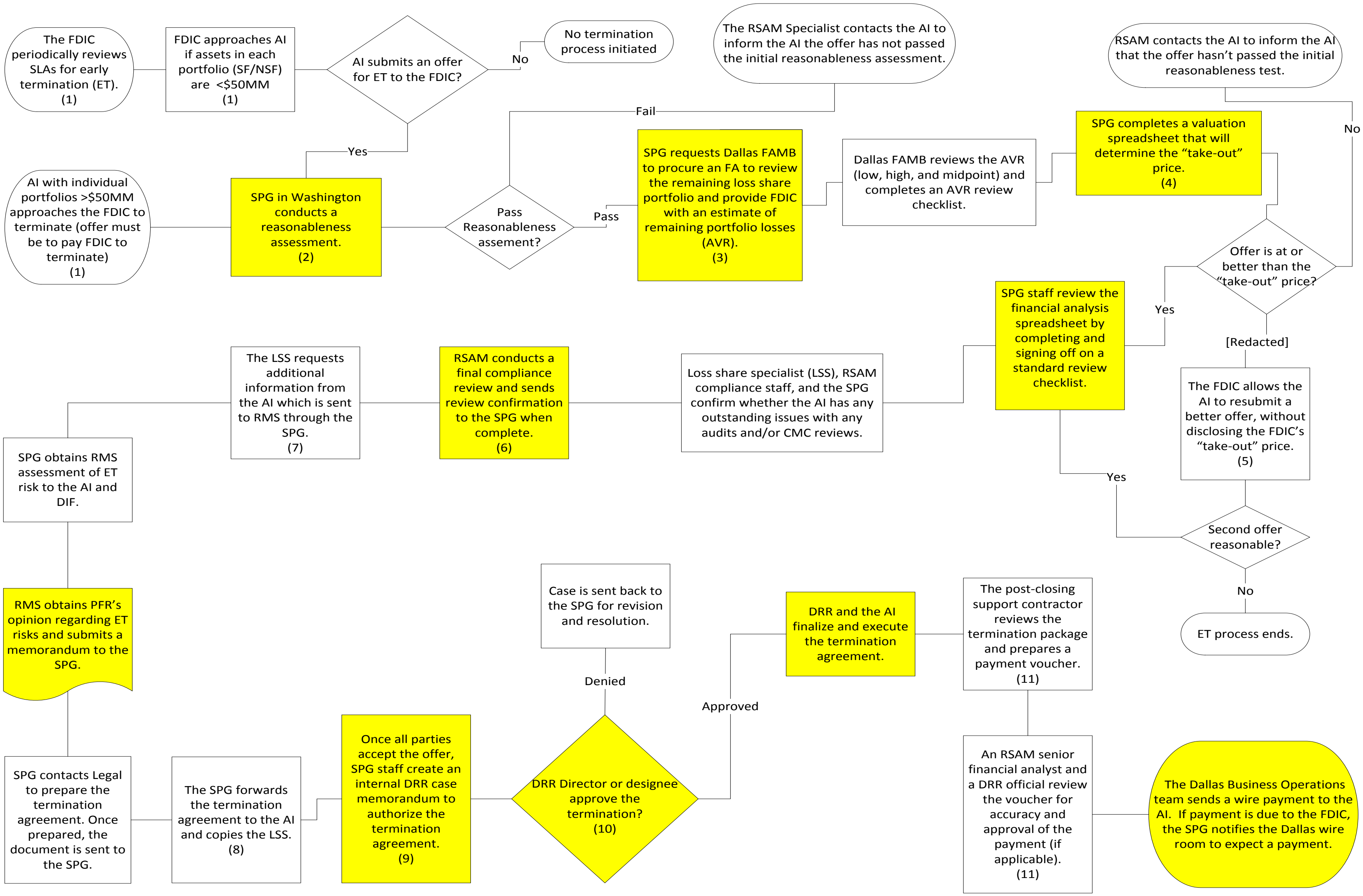
As we were finalizing this report, we learned that the FDIC was reviewing an early termination proposal that would exceed the existing SLA early termination program asset portfolio size and payout limits. That proposal was outside of the scope of our evaluation

[21] The results of a non-statistical sample cannot be projected to the intended population by standard statistical methods.

SLA Early Termination Program Changes Timeline



SLA Early Termination Program Flow Chart



Note: Items highlighted in yellow indicate key controls in the early termination process. Numbers in parenthesis are defined on the following page.

SLA Early Termination Program Flow Chart

Explanation of the numbers used in the flowchart:

(1) The AI provides an early termination offer under the direction of its respective FDIC LSS. The offer should be on bank letterhead or via e-mail from an authorized officer of the AI. The offer should include SF and NSF Agreements and terminate the entire (both SF and NSF) loss-sharing relationship between the FDIC and the AI.

(2) The "reasonableness" assessment determines if the offer may result in savings to the FDIC and considers the cumulative actual losses to date as compared to original estimated losses, current portfolio performance/delinquency status, the trend of claims/losses paid to date, call report information, and other relevant information.

(3) If in the judgment of the SPG the offer appears reasonable, the SPG will submit a request for an FA to conduct a review of the remaining loss share portfolio to estimate the cumulative loss related to those assets. **[--*information redacted*-----------------------------------]**

(4) The SPG will complete a valuation spreadsheet that will include the FA's cumulative loss estimates, estimated recoveries on assets charged off prior to the "as of" date of the valuation, estimated recoveries from the "true-up" provision, estimated administrative expenses, claims settlement estimates (if applicable), adjustments reflecting any additional estimated loss, and other financial information as necessary to determine the threshold for an appropriate settlement amount, or "take-out" price. The FDIC may accept an offer that equals or is less than the "take-out" price.

(5) At no time will the FDIC disclose its specific "take-out" price to the acquirer. If the analysis shows the early termination does not result in a cost savings to the FDIC, **[---------------*information redacted*---------------]**, the FDIC may provide the acquirer the opportunity to re-submit a lower offer that would be acceptable to the FDIC. While not providing the AI the "take-out" price, the FDIC may provide generic guidance as to how much lower the offer would need to be to become acceptable.

(6) The SPG will request that the RSAM Compliance Group conduct a final compliance review, including a review of any loss claim certificates not yet reviewed. All compliance review issues must be resolved to the satisfaction of the FDIC before the early termination can proceed.

(7) The LSS requests the following information from the AI, which is provided by the SPG to RMS:

- written agreement of "take-out" price and conditions;
- the AI's accounting entries planned for the buyout transaction;

SLA Early Termination Program Flow Chart

- before and after measurements of the AI's classified assets and capital coverage, allowance for loan and lease losses, risk-based assets, past due ratios, and capital ratios; and
- the AI's pro-forma financial statements.

(8) Upon receipt of RMS' assessment and the PFR's observations, the SPG contacts the Legal Division to prepare a draft termination agreement. The Legal Division sends the draft termination agreement to SPG, which forwards it to the AI.

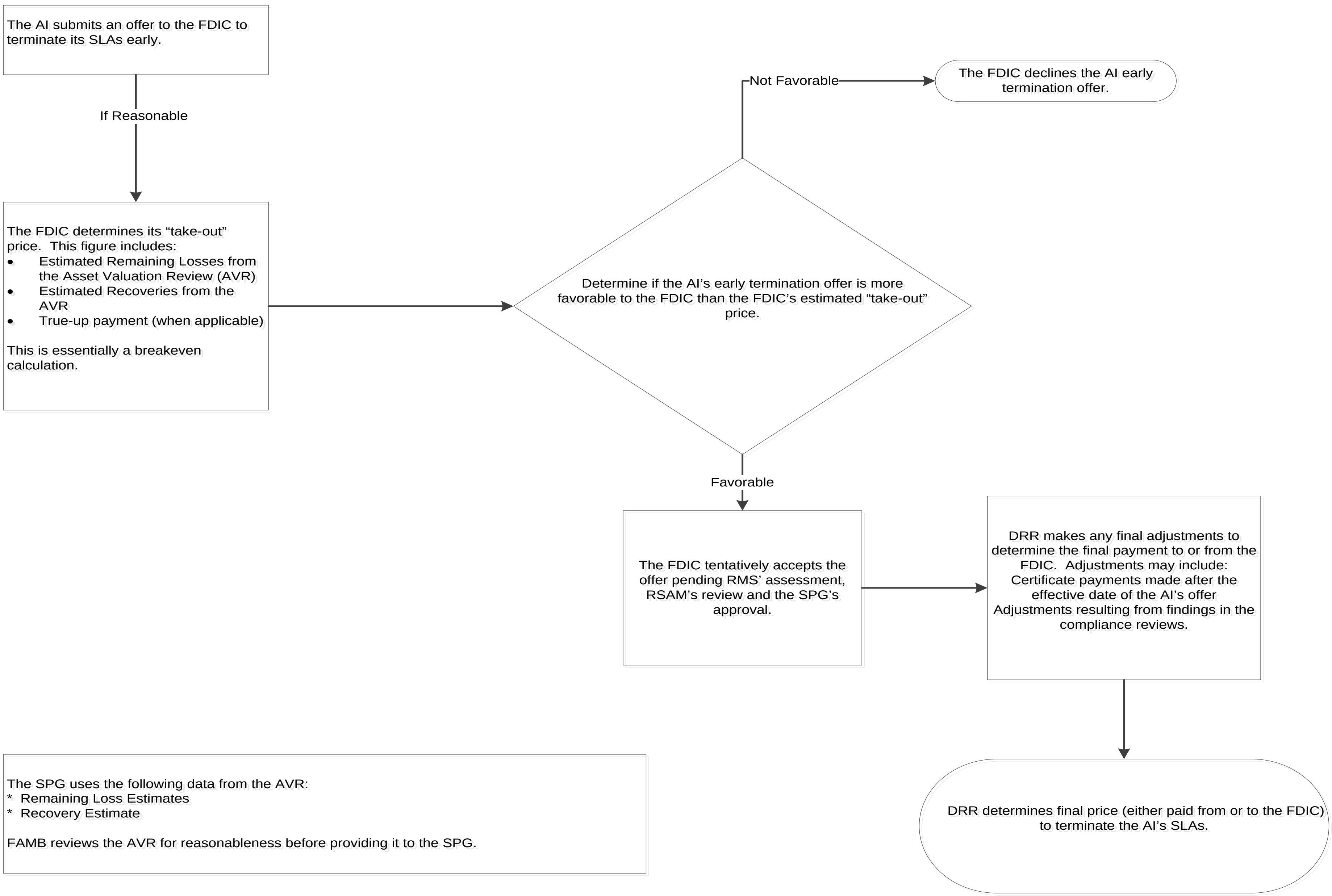
(9) If the FDIC accepts an early termination offer approved by all parties, SPG staff create an internal DRR case memorandum authorizing the termination agreement with the AI. The case describes the early termination request and evaluates the costs associated with the request.

(10) After SPG management reviews the case and the appropriate delegated authority reviews the underlying documents included in the package, SPG performs a high-level judgmental analysis to assess whether the overall case appears reasonable. If the DRR Director or designee approves the termination, DRR and the AI finalize and execute the termination agreement.

(11) If a payment is due to the AI, DRR's post-closing support contractor prepares a payment voucher following a review of the termination package, executed termination agreements, and the executed approval case memorandum. The appropriate delegated authority reviews and approves the payment voucher.

Appendix 4

“Take-Out” Price Calculation Process



Glossary of Terms

Term	Definition
Assuming Institution (AI)	An assuming institution is a healthy bank or thrift institution that purchases some or all of the assets and assumes some or all of the liabilities of a failed institution in a P&A transaction.
Asset Valuation Review (AVR)	A valuation of the bank's loan portfolio, which includes performing and non-performing loans, subsidiaries in which loans may reside, and loan-related rights that can be valued like mortgage servicing rights. The AVR is performed by a third-party financial advisor operating under an SOW and using an FDIC-provided template.
Commercial SLA (NSF SLA)	An SLA that typically covers an 8-year period with the first 5 years for losses and recoveries and the final 3 years for recoveries only. The FDIC pays the AI when the assets are charged off or written down according to established regulatory guidance or when the assets are sold.
Compliance Monitoring Watch List	A report used by DRR to track and monitor AIs that warrant increased scrutiny.
Deposit Insurance Fund (DIF)	A fund established by Section 11(a) (4) of the Federal Deposit Insurance Act (12 U.S.C. § 1821(a)(4)), and used by the FDIC to carry out the Corporation's deposit insurance responsibilities in the manner provided by other provisions of Section 11(a) of the Act.
Financial Advisor (FA)	Third-party contractor performing the AVR.
Minority Depository Institution (MDI)	"Minority" as defined by Section 308 of the Financial Institutions Recovery, Reform, and Enforcement Act of 1989, as amended (12 U.S.C. § 1643), means any "black American, native American, Hispanic American, or Asian American." In general, Section 308 defines "minority depository institution" as any depository institution where 51 percent or more of the voting stock is owned by one or more "socially and economically disadvantaged individuals."
Purchase and Assumption Agreement (P&A Agreement)	A P&A Agreement is the legal document governing the resolution transaction among the FDIC in its corporate and receivership capacities and an AI. P&A Agreements may include specific shared-loss exhibits that govern the operations and obligations of the FDIC and the AI with regard to the SLAs.
Shared-loss Agreement (SLA)	A financial arrangement wherein the FDIC agrees to absorb a portion of the loss on a specified pool of assets sold to an AI. An SLA includes an estimated loss for the final resolution of the shared-loss assets.
Single-family SLA (SF SLA)	An SLA that typically covers a 10-year period. The FDIC provides coverage for losses associated with the following single-family mortgage events: (1) modification, (2) short sale, (3) sale of foreclosed property, and (4) charge-offs pertaining to some second-lien loans. Loss coverage also applies to loan sales, provided that prior approval of the sale was obtained by the FDIC. The AI is paid when a loss is incurred associated with one of the four single-family loss events.
Take-out Price	The value used to determine the threshold for an appropriate early SLA termination settlement amount.
True-up Payment	A provision in a number of SLAs, which requires the AI to reimburse the FDIC when loss-sharing ends if the FDIC's initial estimated losses on covered assets were overstated and actual losses incurred were less than anticipated.

Acronyms and Abbreviations

Acronym	Explanation
AI	Assuming Institution
AVR	Asset Valuation Review
DIF	Deposit Insurance Fund
DRR	Division of Resolutions and Receiverships
ET	Early Termination
FA	Financial Advisor
FAMB	Franchise and Asset Marketing Branch
FDIC	Federal Deposit Insurance Corporation
GAO	United States Government Accountability Office
LSS	Loss Share Specialist
MDI	Minority Depository Institution
NSF	Non-Single Family
OIG	Office of Inspector General
P&A	Purchase and Assumption
PFR	Primary Federal Regulator
RD	Regional Director
RMS	Division of Risk Management Supervision
RSAM	Risk Sharing Asset Management
SF	Single-Family
SLA	Shared-Loss Agreement
SOW	Statement of Work
SPG	DRR's Franchise and Asset Marketing Branch, Resolution Strategy Section, Strategic Programs Group
U.S.C.	United States Code

Corporation Comments

FDIC

3701 N. Fairfax Drive, Arlington, VA 22203 Division of Resolutions and Receiverships

August 13, 2015

TO: Marshall E. Gentry
Assistant Inspector General for Evaluations
Office of Inspector General

FROM: Bret D. Edwards, Director /**Signed**/
Division of Resolutions and Receiverships

SUBJECT: Management Response to Draft Audit Report Entitled, *Evaluation of Risks Associated with Early Termination of Shared-Loss Agreements* (Assignment No. 2014-039)

The Federal Deposit Insurance Corporation (FDIC) has completed its review of the Office of Inspector General's (OIG) draft audit report entitled, Evaluation of Risks Associated with Early Termination of Shared-Loss Agreements (Assignment No. 2014-039). We appreciate the OIG's observations and recommendation regarding the Shared-Loss Agreement (SLA) early termination program.

In its report, the OIG recommends that the Director DRR establish a policy for the SLA early termination program that defines program objectives; explains the early termination process; and assigns roles and responsibilities of each FDIC division and DRR organizational unit involved in the program. We agree that such a policy would help to ensure program understanding, process compliance, and consistent treatment of early termination transactions.

Below is a description of the FDIC's specific corrective actions for the one OIG recommendation.

Recommendation 1: Establish a policy for the SLA early termination program that defines program objectives; explains the early termination process; and assigns roles and responsibilities of each FDIC division and DRR organizational unit involved in the program.

DRR Response: DRR concurs with this recommendation.

Corrective Action: The DRR Strategic Program Group will work with the appropriate divisions to develop and issue a policy for the SLA early termination program that defines program objectives; explains the early termination process; and assigns roles and responsibilities of each FDIC division and DRR organizational unit involved in the program.

Completion Date: May 15, 2016.

Summary of the Corporation's Corrective Actions

This table presents the corrective action taken or planned by the Corporation in response to the recommendation in the report and the status of the recommendation as of the date of report issuance.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Open or Closed[b]
1	The DRR Strategic Program Group will work with the appropriate divisions to develop and issue a policy for the SLA early termination program that defines program objectives, explains the early termination process, and assigns roles and responsibilities of each FDIC division and DRR organizational unit involved in the program.	May 15, 2016	No	Yes	Open

[a] Resolved – (1) Management concurs with the recommendation, and the planned, ongoing, and completed corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but alternative action meets the intent of the recommendation.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Recommendations will be closed when (a) Corporate Management Control notifies the OIG that corrective actions are complete or (b) in the case of recommendations that the OIG determines to be particularly significant, when the OIG confirms that corrective actions have been completed and are responsive.