

Office of Inspector General



Office of Audits and Evaluations
Report No. EVAL-12-002

**Evaluation of the FDIC's Monitoring of
Shared-Loss Agreements**

February 2012



Why We Did The Evaluation

During the recent financial crisis, the FDIC reintroduced and has frequently used Purchase and Assumption (P&A) transactions with Shared-Loss Agreements (SLA) to sell failed bank assets. As of September 30, 2011, the FDIC had entered into 272 SLAs with an initial covered asset base of \$209.5 billion and paid claims totaling \$14.6 billion. In 2010 and 2011, the Office of Inspector General (OIG) issued five confidential audit reports that addressed the compliance of five acquiring institutions (AI) with the terms of their respective SLAs and the FDIC's oversight of the SLAs. All of the reports contained findings and recommendations.

Given the magnitude of the SLA program and prior OIG audit coverage, the objectives of the evaluation were to (1) evaluate the FDIC Division of Resolutions and Receiverships' (DRR) overall efforts to monitor and ensure compliance with the terms and conditions of the SLAs and (2) summarize the findings and recommendations in the five OIG reports on SLA compliance issued to date and associated actions that the FDIC has taken.

Background

The FDIC employs a variety of strategies in fulfilling its goal of resolving failed institutions in the least costly manner to the Deposit Insurance Fund and maximizing net recoveries to the creditors of receiverships. A common resolution method that the FDIC uses to resolve failed institutions is through a P&A transaction, wherein an AI purchases some or all of the assets and assumes some or all of the liabilities of a failed institution. One specific type of P&A Agreement includes both single-family and commercial SLAs, whereby the FDIC agrees to absorb a portion, generally 80 percent, of the losses on specified pools of assets purchased by an AI from the failed bank. One of the primary goals of the SLAs is to allow as many failed bank assets as possible to remain in the private sector, under the management of an AI. This structure is intended to reduce the FDIC's burden of managing receivership assets, maximize asset recoveries, and mitigate losses.

The FDIC provides shared-loss coverage for single-family and commercial assets. Single-family SLAs typically cover a 10-year period. Commercial SLAs typically cover an 8-year period, with the first 5 years for losses and recoveries and the final 3 years for recoveries only. The AI is paid by the FDIC when it experiences certain loss events on the covered assets, as described in the SLAs. The FDIC introduced loss-sharing into selected P&A Agreements in 1991. Faced with an unprecedented number of bank failures and significant uncertainty about future loan performance and collateral values, the FDIC reintroduced P&A Agreements with shared-loss coverage in November 2008. Since then, most P&A Agreements have included a loss-sharing feature.

DRR is responsible for the FDIC's Risk Sharing Asset Management Program and provides primary oversight of the SLA program. As a means of evaluating and monitoring AI compliance with the SLAs, the FDIC also uses third-party contractors, referred to as Compliance Monitoring Contractors (CMC), to evaluate and monitor AI compliance and to complement DRR staff.

Evaluation Results

As noted above, the FDIC reintroduced P&A Agreements with SLAs and entered into 272 such agreements between November 2008 and September 2011. Over 120 SLAs were executed in the first 17 months after they were reintroduced. All of this activity took place as the FDIC was in the midst of establishing and implementing a monitoring program to address the significant financial and operational risks associated with the SLAs.

We determined that the FDIC devoted high-level management attention to the quickly expanding SLA program, including establishing corporate-wide performance goals, convening a Project Management Office task group, and providing quarterly updates to the Chairman and Audit Committee on the findings of its AI compliance reviews and planned corrective actions. The Corporation also substantially increased staff, engaged contractors, and developed procedures and systems to manage the associated workload and risks.

As a result of these efforts, the FDIC has established a number of controls and processes to monitor and ensure that AIs comply with the terms and conditions of the SLAs. We also found that the SLA program is continuing to mature, as evidenced by the recent finalization of policies and procedures, initiation of training programs, strengthened AI compliance monitoring efforts, and implementation of data resources to manage program data.

Further, the FDIC was taking steps to enhance:

- information security of its SLA data resources;
- guidance to AIs to encourage more commercial loan modifications and the tracking of such modifications;
- tracking of questioned claims and processes for ensuring corrective action in response to AI reviews; and
- oversight of AIs by implementing a Proactive Monitoring Initiative to more promptly prevent or detect instances of non-compliance.

However, in any program of this size, there will be emerging issues and risks that require monitoring and attention. In that regard, we are making five recommendations to the FDIC related to the timeliness of contractor task orders, the efficiency of evaluating contractor performance, the consistency of AI monitoring efforts, and the sufficiency of guidance for pursuing and reporting recoveries and monitoring non-compliant AIs. These recommendations are intended to strengthen the SLA program.

With respect to the OIG's five previous SLA reports, the FDIC implemented corrective actions to address 79 of the 85 recommendations made in those reports, as of January 2012. These reports questioned \$67.4 million in SLA claims paid by the FDIC, and the FDIC had recovered \$29.8 million of these claims as of September 30, 2011. DRR did not pursue recoveries on \$6.2 million of the questioned costs, the vast majority of which resulted from misinterpretations of the SLAs and subsequent events that made certain questioned costs allowable at a later date. DRR continues to work with the AIs to resolve the outstanding questioned costs and expects to resolve these issues, as well as the outstanding recommendations, by March 2012. These OIG reports also included recommendations for enhanced guidance to AIs and FDIC staff and contractors to better ensure SLA compliance. All of the recommendations related to these issues had been implemented at the time of our evaluation.

Management Response

After we issued our draft report, DRR management provided additional information and informal comments for our consideration, and we revised our report to reflect this feedback, as appropriate. The Director, DRR, provided a written response, dated February 10, 2012, to the draft report. In the response, the Director concurred with the report's five recommendations and agreed to work with the Division of Administration to address issues involving joint responsibility. DRR expects to complete corrective actions by July 31, 2012. The planned actions were responsive to the recommendations.

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ACRONYMS

AI	Acquiring Institution
APM	Acquisition Policy Manual
CMC	Compliance Monitoring Contractor
CRC	Compliance Review Committee
DIF	Deposit Insurance Fund
DIT	Division of Information Technology
DOA	Division of Administration
DOF	Division of Finance
DPO	Discounted payoff
DRR	Division of Resolutions and Receiverships
FDIC	Federal Deposit Insurance Corporation
GAO	Government Accountability Office
ICE	Integrated Compliance Engine
IT	Information Technology
LSCED	Loss Share Cost Estimate Database
OIG	Office of Inspector General
OM	Oversight Manager
P&A	Purchase and Assumption
PMO	Program Management Office
RMS	Division of Risk Management Supervision
RSAM	Risk Sharing Asset Management
SAR	Suspicious Activity Report
SLA	Shared-Loss Agreement
TOOM	Task Order Oversight Manager
TSO	Temporary Satellite Office



DATE: February 17, 2012

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

FROM: */Signed/*
Stephen M. Beard
Deputy Inspector General for Audits and Evaluations

SUBJECT: *Evaluation of the FDIC's Monitoring of Shared-Loss Agreements*
(Report No. EVAL-12-002)

This report presents the results of the Office of Inspector General's (OIG) evaluation of the FDIC's efforts to monitor the closed bank Shared-Loss Agreement (SLA) program. SLAs are frequently used by the FDIC to resolve failing banks. In such cases, an acquiring institution (AI) purchases assets from a failing institution and the FDIC agrees to share in the associated losses and recoveries with the AI at pre-arranged levels. One of the primary goals of loss-sharing is to allow as many failed bank assets as possible to remain in the private sector, under the management of an AI. This structure is intended to reduce the FDIC's burden of managing receivership assets, maximize asset recoveries, and mitigate losses. The FDIC's Division of Resolutions and Receiverships (DRR) is responsible for the FDIC's Risk Sharing Asset Management (RSAM) Program, which serves as the primary means of providing SLA program oversight. As a means of evaluating and monitoring AI compliance with these Agreements, the FDIC uses third-party contractors to complement its staff.

EVALUATION OBJECTIVES AND APPROACH

This evaluation was undertaken to assess the controls that the FDIC has put in place to protect its interests with respect to the SLA program. Specifically, the objectives of the evaluation were to (1) evaluate DRR's overall efforts to monitor and ensure compliance with the terms and conditions of the SLAs and (2) summarize the findings and recommendations in the five confidential OIG reports on SLA compliance issued to date and associated actions that the FDIC has taken.

To address the first objective, we reviewed the FDIC's policies and procedures related to the SLA program and interviewed FDIC program officials in order to understand the existing governance and control framework, including how program data is collected and used to manage and evaluate the program. We also interviewed officials from each of the FDIC's eight compliance monitoring contractors (CMCs) in order to gain their perspectives on the program.¹

¹ We provided DRR with a summary of the results of our interviews. The summary document provided to DRR did not attribute comments of the CMCs by name.

Typically, the CMCs assist DRR in monitoring AIs with SLA portfolios greater than \$200 million, and DRR staff independently monitor AIs with SLA portfolios less than or equal to \$200 million. The majority of SLA portfolios are greater than \$200 million and are therefore monitored by the CMCs. We evaluated the extent to which the FDIC has established controls to help ensure that (1) claims paid by the FDIC are valid and contain supporting documentation, (2) AIs are complying with the terms of the SLAs, (3) estimated SLA losses are appropriately derived and compared to actual losses, and (4) SLAs are terminated appropriately.

To address the second objective, we reviewed the five OIG audit reports issued between May 2010 and June 2011 that assessed the extent to which AIs complied with the terms of their respective SLAs. The results of these audits were issued as confidential reports with a limited distribution because they discuss the internal controls of open banks. However, in an effort to provide a level of transparency with respect to those audits, we summarized the reports' findings and recommendations along with the status of the FDIC's corrective actions.²

We performed our evaluation between May 2011 and October 2011 in accordance with the *Council of Inspectors General on Integrity and Efficiency's Quality Standards for Inspection and Evaluation*. Appendix I includes additional detail on our objectives, scope, and methodology. Appendix II provides a high-level summary of CMCs officials' perspectives on the program. Appendix III provides an overview of how SLAs have evolved since November 2008. Appendix IV presents the Corporation's comments on our report. Appendix V contains a summary of management's response to the report's recommendations.

² In the latter half of 2011, the FDIC OIG changed its practice and now publicly issues the Executive Summaries of such reports.

BACKGROUND

The FDIC employs a variety of strategies in fulfilling its goal of resolving failed institutions in the least costly manner to the FDIC’s Deposit Insurance fund (DIF) and maximizing net recoveries to the creditors of receiverships. A common method that the FDIC uses to resolve failed institutions is through a Purchase and Assumption (P&A) transaction, wherein an AI purchases some or all of the assets and assumes some or all of the liabilities of a failed institution. One specific type of P&A Agreement includes an SLA, whereby the FDIC agrees to absorb a significant portion of the losses experienced by an AI on a specified pool of assets. In exchange, the AI manages the assets. An SLA sets forth the requirements regarding the AI’s management of the covered assets as well as procedures for notices, consents, reporting, and payments. The adjacent text box highlights the benefits that the FDIC associates with the SLA program.

The FDIC introduced loss-sharing into selected P&A Agreements in 1991

and found that P&A transactions with loss-sharing provisions were less expensive than P&A transactions without the loss-sharing feature. According to information reported in the FDIC publication, *Managing the Crisis: The FDIC and RTC Experience 1980-1994*, the cost to the FDIC of using 16 P&A Agreements with loss-sharing provisions was 6 percent of failed bank assets as compared to 10.4 percent of failed bank assets for 175 P&A Agreements executed without loss-sharing provisions. According to this publication, the savings resulted from the fact that by using SLAs, failed bank assets remained in the private sector, under the expertise of the AIs where they could be better managed, as opposed to government ownership where such expertise was lacking and the assets were more apt to be liquidated at a discount. Faced with an unprecedented number of bank failures and significant uncertainty about future loan performance and collateral values, the FDIC reintroduced P&A Agreements with shared-loss coverage in November 2008.

The FDIC provides shared-loss coverage for single-family and commercial assets, with both types covering credit losses as well as certain types of expenses associated with troubled assets (such as advances for taxes and insurance, sales expenses, and foreclosure costs).

Single-family SLAs. These SLAs typically cover 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

Risk Sharing Program Benefits		
To FDIC	To Acquiring Institutions	To Community
<ul style="list-style-type: none"> ▪ Places problem assets in the private sector and management with private sector expertise ▪ Reduces the immediate funding required of FDIC ▪ Avoids severe liquidation discounts for assets sold from an FDIC receivership ▪ Aligns the interests of the FDIC and the acquiring institution to maximize asset values 	<ul style="list-style-type: none"> ▪ Limits exposure to credit risk ▪ Mitigates the uncertainty regarding collateral values in deteriorating market conditions ▪ Allows time and protection to the acquiring institution in accomplishing restructures and work-outs on problem loans ▪ Aligns the interest of the FDIC and the acquiring institution to maximize asset values 	<ul style="list-style-type: none"> ▪ Maintains continuity of banking relationships for borrowers as well as depositors ▪ Requires implementation of a loan modification program; avoids unnecessary foreclosures ▪ Gives borrowers with existing commercial loans a bank with an incentive to work with them rather than seek immediate termination of the credit relationship

Source: FDIC

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.

Commercial SLAs. These SLAs typically cover an 8-year period with the first 5 years for losses and recoveries and the final 3 years for recoveries only. The AI is paid when the assets are charged off or written down according to established regulatory guidance or when the assets are sold.

Since November 2008, most P&A Agreements have included a loss-sharing feature. Specifically, between November 2008 and September 30, 2011, the FDIC entered into 272 SLAs. Table 1 summarizes shared-loss information by type of Agreement.

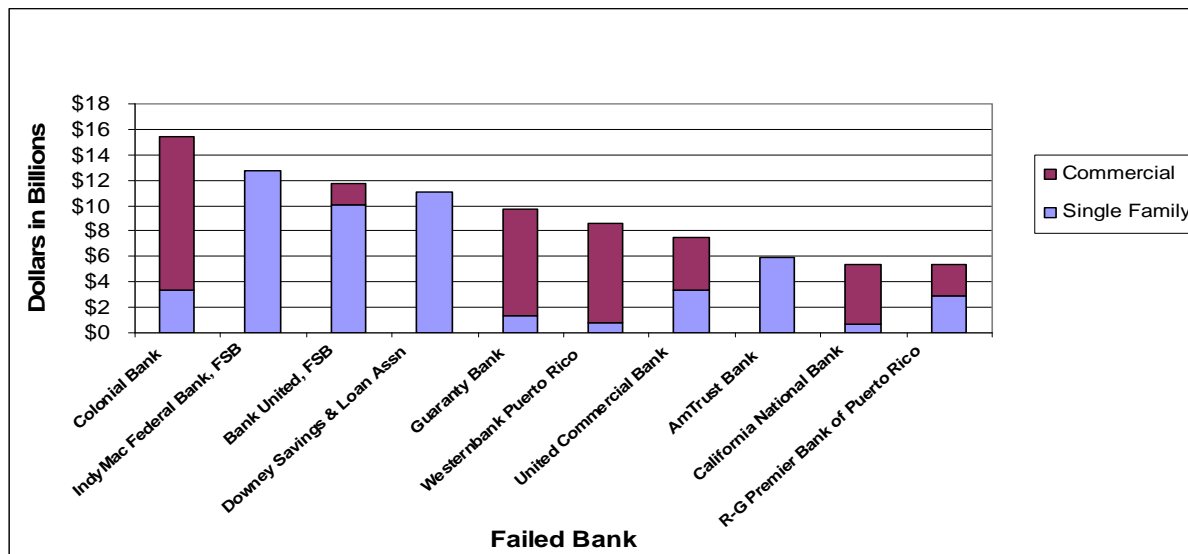
Table 1: Shared-Loss Data by Type of Agreement, as of September 30, 2011

Type of Agreement	Initial Covered Assets	Current Covered Assets	Loss Share Claims Paid by FDIC
	(Dollars in \$000)		
Single-family	\$77,088,818	\$52,155,956	\$2,189,506
Commercial & Subsidiaries	\$130,633,171	\$90,209,649	\$12,350,753
Securities	\$1,735,978	\$2,214,813	\$20,750
Total	\$209,457,967	\$144,580,418	\$14,561,009

Source: OIG-generated based on information from the Division of Finance (DOF) and DRR's Loss Share Database.

The figure below shows the 10 failed banks with the largest amount of assets that were initially subject to shared-loss coverage. Covered assets from these banks included \$52.5 billion of single-family assets and \$41.0 billion of commercial assets, for a total of \$93.4 billion, comprising 45 percent of the initial covered asset base.

Figure: Top 10 Bank Failures by Initial Shared-Loss Balance



Source: DRR's Loss Share Database as of September 30, 2011.

The loss-sharing provisions of SLAs have evolved since November 2008, as illustrated in Appendix III of this report. For SLAs executed since March 26, 2010, the FDIC generally reimburses an AI for 80 percent of losses incurred on covered assets and the AI covers the remaining 20 percent of losses. Previously, the FDIC shared losses with an AI on an 80/20 basis until the losses exceeded a stated threshold defined in the SLA, after which the basis for sharing losses shifted to a 95/5 basis. The stated threshold amount was generally the FDIC's dollar estimate of the total projected losses on shared-loss assets. Sharing losses on a 95/5 basis was eliminated for all SLAs executed after March 26, 2010. Some SLAs were also structured with loss tranches, whereby the AI assumed a certain amount of losses before loss-sharing began or loss coverage varied in accordance with pre-defined loss levels. The FDIC estimated the total cost savings of maintaining SLAs as opposed to immediately selling failed bank assets to be \$40.3 billion.

EVALUATION RESULTS

As noted above, the FDIC reintroduced P&A Agreements with shared-loss coverage and entered into 272 such agreements between November 2008 and September 2011. Over 120 SLAs were executed in the first 17 months after they were reintroduced. All of this activity took place while the FDIC was establishing and implementing a monitoring program to address the significant financial and operational risks associated with the SLAs.

We determined that the FDIC devoted high-level management attention to the quickly expanding SLA program, including establishing corporate-wide performance goals, convening a Project Management Office (PMO) task group, and providing quarterly updates to the Chairman and Audit Committee on the findings of its AI compliance reviews and planned corrective actions. The Corporation also substantially increased staff, engaged contractors, and developed procedures and systems to manage the associated workload and risks.

As a result of these efforts, the FDIC has established a number of controls and processes to monitor and ensure that AIs comply with the terms and conditions of the SLAs. We also found that the SLA program is continuing to mature, as evidenced by the recent finalization of policies and procedures, initiation of training programs, strengthened AI compliance monitoring efforts, and implementation of data resources to manage program data.

Further, the FDIC is taking or has taken steps to enhance:

- information security of its SLA data resources;
- guidance to AIs to encourage more commercial loan modifications and the tracking of such modifications;
- tracking of questioned claims and processes for ensuring corrective action in response to AI reviews; and
- oversight of AIs by implementing a Proactive Monitoring Initiative to more promptly prevent or detect instances of non-compliance.

However, in any program of this size, there will be emerging issues and risks that require monitoring and attention. In that regard, we are recommending that the FDIC (1) ensure that it issues CMC task orders in a timely manner; (2) determine whether there are efficiencies that can be gained in how the Corporation monitors and assesses contractor performance; (3) issue guidance to better ensure consistent AI monitoring efforts among DRR staff and the CMCs; (4) issue guidance on how to evaluate whether AIs are pursuing and reporting recoveries experienced on covered assets; and (5) enhance its guidance pertaining to monitoring and implementing actions to address non-compliant AIs.

With respect to the OIG's five previous SLA reports, the FDIC implemented corrective actions to address 79 of the 85 recommendations made in those reports. These reports questioned \$67.4 million in SLA claims paid by the FDIC, and the FDIC had recovered \$29.8 million of these claims as of September 30, 2011. Due to misinterpretations of the SLAs, subsequent events that made certain questioned costs allowable at a later date, and instances where some questioned costs were later found to be valid or unsupported, DRR did not pursue \$6.2 million of the questioned costs. DRR continues to work with the AIs to resolve the outstanding questioned costs and expects to resolve these issues, as well as the outstanding recommendations, by March 2012. These OIG reports also included recommendations for enhanced guidance to AIs and FDIC staff and contractors to better ensure SLA compliance. All of the recommendations related to these issues had been implemented at the time of our evaluation.

Program Governance and Administration

SLA program governance and administration involves assorted responsibilities for the AIs, various FDIC divisions and offices, and contractors. These responsibilities are outlined below. Consistent with its corporate-wide performance goals established for the SLA program, DRR developed RSAM policies and procedures, conducted on-site compliance monitoring reviews of the AIs and issued related reports, and provided quarterly updates to the Chairman and Audit Committee on the findings of its AI reviews and planned corrective actions.³ In 2009, the FDIC's Chief Financial Officer established PMO groups to oversee key areas of challenge, including one for the SLA program. DRR also instituted a training program to ensure that program staff and contractors understand their responsibilities and are kept up-to-date on program changes. Finally, as part of its governance structure, DRR utilizes various databases, applications, and other electronic means to generate reports, track claims, and evaluate program outcomes.

Acquiring Institutions. AIs' responsibilities are described in the SLAs and generally include the following:

- manage, administer, and collect amounts owed on SLA assets using normal and prudent business and banking practices as required under customary servicing procedures (which are defined in the SLA);

³ To meet one of its performance goals, by the end of 2011, DRR stated that it conducted on-site visitations of all the AIs participating in the SLA program and issued final reports and corrective action plans for at least 75 percent of those reviews, including all AIs with SLAs valued at more than \$1 billion.

- strive to maximize collections on shared-loss assets without favorable treatment of any assets owned by the AI or its affiliates that are not shared-loss assets;
- comply with single-family loan modification guidelines with the objective of minimizing losses to the AI and the FDIC and maximizing the opportunity for qualified homeowners to remain in their homes with affordable mortgage payments;
- provide to the FDIC certificates, notifications, and required reports, including annual internal audit reports describing their compliance with the SLAs; and
- permit the FDIC and outside parties to monitor the AI's performance of its duties under the SLA.

FDIC Division and Office Resources. The FDIC has invested a substantial number of staff and contractor resources to the increased resolution and receivership workload resulting from the financial crisis, including the shared-loss program. Most notably, DRR has increased its overall staffing from 223 to 2,100. As of September 30, 2011, 196 of those 2,100 staff were dedicated to SLA operations. Table 3 summarizes the roles and responsibilities of DRR and other FDIC organizations that support the SLA program.

Table 2: Divisions and Offices that Support the SLA Program

FDIC Office		Role/Responsibility
DRR	Headquarters	<ul style="list-style-type: none"> Provides overall oversight and management of the SLA program. Establishes and implements policies, processes, procedures, and delegations of authority for the management of SLA program. Provides advice for resolving disputes between the AIs and the FDIC such as whether certain claims are permitted under the program. Handles policy issues, prepares management reports, and conducts briefings pertaining to the SLA program.
	Dallas Field Operations Branch	<ul style="list-style-type: none"> Responsible for SLA monitoring activities. Compliance oversight functions pertaining to the CMCs, DRR, and AIs are consolidated in this office. Implements policies and procedures related to the SLA program.
	Temporary Satellite Offices (TSO) * <ul style="list-style-type: none"> West Coast Midwest East Coast 	<ul style="list-style-type: none"> Responsible for SLA monitoring activities. Functions will be merged into the DRR Headquarters and Dallas Field Operations Branch as the TSOs close. Implements policies and procedures related to the SLA program.
	Internal Review	<ul style="list-style-type: none"> Performs periodic assessments of the internal controls in place within, and evaluates compliance with, the SLA program.
Other Divisions and Offices	Legal Division	<ul style="list-style-type: none"> Provides legal advice, guidance, and assistance in interpreting provisions associated with P&A Agreements and SLAs.
	Division of Finance (DOF)	<ul style="list-style-type: none"> Records in the FDIC's financial statements, estimated SLA liabilities, which are calculated by DRR. Adjusts the estimates each month, based on actual FDIC payments.
	Corporate Management Control, DOF	<ul style="list-style-type: none"> Assists DRR with its process of ensuring AIs have taken adequate corrective action to address CMC recommendations directed towards the AIs. Reviews draft policies and procedures related to the SLA program from a risk perspective to ensure that the program includes requisite controls. Performs certain testing to identify risks and internal control deficiencies in the SLA program.
	Division of Risk Management Supervision (RMS)	<ul style="list-style-type: none"> Monitors AIs' compliance with certain SLA requirements, as part of its examinations.

Source: OIG-generated based on OIG review of RSAM policies and procedures.

* The West Coast TSO closed on January 13, 2012. The Midwest TSO is scheduled to be closed on September 28, 2012. The East Coast TSO will remain open until at least the fourth quarter of 2013 and the FDIC expects to establish a closing date in late 2012 or early 2013.

Many of the staff responsible for shared-loss monitoring are located in one of the FDIC's three TSOs. The FDIC's Board approved the creation of the TSOs to address the increased workload associated with the resolutions and receivership activity. The TSOs are primarily staffed by non-permanent FDIC employees and contractors. Key RSAM staff and their responsibilities include:

- **TSO Office Managers**

- Manage RSAM Specialists/Task Order Oversight Managers (TOOM),⁴ Data Specialists, and Technicians;
- Prepare evaluation reports for headquarters' staff; and
- Monitor contractor performance.

- **RSAM Specialists/TOOMs**

- Serve as primary points of contact for the AIs;
- Monitor AI compliance with the SLAs;
- Monitor contractor performance, review invoices, and accept deliverables;
- Validate AIs' certificates and data submissions;
- Generally oversee a number of AIs; and
- Report to one of DRR's four Oversight Managers (OM).

- **OMs**

- Manage contractor relationships and track contractor performance and
- Foster communications and act as a liaison between the AIs, CMCs, and DRR staff.

- **Technicians**

- Provide administrative support to the RSAM specialists, data specialists, and TSO managers;
- Assist in preparing the schedules of covered assets; and
- Assist in the processing of data submissions and certificates for payment submitted by the AIs.

Finally, RMS is responsible for conducting safety and soundness examinations of banks whose primary federal regulator is the FDIC. According to a May 2010 RMS memorandum,⁵ when examining banks that have SLAs in effect, examiners are supposed to:

⁴ RSAM specialists are DRR staff that directly monitor AI compliance with an SLA. TOOMs are DRR staff who coordinate with and oversee a CMC's efforts to monitor an AI's compliance with an SLA.

⁵ Division of Risk Management Supervision: *Examinations of Institutions with Assets Covered by Loss-Sharing Agreements*, Memorandum No. 2010-018, May 6, 2010.

- Consider the impact of SLAs when performing asset reviews, assessing accounting entries, assigning adverse classifications to assets, and determining examination ratings and conclusions.
- Assess whether the AI applies its loan administration processes, credit risk management policies, and loss recognition and charge-off standards to SLA-covered assets in a manner consistent with its treatment of assets not covered by SLAs (referred to as legacy assets, hereinafter).
- Consult with the appropriate RMS regional office to determine whether the AI is in compliance with the SLA and that the FDIC's shared-loss coverage remains in effect.
- Determine the appropriateness of the accounting for the AI's acquisition of the failed bank.

RMS amended its 2010 internal guidance in October 2011 to enhance coordination between RMS and DRR and to avoid duplicating efforts.⁶ The memorandum states that DRR should provide RMS with a copy of visitation reports and RMS should accommodate information requests from DRR for banks with SLAs. The guidance also states that the Federal Reserve Board, the Office of the Comptroller of the Currency, and state banking supervisors should be invited to participate in the FDIC's shared-loss oversight efforts so the FDIC can be informed of important developments regarding an acquiring national or state-chartered bank's financial condition and performance under an SLA.

Risks Associated with the FDIC's Staffing Strategy. Although the FDIC increased its staff to handle the workload associated with the failed banks during the financial crisis, the majority of the TOOMs and OMs are term employees with terms of 2 to 4 years.⁷ DRR elected to hire term employees as opposed to permanent employees because the workload associated with SLAs is expected to decline steadily based on the following factors:

- The SLAs will become more seasoned and presumably require less oversight,
- The rate of bank failures is projected to decrease, and
- DRR believes that an increasing number of AIs will terminate their SLAs early.

The FDIC has successfully used term employees in the past to address temporary workload surges. However, in this instance, the length of the term appointments creates some challenges with respect to providing continuity, given that the SLAs have longer time spans (8 to 10 years) than the term appointments. As one might expect in these circumstances, some term employees have left the FDIC before their terms expired. According to FDIC and CMC officials, these departures have resulted in some loss of institutional knowledge and impacted the consistency of communication between the CMCs and the AIs.

To help mitigate risks associated with the TSO closings, the FDIC developed a *Functional Continuity Project Plan*, to ensure that core business functions, critical documentation, and

⁶ Division of Risk Management Supervision: Amendment to Memorandum 2010-018: *Examinations of Institutions with Assets Covered by Loss-Sharing Agreements*, Memorandum No. 2011-023, October 14, 2011.

⁷ We reviewed a judgmentally selected sample of 27 of the 58 OMs and TOOMs at the FDIC as of July 18, 2011, and found that all of the sampled individuals had completed required oversight management training. In addition, the FDIC produced signed appointment memoranda for all sampled individuals, which outlined their responsibilities and tasks, in response to exceptions that we identified.

electronic files are accounted for and successfully migrated into DRR's headquarters and/or the Dallas Field Operations Branch, as the TSOs close. The objectives of the Plan are to:

- Provide early warning of significant issues that may adversely affect DRR,
- Establish a framework for coordination and cooperation,
- Ensure that DRR's mission is continued with minimal disruptions, and
- Maximize effectiveness, efficiency, and consistency of operations.

Compliance Monitoring Contractors. DRR relies on CMCs to perform on-site visits of the AIs and review loss claims for compliance with the SLAs. The eight CMCs provide approximately 265 additional staff to assist DRR. DRR typically assigns a CMC by issuing a task order, which outlines a CMC's duties associated with monitoring an AI's compliance with the P&A Agreement and conducting site visitations. DRR works with the Division of Administration's (DOA) Acquisition Services Branch to carry out contracting activities and is subject to controls included in the FDIC's *Acquisition Policy Manual* (APM), including requirements associated with the protection of confidential or sensitive information about borrowers.

We reviewed the 24 CMC task orders that were issued from March 2011 through July 2011, which corresponded to P&A Agreements signed from March 2010 through January 2011, to determine how long it took the FDIC to issue a task order. We found task orders were issued an average of 258 days (approximately 8.5 months) after the corresponding P&A Agreements were signed. We noted the trend was improving; that is, less time was required to issue the more recent task orders in our sample. DRR attributed the improvement to its increased experience with the SLA program.

DRR has not, however, established a firm goal for the timeframes in which a CMC task order should be issued. One CMC that we interviewed stated that, ideally, task orders should be issued so that the first on-site visitation is conducted shortly after the AI files its first claim with the FDIC. This timeframe appears appropriate because it allows the CMC to review a sample of an AI's initial claims and identify any areas of non-compliance at an early stage. The time it takes an AI to issue its first SLA claim varies, as it depends on several factors such as the condition of the failed bank's records, and the size, complexity, and performance of the covered assets. Given the important role the CMCs play in the RSAM program, DRR and DOA should continue to work towards issuing task orders in a timelier manner and establish an appropriate timeframe goal for doing so. Accordingly, we recommend that the Director, DRR, in conjunction with the Director, DOA:

Recommendation 1. Review the current process for issuing task orders to determine whether there are opportunities for streamlining and then establish a goal for the timeframe within which a CMC task order should be issued.

The FDIC's APM generally requires that program offices evaluate the performance of its contractors on an annual basis. Information on a contractor's performance is critical for subsequent contract awards and also a primary means of reporting contractor performance data to management. Accordingly, DRR managers complete a required DOA evaluation form rating

the quality of the CMC's work products, cost-effectiveness, timeliness, business relations, and customer satisfaction for DOA. DRR aggregates and maintains the information in an Excel spreadsheet. For most of the 67 performance evaluations completed through October 17, 2011, DRR has rated the CMCs as "good or better."

In August 2011, in addition to completing DOA's evaluation form, DRR began separately evaluating the CMCs based on their performance at the on-site visitations of the AIs. DRR's rating form is substantially similar to DOA's, but DRR's form contains more specific criteria relevant to a CMC's shared-loss review responsibilities. DRR compiles its CMC performance ratings into a management report. However, many of the on-site visitations are performed annually, which means that DRR's evaluations are not likely to provide more timely information on the CMC's performance than the evaluations required by DOA. We recognize that DRR implemented its evaluation process with the intent to more effectively assess the CMCs' performance, which is important given their role and the funds expended for their services. However, there may be opportunities for improving the efficiency of the two evaluation processes. Accordingly, we recommend that the Director, DRR, and the Director, DOA:

Recommendation 2. Evaluate the DOA and DRR evaluation processes and related forms and determine whether there are efficiencies that can be gained in how CMC contractor performance is monitored and assessed, and take appropriate action.

RSAM Policies and Procedures. As the SLA program has evolved, DRR has worked to finalize policies and procedures for managing and monitoring SLAs. The *RSAM Manual* was finalized in July 2011 and a technical direction manual for the CMCs was issued in June 2011. The *RSAM Manual* outlines the responsibilities of DRR, AIs, and contractors, and contains an overview of key program activities and related guidance. Guidance in the *RSAM Manual* is supplemented by a myriad of job aids and checklists, which are available on a DRR SharePoint site and on an FDIC secure virtual data room for AIs and CMCs. The job aids contain detailed guidance pertaining to paying claims, finalizing the schedules of covered assets, monitoring compliance with specific provisions in the Single-Family and Commercial SLAs, overseeing contractors, and terminating SLAs. The technical direction manual outlines CMC reporting timeframes and provides specific guidance on categorizing findings, reviewing AI single-family loan modification programs and modification denials, selecting statistically valid samples, reporting questioned costs, reporting findings and observations, formatting the visitation reports, and monitoring AIs to ensure that findings are addressed. This manual is designed to foster greater consistency among the CMCs' monitoring efforts and visitation reports.

Policies and procedures help ensure that management's directives are implemented consistently and completely and document the processes that should be followed to ensure that a program's objectives are met. Policies and procedures are an important element of a strong internal control program.

DRR has also developed training programs related to SLA management and monitoring activities. Because many of the program staff were hired as new, term employees, strong training and development programs are important to quickly building competencies and job knowledge. DRR conducts training for its own staff, including new employees, the AIs, and CMCs to reinforce policies and procedures. DRR plans to update staff on new policies approximately every 6 months.

<p>DRR Training Initiatives</p> <hr/> <p>Between May and October 2011, DRR conducted training related to:</p> <ul style="list-style-type: none">• finalizing schedules of covered assets;• processing and reviewing the validity of claims, including the Proactive Monitoring Initiative and interpretation of electronic claim reviews;• CMC’s monitoring responsibilities;• loan modification guidelines;• documentation of findings in visitation reports;• tracking corrective actions, including the use of DRR’s Integrated Compliance Engine (ICE) data resource;• changes to the P&A agreements; and• the early termination process.

Data Collection, Management, and Security. DRR relies on various databases, applications, and other electronic means to generate reports, track claims, and evaluate program outcomes. Table 3 provides an overview of the primary data resources that DRR uses to monitor the SLA program.

Table 3: Primary Data Resources for the SLA Program

Source	Description / Purpose
Loss Share SharePoint Site	An FDIC storage facility containing P&A Agreements for each AI, visitation reports, claim filings, training materials, written guidance, and other SLA resource materials. DRR and other FDIC staff who support the SLA program have access to this site.
Virtual Data Room	A secure FDIC Web site that the FDIC uses to post documents and exchange comments with internal and external users. Within the SLA process, the virtual data room is used to exchange bank data and supporting documentation between the FDIC, AIs, CMCs, and other contractors.
Data Aggregator	A contractor, referred to as the data aggregator, provides the FDIC with the ability to electronically review SLA claims; store, manage, and analyze SLA data; produce management reports; and perform statistical analyses.
Loss Share Database	A DRR database that houses loan and loss claims data and tracks SLA program activity by receivership. Using this database, the FDIC is able to produce management reports identifying the assets subject to shared-loss coverage. The database is populated through manual entry, and in 2012, DRR expects to implement a means to automatically populate the database and migrate it into the data aggregator.
Risk Share Analysis Database	A DRR database containing loan-level details on the initial and final schedules of shared-loss assets and summary information on claim filings. Data from this database is used to create management reports.
Loss Share Cost Estimate Database (LSCED) and Other Related Datasets	Datasets containing basic data from the initial and updated resolution cost estimates for shared-loss failures. LSCED contains initial estimates. Two other datasets contain more up-to-date estimates. These datasets are used for reporting, research, and analysis.
Dashboard Oracle Environment	Oracle database with a wide variety of data that supports the Chairman's dashboard. Contains data on resolutions, SLAs, receiverships, and industry aggregates. This database is used for managerial reporting.
Integrated Compliance Engine (ICE)	A DRR data resource deployed on July 26, 2011, used to identify and record the disposition of all recommendations contained in the CMC visitation reports.

Source: OIG-generated based on information from DRR.

DRR officials view the data aggregator to be one of the program's key data resources. Among other things, the data aggregator will:

- process monthly and quarterly SLA financial data from the AIs and validate and consolidate the information to meet the FDIC's operational and reporting requirements;
- provide the FDIC with an enhanced ability to electronically review SLA claims;
- store and manage SLA data;
- produce management reports;
- allow FDIC staff to perform statistical analyses, and manage overall SLA cash flow projections and exposure to risk; and

- provide a secure user interface, allowing a minimum of 100 users to concurrently query the data.

As part of its 2010 financial statement audit, the U.S. Government Accountability Office (GAO) found that the FDIC had not established appropriate internal controls associated with several of the data resources that DRR uses to monitor the SLA program. In its response, the FDIC concurred with GAO's finding that additional internal controls were required over the SLA business processes and stated that the associated data resources deserve proper identification, assessment, and protection.⁸ For instance, some of DRR's data resources consisted of Excel[®] spreadsheets and databases, which had not been assessed from an Information Technology (IT) perspective or subject to IT security reviews.

On June 30, 2011, DRR issued a plan to address GAO's concerns. Pursuant to this plan, staff in DRR and the Division of Information Technology (DIT) started to evaluate the IT controls surrounding several of the SLA data resources and made decisions regarding which ones to retain, discontinue, or migrate into the data aggregator. By the end of 2011, DRR plans to issue a report describing the work performed and changes that were made to improve IT controls. DRR and DIT plan to perform additional work in 2012 to ensure the confidentiality, integrity, and availability of SLA data resources.

⁸ GAO Report: *Information Security: Federal Deposit Insurance Corporation Has Made Progress, but Further Actions Are Needed to Protect Financial Data* (GAO-11-708), August 2011.

Management Reporting. To monitor and manage the program, DRR and other FDIC offices produce management reports outlining various aspects of the program. Table 4 describes some of the primary SLA-related management reports.

Table 4: SLA Management Reports

Report	Description
Loss Sharing Summary Report	A monthly report that shows the initial assets subject to loss sharing, SLA losses and recoveries, and FDIC payments broken out by each failed institution.
PMO Report	A monthly report to the Chairman that provides a snapshot of the SLA program, including claims paid to date, the balance of covered assets, a comparison of estimated SLA claims to actual claims, delinquency rates of SLA assets compared to the overall market, loss severity trends for the largest single-family portfolios, and SLA program accomplishments. The report also tracks the status of OIG recommendations contained in OIG reports on SLA compliance.
Quarterly Report to the Chairman and Audit Committee	A quarterly report that contains information on SLA activities and accomplishments, among other things. The most recent report, dated July 8, 2011, documented DRR’s progress in conducting compliance reviews, resolving compliance review findings, providing guidance to CMCs to enhance the quality and consistency of their reviews, and meeting corporate goals associated with the SLA program.
DRR at a Glance Report	A weekly report that identifies SLA staffing resources, resolution activities, and information about contract awards.
Loss Sharing Summary Net Payments Report	A monthly report showing the balance of assets subject to loss-sharing, estimated losses, actual losses, FDIC payments, and recoveries.
RSAM Watchlist Report	A report used to track and monitor AIs that warrant increased scrutiny.
SLA Report	A report generated for each shared-loss transaction, which contains high-level information about the closed bank and AI.

Source: OIG-generated based on information from DRR and DOF.

We reviewed these reports and determined that they contained information useful to assist management in monitoring the progress of the SLA program, tracking claims, and staying abreast of AIs that do not comply with the SLAs.

Controls to Ensure the Validity of AI Claims

To help ensure that SLA claims are valid and contain adequate supporting documentation, DRR established processes to properly account for and reach agreement with the AIs on the covered assets, meet with the AIs to discuss program requirements, and review SLA claims. DRR also established a Proactive Monitoring Initiative to address program risks.

Accounting for and Reaching Agreement on the Covered Assets. An integral part of the SLA monitoring program is identifying the single-family and commercial assets for which the FDIC provides shared-loss coverage. Schedules 4.15A and 4.15B of the SLA contain listings of

all of the single-family and commercial assets subject to SLA coverage, respectively. DRR's goal is to prepare the draft and final schedules within 30 and 120 days of the bank closing date, respectively. The steps involved in developing the schedules include:

- **Preparing the initial 4.15A and 4.15B schedules.** These schedules list assets covered by the SLAs and include the value of the assets, as assigned by DRR. DRR samples assets to help ensure the assets are listed on the correct schedules.
- **DRR's review and approval.** DRR staff in headquarters and the responsible TSO review and approve the schedules. These review processes are done to ensure (1) mathematical accuracy of aggregate amounts listed in the schedules, (2) each asset is assigned a unique identification number, and (3) all changes to the draft schedules are reviewed and approved by DRR officials.
- **AI's review.** AIs are allowed to review the draft schedules and request that additional assets be added to or deleted from the schedules or moved from one schedule to the other. The FDIC requires the AIs to produce documentation to support any assets that they want to add to the schedules.
- **Signing letter of agreement.** Once DRR and the AI agree on the assets that should be included in the schedules, they sign a standard letter, which acknowledges their agreement to all of the assets listed in the final schedules. After the letter is signed, DRR uploads the draft and final schedules and any other related information to SharePoint.

According to FDIC officials, most changes requested by the AIs consist of moving assets from one schedule to the other because of misclassifications between schedules 4.15A and 4.15B.

In June 2011, DRR stated that it was taking 14-21 days from the bank closing date to draft the schedules but an average of 157 days to finalize the schedules. DRR officials stated that the quality of the closed bank's records and the timeliness of the AI's support for proposed adjustments impacted their ability to timely finalize the schedules. We reviewed the 15 most recently closed banks with SLAs as of June 16, 2011, to assess how long it took DRR to finalize schedules 4.15A and 4.15B. We found that the time to finalize the schedules ranged from 119 to 207 days, averaging 152 days. Finalizing the schedules in a timely manner is important to help ensure that all parties are clear as to what assets are covered by an SLA. DRR should continue to monitor its progress in meeting its goal of finalizing schedules 4.15A and 4.15B within 120 days of a bank closing and implement additional procedures, as appropriate, to meet this goal.

Currently, the FDIC permits AIs to submit claims based on draft schedules 4.15A and 4.15B and when the draft schedules are finalized, the claims must be based on the final schedules. Therefore, we performed a test to determine the extent of differences between the draft and final schedules. We compared the draft and final schedules for 15 of the most recently closed banks, based on information contained on DRR's SharePoint site as of July 19, 2011. Overall, we found that the number and dollar amount of assets in schedules 4.15A and 4.15B did not vary significantly from the draft to final schedules. Based on our results, DRR's approach of allowing claims to be based on the draft schedules seems to be reasonable and efficient.

Meetings with AIs. RSAM specialists conduct meetings with the AIs to explain SLA requirements, loan modification programs, ongoing monitoring activities, reporting, and other compliance and data requirements.

Reviewing Loss Claims. AIs submit claims to the FDIC for reimbursements of losses associated with SLA assets. An AI is permitted to submit single-family claims on a monthly basis and commercial loss claims on a quarterly basis. DRR and the CMCs initially conducted manual reviews of the claims and corresponding data but these reviews are now performed electronically by the data aggregator. As part of the electronic review process, each claim is checked against data specifications pre-defined by the FDIC and a report is generated that assigns each data field with a “pass,” “warning,” or “fail” notification. The AI must correct all of the “fail” and address certain “warning” notifications before the FDIC will pay the claim.

Proactive Monitoring Initiative. Originally, the FDIC paid claims and subsequently reviewed a sample of claims to determine whether they were accurate and complied with SLA provisions. While the FDIC generally continues this practice, in 2011, it developed a Proactive Monitoring Initiative to further address risks in the SLA program. Through this initiative, the FDIC now requests documentation from AIs in support of certain large claims on commercial certificates before making payments and reviews a sample of such submittals. These claims include those that exceed \$1 million, and that are included in commercial certificate filings totaling more than \$25 million.⁹ These proactive reviews are intended to:

- mitigate the risks of paying unsupported or excessive loss claims,
- provide DRR with advance information about an AI’s charge-off methodology,
- better ensure that AIs submit supportable claims, and
- satisfy an internal FDIC requirement to review commercial certificates with total claims over \$25 million.

DRR reported that the AIs are complying by sending in the supporting documentation and in a few rare instances, the FDIC has delayed payments due to insufficient documentation.

As part of its Proactive Monitoring Initiative, DRR RSAM staff also started visiting the largest AIs to:

- foster communications between DRR and the AIs and address issues in a timely manner,
- assess AIs’ loss mitigation strategies and efforts to maximize collections,
- encourage loan modifications, and
- qualitatively assess the AIs’ effectiveness in carrying out required SLA provisions.

DRR’s RSAM staff plan to visit the AIs on an annual or semiannual basis. As of December 31, 2011, DRR completed 18 reviews and found that the AIs were generally complying with the SLA provisions but needed to increase their efforts to modify commercial loans. DRR plans to complete six AI reviews in January 2012 and then schedule additional reviews for 2012. The FDIC estimated that these 24 AIs account for 70 percent of the remaining

⁹ At the time of our fieldwork, the FDIC had not established a similar process for single-family claims.

expected SLA losses. DRR's loss mitigation team provided training and written guidance to DRR staff on how to perform these assessments.

Although not required by the SLAs, DRR has also asked that AIs provide advance notice to the FDIC before executing discounted payoff (DPO) transactions. A DPO transaction may occur when a bank charges off a certain portion of an impaired loan and then works with a borrower to close out the loan by collecting as much of the remaining balance as possible. The bank may agree to accept an amount that is less than the remaining balance of the loan, provided the borrower pays the bank upfront. The AI is permitted to seek reimbursements from the FDIC on losses related to DPO transactions. DRR has not yet issued related guidance in this area. DRR would like to review these transactions prior to their execution, to:

- confirm that the DPO will maximize collections,
- confirm that the AI considered other alternatives such as loan modifications,
- mitigate the potential risk that an AI will accept a greater discount than it would with its legacy assets because of the FDIC's shared-loss coverage, and
- confirm that the assessed value of the associated asset is current.

In November 2011, DRR developed SLA reports for each AI, which contain high-level information about the closed bank and the AI, the single-family and commercial asset balances, the dates of compliance visitations, when the covered asset schedules were completed, upcoming and recent events, and operational concerns. DRR uses these reports as management tools to stay abreast of current issues regarding the AIs.

Collectively, DRR's efforts to proactively review AIs' claims and key transactions, visit the AIs, and develop snapshot reports should strengthen existing controls and further guard against paying unsupported claims.

Controls to Ensure AIs Are Complying with the Terms of the SLAs

Under the RSAM program, CMC or DRR staff perform on-site and off-site monitoring activities to ensure that the AIs are complying with the terms of SLAs. As discussed earlier in this report, the CMCs assist DRR in monitoring AIs with SLA portfolios greater than \$200 million, and DRR staff independently monitor AIs with portfolios less than or equal to \$200 million. The text box below provides an overview of the on- and off-site monitoring activities.

Overview of On-Site and Off-Site Compliance Monitoring Activities

On-Site Activities

- Review certificates and supporting documentation.
- Review loan files to support claims for covered losses.
- Follow up with AI management on corrective actions taken to remediate prior findings.
- Review AI policies and procedures and shared-loss loan files to ensure shared-loss assets are treated in a similar manner to the AI's legacy loans.

Off-Site Activities

- Review and analysis of certificates and supporting data packages submitted by the AIs.

Monitoring and Visitation Plans. Each CMC firm develops its own monitoring and visitation plans based on DRR guidance and its own expertise. DRR staff also develop monitoring and visitation plans for the AIs they directly monitor on their own. The monitoring plan establishes the strategy and action plan for evaluating an AI's overall compliance with the P&A Agreement and includes a visitation plan. The TOOM determines the frequency of the CMC visits, considering the risk and size of the AI's SLA portfolio and overall compliance with the SLA. In general, visitations are conducted semi-annually or annually over the term of the SLA. A review of unaudited claims may be performed prior to terminating an SLA. The TOOM also approves a CMC's visitation plan, which provides specific work-steps to perform during an on-site visitation. For example, the visitation plan consists of testing scripts, checklists, and other documents outlining the approach to assessing an AI's compliance with the P&A Agreement. The monitoring and/or visitation plans also include a methodology for selecting a statistically valid sample of loans to review during an on-site visitation, as required by DRR's guidance.

While the CMCs and DRR can and should develop monitoring and visitation plans to fit the risk factors associated with specific AIs, we reviewed a sample of eight plans and found that the CMCs and DRR are using very different plans to assess compliance. For example, some plans contained detailed procedures for testing an AI's compliance with specific provisions of the SLAs, while others did not. We believe more structured guidance would provide additional assurance that the approach for monitoring AIs is consistent. Accordingly, we recommend that the Director, DRR:

Recommendation 3. Conduct a review of the CMC and DRR monitoring and visitation plans to identify best practices, testing areas, and core elements that should be included in all of the monitoring and visitation plans and develop and issue additional guidance.

The following sections of the report summarize what we learned from our discussions with the CMCs regarding their efforts to evaluate the extent to which AIs were meeting their responsibilities under the P&A Agreements.

Ensuring that AIs Treat Covered Assets Similarly to Legacy Assets. A significant portion of SLA claims result from assets charged off by an AI, and a risk exists that AIs will charge off SLA assets prematurely or manage the SLA assets less prudently than legacy assets because the

AI is only responsible for 20 percent of the associated losses. DRR officials also expressed a concern that AIs may submit a larger number of loss claims just before SLA coverage ends. To help mitigate these risks, the Single-family and Commercial SLAs require an AI to use its best efforts to maximize collections on covered assets. Further, the Commercial SLA allows the FDIC to purchase charged-off assets if the AI does not diligently pursue collection efforts.

All of the CMCs interviewed stated that they compared how the AIs charged off SLA assets to their charge-offs of legacy assets to ensure that the AIs applied consistent policies in this area. For example, the CMCs determined whether the AIs charged off SLA assets more aggressively than legacy assets. The CMCs also stated that AIs were generally in compliance with rules pertaining to charge-offs and treated their SLA and legacy assets in a similar manner. However, the CMCs also stated that they had identified AIs that aggressively charged off SLA assets. One CMC said that two or three of its AIs applied significantly higher discount rates to appraisals for its SLA assets, compared to its legacy assets.

CMC officials commented that their monitoring efforts to ensure consistent treatment of SLA and legacy assets can be difficult because (1) an AI's SLA assets may be inferior to its legacy assets and (2) some actions that an AI takes regarding the disposition of an asset involve business decisions that can be unique to the asset, making it more difficult to determine if the AI treats its SLA and legacy assets in a similar manner.

Ensuring that AIs Pursue and Report Recoveries. The SLAs are structured such that the FDIC shares in recoveries associated with covered assets and AIs are required to include recoveries in their loss claims. Recoveries constitute funds collected on assets that were fully or partially charged off by the closed bank or AI. The risk exists that the AIs may not pursue recoveries as vigorously as they should because they may only share in a relatively small percentage of recoveries. Further, AIs may not have controls in place to identify and report recoveries to the FDIC. Originally, the AIs were required to provide 80 percent of all recoveries to the FDIC. During 2010, to increase the incentive for AIs to pursue recoveries, the FDIC changed the percentage of recoveries required to be remitted for zero balance Commercial SLA assets to 50 percent.¹⁰ Zero balance assets refer to assets that were fully charged off by a closed bank and then acquired by an AI. In all other circumstances, the AIs are still required to remit 80 percent of recoveries to the FDIC.

Although some CMCs did not view tracking and reporting recoveries to be a large-scale problem or to pose significant risks, others believed additional guidance was needed to mitigate the risks that AIs are not reporting recoveries. DRR has not issued formal guidance outlining how DRR and the CMCs should review an AI's portfolio to determine whether an AI is appropriately reporting recoveries. As a result, the monitoring efforts performed by the eight CMCs and DRR could vary.

Further, DRR's controls surrounding recoveries associated with zero balance assets need to be strengthened. The FDIC did not initially include zero balance assets on the covered asset

¹⁰ Recoveries pertaining to Commercial SLA assets are more prevalent than recoveries on Single-family SLA assets.

schedules, which made it difficult to track associated recoveries and corresponding remittances to the FDIC. In 2010, DRR began listing zero balance assets on the covered asset schedules. In 2011, DRR assigned a unique asset identification number to each covered asset in all of the previously executed SLAs, including zero balance assets, provided they were listed in the original asset schedules. Asset identification numbers, which are now routinely assigned when new SLAs are executed, enable DRR to better track the disposition of covered assets. DRR officials informed us that they may not be able to identify zero balance assets that were not included on the original schedules of covered assets. Accordingly, with respect to recoveries, we recommend that the Director, DRR:

Recommendation 4. Issue guidance to DRR staff and the CMCs on how to evaluate whether AIs are sufficiently pursuing and reporting recoveries on covered assets. Guidance should include procedures for testing whether recoveries have been made on any zero balance covered assets.

Single-family Loan Modifications. The AIs are required to modify single-family loans and to pursue other loss mitigation efforts to minimize foreclosures, when possible. The SLA requires AIs to have a single-family loan modification program in place. An AI may use the loan modification program implemented by the FDIC or the Treasury.¹¹ Conversely, an AI may adopt its own proprietary program, subject to FDIC approval. AIs sometimes adopt a proprietary program to better accommodate borrowers who do not meet the strict criteria outlined by the FDIC or Treasury's program. DRR established a group to review bank proprietary loan modification programs, and 27 such programs were approved as of August 15, 2011. Further, the FDIC issued a letter on March 9, 2011 to all AIs encouraging them to employ a single-point-of-contact protocol. In this way, a borrower applying for a loan modification would be assigned to the same person regarding the status of his/her application. DRR tracks the number of single-family loan modifications performed by the AIs as well as charge-offs resulting from losses incurred as a result of the modifications.

The CMCs we interviewed stated that the AIs generally understood the loan modification program guidelines, consistently applied the rules, and that their monitoring efforts were fairly straightforward. Two CMCs said that the AIs were generally denying applications for single-family loan modifications because the borrowers did not qualify, which has been consistent with industry trends. The CMCs said that borrowers are typically denied loan modifications due to the stringent standards of certain loan modification programs. As of September 30, 2011, 30 percent of the AIs' claims resulted from single-family loan modifications. The CMCs also noted instances of non-compliance. For example, the CMCs stated that:

- In some cases, AIs did not calculate a borrower's income properly or accurately compute certain ratios related to a borrower's income.

¹¹ The FDIC's loan modification program is called the *Loss Share Loan Modification Program* and the Treasury's program is called the *Home Affordable Modification Program*.

- AIs with smaller single-family portfolios did not initially have loan modification programs in place.
- AIs did not consistently document their rationale for denying a loan modification application, as required by the Single-family SLA.

Further, one CMC noted that some AIs erroneously applied the debt-to-income provisions specified by the FDIC's loan modification program known as *Mod-in-a-Box*, which is on the FDIC's Web site. This program only applied to IndyMac Bank, which failed in 2008. The *Mod-in-a-Box* program allows a borrower's debt-to-income ratio to range from 31-38 percent. Conversely, the FDIC's current loan modification program limits a borrower's debt-to-income ratio to 31 percent. To avoid confusion, this CMC suggested that the FDIC remove the information about the *Mod-in-a-Box* program from its Web site. DRR officials agreed with this suggestion and stated that they planned to do so.

According to DRR, in general, when an AI is found to not have implemented a Loan Modification Program correctly (or not at all), the AI is immediately required to take corrective actions to implement or improve its program.

Commercial Loan Modifications. The Commercial SLA does not prescribe specific criteria outlining when an AI is required to modify a commercial loan. Nevertheless, DRR has informed the AIs that modifying commercial loans may reduce loan losses, legal costs, and non-accrual and non-performing loans, and avoid foreclosures and selling related collateral in a depressed market. Because of these benefits, DRR has encouraged AIs to modify commercial loans when practicable. Additionally, section 3.2 of the Commercial SLA states that the AI shall administer and manage shared-loss assets:

- Using its best efforts to maximize collections,
- In a manner consistent with its own policies and procedures, and
- In a manner consistent with normal and prudent banking practices.

The AI has the right to choose the workout strategy, provided it complies with these covenants. DRR has also provided guidance to the AIs regarding what types of commercial loans may be modified and under what circumstances to pursue such modifications. In March 2011, the FDIC requested that AIs begin reporting the number of commercial loan modifications performed and whether charge-offs resulted from the modifications. The AIs had only reported a small number of commercial loan modifications as of June 30, 2011.

The CMCs review AIs' efforts to modify commercial loans. Two CMCs said that the AIs modify commercial loans, when possible. However, one CMC said that AIs rarely modify commercial loans because doing so is not required by the Commercial SLA. Another CMC said that the AIs may be reluctant to modify commercial loans because certain modifications result in the loss of SLA coverage or at least raise questions about continued coverage. For example, if an AI modifies a commercial loan so that its maturity date extends beyond the period covered under the SLA, the loan is removed from SLA coverage. In December 2011, DRR changed its policy and now allows SLA coverage to remain unaffected for such commercial loan

modifications. The intent of this policy change is to promote commercial loan modifications, where practicable.

Other restrictions in the Commercial SLA may make an AI reluctant to modify a commercial loan. For example, the Commercial SLA limits an AI to providing a borrower up to an additional 10 percent of the original loan balance, in order to retain SLA coverage of the related asset. In such instances, the AI may decline funding requests that exceed this 10-percent threshold. Also, under the terms of the Commercial SLA, if an AI makes a charge-off on a loan and subsequently advances money to the borrower on the same loan, the AI will lose SLA coverage on that loan. These provisions are intended to protect the FDIC's interests. DRR officials have explained these provisions to the AIs and also informed the AIs that the FDIC may make exceptions to these provisions on a case-by-case basis.

Ensuring that Suspicious Activity Reports (SAR) Are Filed. In some instances, an AI's acquired SLA loans were associated with fraudulent or other suspicious activities. In such instances, the AIs may have been required by law to file SARs. There is a risk that if an AI acquires a fraudulent loan that ultimately fails and is charged off, the AI may not have an incentive to also file a SAR. Instead, the AI may only file a claim with the FDIC for 80 percent of the associated losses. None of the CMCs believed that an AI's failure to file SARs, when required, was a problem or serious risk to the SLA program. Three CMCs noted specific AIs that acquired SLA loans where fraud was present but noted that the FDIC was aware of the situations and taking appropriate action. The CMCs are not required to review an AI's policies and procedures associated with SAR filings. However, RMS staff are expected to review a bank's SAR filings as a part of their supervisory oversight efforts.¹²

Visitation Reports and Findings. Upon completing each visitation, the CMC or DRR produces a draft report documenting its findings and recommendations for appropriate corrective actions. The AI has an opportunity to review the draft report and submit a management response for inclusion in the final report. A TOOM reviews the draft report and assists the CMC in finalizing the report, which is approved by an OM and DRR's Compliance Review Committee (CRC). DRR's goal is to finalize each report within 45 days of the CMC's fieldwork completion date and DRR tracks its progress in meeting this goal. For each finding identified in the report, DRR establishes a timeframe within which the AI should implement corrective action. In an effort to streamline the CMC visitation reports, DRR issued written guidance to the CMCs on how to review and test for SLA compliance. The guidance also contained several templates on how to report findings and recommendations. As a result, all of the CMCs' visitation reports are now formatted in a similar manner and contain more consistent information. Table 5 summarizes information related to visitations conducted in 2010 and through September 30, 2011.

¹² Division of Risk Management Supervision: *Guidance on Review of Suspicious Activity Reports*, Memorandum No. 6426, December 13, 2006.

Table 5: Visitation Reports and Corrective Action Statistics: 2010 and 2011

Reports	2010	As of September 30, 2011
No. of Visitation Reports	191	250
Total No. of Findings	2,025	1,099
Types of Findings		
• Administrative Oversight ^a	975	428
• Reporting and Financial ^b	327	137
• SLA Management ^c	723	534
Recommendations Closed	1,978	619
Questioned Costs		
Total Questioned Costs	\$153.4 million ^d	\$328.2 million
Amounts Recovered	\$63.4 million	\$76.9 million
Support Provided by AI	\$72.7 million	\$5.9 million
Unresolved Questioned Costs ^e	\$17.2 million	\$245.4 million

Source: OIG-generated based on DRR data as of September 30, 2011.

^a Findings involve compliance, staffing, policies and procedures, delinquency management, and recordkeeping.

^b Findings primarily involve the quality of an AI's loss claims.

^c Findings may involve questioned costs and primarily relate to charge-offs, recoveries, accrued interest, reimbursable expenses, and documentation related to loan modifications and loss mitigation efforts.

^d Originally, questioned claims from the 2010 visitation reports totaled \$313 million. DRR revised this estimate to \$153 million based on further analysis.

^e The amount of unresolved questioned costs typically declines as progress is made in resolving individual audit recommendations.

In June 2011, DRR requested that the CMCs provide the amount of questioned costs in each visitation report. In September 2011, DRR informed us that it had recently begun tracking questioned costs as well as reversed claims and is able to break this information out by each AI or CMC. We believe that it is important to track this information because questioned costs demonstrate the added value the CMCs and DRR specialists provide to the oversight of the SLA program and reversals represent DIF savings.

Closing Recommendations. DRR specialists and TOOMs track the resolution of all of the SLA findings and work with the AIs and CMCs to ensure corrective actions are taken. For each recommendation, the specialist or TOOM completes a standard form, which documents the issue and its resolution. DRR managers sign the form when they believe an AI took appropriate action in response to a recommendation and close out the recommendation. DRR staff input information about the status of each finding and recommendation into DRR's ICE data resource. ICE is the FDIC's official system of record for tracking and monitoring the disposition of all of the SLA findings and recommendations.

In an effort to provide greater assurance that DRR is effectively tracking and closing recommendations, Corporate Management Control adopted a risk-based approach to review DRR's supporting documentation for closing recommendations. Specifically, DOF reviews DRR's corrective action documentation related to all monetary findings with questioned costs

over \$75,000¹³ and records information on these findings in its own tracking system. DOF will also have access to ICE and may choose to review corrective action documentation pertaining to any recommendations and thus will not be limited to only reviewing recommendations pertaining to questioned costs above \$75,000. DRR and/or DOF plan to formally document the new process for closing SLA recommendations, the criteria that must be met to close out a recommendation, and the respective roles of the offices.

Addressing Non-Compliance. Overall, the FDIC reported that the majority of AIs are diligent in their efforts to comply with the SLA terms. Nevertheless, certain AIs have not complied with the terms of the SLAs, and in those cases, the FDIC has the option to:

- withhold SLA payments,
- remove certain SLA assets from coverage,
- repurchase SLA assets, or
- terminate an AI's participation in the program all together.

DRR has pursued each of those options with the exception of terminating an AI's participation in the program for non-compliance. Between December 2009 and November 2011, DRR issued letters of non-compliance to seven AIs. According to DRR officials, as of September 2011, five of the seven AIs have complied with the requirements outlined in the letters. DRR is continuing to work with the remaining two institutions.

DRR uses a Watchlist report to monitor non-compliant AIs. The Watchlist report also includes other AIs with risky SLA portfolios that DRR has determined warrant increased scrutiny. DRR may place an AI on the Watchlist for any number of reasons, including failing to:

- treat its SLA assets in a manner consistent with its legacy assets,
- routinely maintain documentation in support of claimed expenses, or
- routinely take corrective actions in response to findings.

AIs with composite FDIC examination ratings of "3" or higher also appear in the Watchlist report.

DRR staff are responsible for tracking an AI's actions to resolve issues identified in the Watchlist report. Further, in August 2011, DRR consolidated the oversight of the Watchlist report in Dallas' Field Operations Branch and this office updated the report to ensure its accuracy. DRR plans to update and issue the report to DRR and RMS staff two times a month. Finally, DRR plans to involve its CRC by having it approve the addition and deletion of AIs from the Watchlist report.

DRR has issued guidance to its staff on how to coordinate with the CMCs and AIs to resolve issues of non-compliance identified in the visitation reports and established procedures for escalating issues when the AIs do not take appropriate corrective actions. However, DRR has

¹³ DRR found that 98 percent of the questioned claim amounts were over \$75,000. DOF stated that it would review the threshold amount on a regular basis to determine if a change is warranted.

not issued guidance to its staff outlining what specific actions warrant an AI's placement on the Watchlist (*i.e.*, how egregious an AI's behavior should be), and specific procedures for handling non-compliant AIs. Accordingly, we recommend that the Director, DRR:

Recommendation 5. Update written guidance to define (1) criteria for placing an AI on the Watchlist, (2) types of actions DRR should take in response to different levels of non-compliance, (3) when to issue formal letters of non-compliance to AIs, and (4) criteria that demonstrate appropriate corrective actions. The guidance should also discuss the role of the CRC in reviewing the Watchlist reports, frequency of updates, and the distribution of reports to DRR and RMS staff on a routine basis.

Controls Related to Estimating and Evaluating Program Costs

The FDIC has established processes to estimate its costs associated with paying SLA claims and monitoring the AIs. The FDIC includes the SLA loss estimates in its financial statements and reconciles estimated to actual data as the data become available.

Estimating SLA Costs. DRR engages financial advisory contractors (financial advisors) to assist in valuing failed bank assets. Specifically, to estimate the FDIC's shared-loss payments, a financial advisor reviews the failing bank's loan-level information to estimate asset values and develops two loss amounts: (1) a cumulative loss amount which reflects a "hold" strategy and estimates the "intrinsic" value of the assets if an owner held the assets until the market improves and (2) a market loss amount which reflects the value of the assets if they were sold today in a depressed market. The financial advisors use their own models to value failed bank assets and review a sample of loans at each failing institution to validate their valuation analyses.

The financial advisors provide an asset valuation report to the FDIC that includes the assumptions and factors used to estimate the valuation amounts so that DRR can verify that it agrees with the model's assumptions. The financial advisors provide a "high" and "low" estimate for cumulative losses and enter both estimates into their models; the models calculate the midpoint, which is used as the loss estimate. The estimated cumulative losses are distributed over 10 years for single-family assets and over 5 years for commercial assets.

DRR staff estimate CMC and in-house monitoring costs over the entire terms of the SLAs. DRR staff estimate CMC costs by projecting the number of hours required to accomplish tasks and applying the CMCs' hourly rates. Travel costs are also included in the estimate. DRR's estimated in-house monitoring costs include salaries, travel costs, and data aggregator costs.

The FDIC has documented its methodology for estimating SLA costs. Estimated SLA costs are recorded in the FDIC's DIF financial statements as a loss reserve. Each month, DOF adjusts the loss reserve up or down to reflect the FDIC's actual shared-loss payments and receipt of recoveries. The FDIC formed a Closed Bank Financial Risk Committee in July 2010 to provide a governance structure over the FDIC's process for estimating the cost of resolving failed insured institutions and their assets. The committee reviews and approves the FDIC's cost estimates,

including valuations and performance methodologies, assumptions, and controls as well as any changes that the FDIC makes to computing estimated losses and recoveries.

GAO reviews estimated loss figures as part of its annual financial statement audit of the FDIC. In the 2009 financial statement audit, GAO identified a material weakness in the FDIC's controls over its process for deriving and reporting estimated SLA losses.¹⁴ Specifically, GAO found that the FDIC's existing controls were not fully effective in preventing or detecting and correcting errors in developing and reporting loss-share estimates. In 2010, the GAO found that the FDIC significantly improved its controls over this process and concluded that the FDIC no longer had a material weakness in this area. However, the GAO found that the FDIC did not have clear and comprehensive written procedures explaining all facets of its process for estimating SLA losses. The FDIC agreed with this finding and stated that it would improve its documentation of the loss-share estimation process through the development of better data flow diagrams and improved linkages and traceability across documents. The GAO plans to evaluate the FDIC's documentation of the loss-share loss estimation process during its 2011 financial audit.¹⁵

GAO also found that the FDIC had not documented its plans for recovering the automated and semi-automated processes supporting its loss-share estimation process in the event of a business interruption. The FDIC had not documented or tested contingency plans that addressed restoring computer programs, workstations, and datasets supporting the preparations of the loss estimates and costs associated with SLAs or of the electronic workspaces where loss-share and asset valuation information is stored. As a result, the GAO concluded the FDIC may not be able to recover loss-estimation process data after a disruption and recommended action to address this issue. The FDIC stated that it began taking corrective actions to address this issue and will continue to so through December 2011.¹⁶

Comparison of Estimated to Actual SLA Losses. Through September 30, 2011, the magnitude of actual SLA losses experienced by the AIs has been significantly less than the FDIC's projected losses. The FDIC estimated SLA losses to be \$38.3 billion, compared to actual losses of \$23.6 billion, through September 30, 2011.¹⁷ These estimated and actual figures include the FDIC's and the AIs' losses combined. The FDIC's actual SLA payments, which represent only the FDIC's portion of the \$23.6 billion of actual losses, were \$14.6 billion as of September 30, 2011.¹⁸

¹⁴ A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

¹⁵ GAO Management Report: *Opportunities for Improvements in FDIC's Internal Controls and Accounting Procedures*, GAO-11-687R, August 5, 2011.

¹⁶ GAO Report: *Information Security: Federal Deposit Insurance Corporation has Made Progress, but Further Actions are Needed to Protect Financial Data*, GAO-11-708, August 2011.

¹⁷ The FDIC estimates total losses over the life of all of the SLAs to be \$60.1 billion. This figure includes the FDIC's and the AIs' losses combined.

¹⁸ As described on page 5 of this report, since March 26, 2010, the FDIC has generally covered 80 percent of an AI's losses. However, some SLAs were structured with loss tranches, whereby the AI assumed a certain amount of losses before loss-sharing began or loss coverage varied in accordance with predefined loss levels.

The FDIC also compares estimated to actual burn rates for all of the AIs based on the quarter when each bank failed. The burn rate shows the percentage of total projected losses that the FDIC has paid to date. The FDIC's actual burn rates are significantly lower than its estimated burn rates, illustrating that the FDIC's actual SLA payments are lower than its projected payments, to date.

In making assumptions to estimate SLA losses and burn rates, DRR relies on analyses of SLA assets performed by its financial advisors, makes estimates regarding default rates on SLA assets and what the markets will do, and considers unemployment rates. According to DRR officials, the differences between estimated and actual SLA losses and burn rates result from a number of factors, including the following:

- DRR assumed there would be more upfront losses on the SLA assets than there have been to date;
- Many AIs have not submitted their loss claims timely, which delays the FDIC's loss share payments; and
- Overall, commercial assets have recovered their values more quickly than what DRR had estimated.

Comparison of Estimated to Actual CMC Costs. With respect to estimated CMC costs, DRR's estimates were approximately 150-200 percent higher than actual costs incurred from 2009 through June 30, 2011. DRR officials attributed this disparity to the fact that when the models were developed, DRR did not have related historical or actual data and therefore the models relied primarily on expert opinions. According to DOA, the FDIC expended \$45.1 million on the eight CMC contractors for SLA monitoring efforts, as of October 7, 2011. With respect to estimated in-house monitoring costs, DRR estimates this information for its own internal management purposes but does not identify actual monitoring costs by SLA, as neither estimated nor actual in-house monitoring costs are required to be separately identified by SLA in the FDIC's financial statements.

Controls for Terminating SLAs Early

In deciding whether to approve an AI's proposal for an early termination, the FDIC's goal is to maximize DIF savings. The FDIC has established guidance and a process for evaluating an AI's offer for an early termination and successfully executed three early terminations that resulted in DIF savings, according to the FDIC. DRR continues to update its procedures related to assessing early termination requests as modifications are made to the process.

Early Terminations. As the dollar amount of the remaining covered assets declines over the life of the SLA, an AI may have an incentive to terminate an SLA with the FDIC to reduce or eliminate future compliance costs and discontinue the level of FDIC oversight. The FDIC also has an incentive to accept an early termination offer if its acceptance results in estimated savings to the DIF. The early termination process is generally initiated in one of two ways: (1) the FDIC reaches out to the AI and presents the opportunity for early termination or (2) the AI presents the FDIC with an offer to terminate early.

An offer to terminate occurs when an AI proposes a dollar amount that the FDIC would pay the AI in exchange for an early termination. An AI may submit a proposal to terminate an entire single-family or commercial portfolio, or both. An AI, however, is not allowed to propose the termination of the FDIC's shared-loss coverage of only certain assets of a particular portfolio. The FDIC conducts a preliminary analysis to determine whether an AI's proposal is reasonable, or has the potential to generate a cost savings. If the FDIC concludes that the offer is reasonable, it engages a financial advisor to examine the AI's remaining shared-loss portfolio to estimate the cumulative loss related to those assets. If the FDIC concludes the AI's offer does not appear to generate a cost savings to the FDIC (*i.e.*, significantly "out of the money"), it rejects the offer outright, without engaging a financial advisor's services.

For those offers that the FDIC deems are reasonable, the financial advisors perform a detailed analysis to estimate the FDIC's total cost to continue coverage of the SLA assets through the full term of the Agreement (the FDIC's take-out price). The FDIC compares the AI's early termination offer to the FDIC's take-out price. If the AI's offer is "in the money" (*i.e.*, generates an estimated cost savings to the DIF), the FDIC will preliminarily accept the AI's termination offer. Finalizing an early termination involves coordination with appropriate FDIC regional and headquarters staff in DRR, RMS, and Legal as well as the AI's primary federal regulator and chartering authority. Finalization is contingent upon the resolution of all outstanding SLA claims and issues. DRR, in consultation with the Legal Division, finalizes the early termination decision. As part of its review, RMS is required to assess the AI's financial condition, the impact on the AI from the loss of indemnification on the covered assets, and the risks to the DIF associated with an early SLA termination.

The FDIC does not publicly disclose its take-out price and instead asks an AI to submit its best faith buyout offer. If the FDIC rejects the offer, the AI may resubmit an offer at the FDIC's discretion. FDIC staff stated that they would not negotiate a settlement amount with an AI.

The FDIC provided guidance to the AIs on how to submit a proposal for an early termination agreement. The FDIC also provided detailed guidance to the financial advisors on how to estimate the FDIC's costs to maintain an SLA for its full term. In March 2011, RMS also issued guidance to its staff on how to evaluate the impact on an AI associated with an early termination agreement.¹⁹ DRR planned to incorporate its procedures related to assessing early termination requests into its RSAM manual by the end of January 2012.

On November 8, 2010, the FDIC's Board of Directors authorized DRR to terminate individual SLAs. If the SLA assets total \$50 million or less, the Director of DRR has the delegated authority to approve and sign off on the early termination agreement. If the SLA assets are greater than \$50 million, DRR drafts a Board Case and the FDIC's Board of Directors is required to sign off and approve the early termination. As of October 12, 2011, the FDIC

- executed three early terminations, resulting in DIF savings according to DRR's calculations,²⁰

¹⁹ Division of Risk Management Supervision: *Early Termination of Shared-Loss Agreements*, Memorandum No. 2011-011, March 24, 2011.

²⁰ We did not validate these calculations.

- was considering two additional terminations, and
- rejected 16 proposals.

Twelve other AIs submitted requests for terminations but subsequently indicated no further interest in terminating their agreements.

In August 2011, DRR’s Internal Review unit initiated a review of the controls surrounding the early termination process. As part of the review, DRR plans to evaluate the internal controls, policies, and procedures associated with the SLA early termination process. DRR also plans to determine the effectiveness of the models used to estimate costs associated with early terminations and maintaining the SLAs for their entire terms.

Summary of Prior OIG SLA Reports

As discussed in the background section of the report, since 2008 most P&A Agreements have included a loss-sharing provision. The OIG initiated audit work in this area because of the financial risks associated with those transactions. The objective of each of the OIG’s five prior SLA audits was to evaluate the respective AI’s compliance with the terms of its SLA with the FDIC. The audits specifically focused on evaluating the AI’s SLA policies and procedures, compliance with the SLA reporting requirements, and the extent to which the AI maximized returns. The audits also addressed the FDIC’s oversight of the SLAs. The OIG selected the AIs that were reviewed based on the size of their SLA portfolios (a mix of large and small) and input from DRR.

Overview of Findings and Status of Corrective Actions. The audit reports concluded that none of the assuming institutions were in full compliance with the terms of the SLAs. Table 6 summarizes the number of recommendations and questioned costs identified in each audit report.

Table 6: Report Recommendations and Questioned Costs as of September 30, 2011

AI	Report Date	Number of Recs.	Submitted Claims	Total Questioned Costs	FDIC’s Share of Questioned Costs	Recovered Costs *
1	5/11/2010	20	\$870,000,000	\$13,105,913	\$10,484,731	\$8,025,167
2	9/10/2010	18	\$844,100,000	\$19,722,788	\$15,778,230	\$14,726,911*
3	9/10/2010	20	\$473,000,000	\$11,712,333	\$9,369,866	\$6,732,604*
4	1/10/2011	14	\$96,300,000	\$9,489,573	\$7,591,658	\$0
5	6/9/2011	13	\$115,400,000	\$30,275,153	\$24,220,123	\$336,115
Total		85	\$2,398,800,000	\$84,305,760	\$67,444,608	\$29,820,797

Source: OIG analysis of audit reports and related documentation as of September 30, 2011.

* Based on the OIG’s initial findings, these assuming institutions identified an additional \$2,546,831 of questioned costs that resulted in recoveries associated with assets outside of those sampled by the OIG. This additional amount was recovered from AIs 2 and 3 and is not reflected in this table.

The reports generally recommended that DRR disallow the questioned costs, inform the AIs of actions required to ensure SLA compliance, and implement policies and procedures to ensure

compliance with the SLAs. The reports also identified \$409,842 of funds that could have been put to better use as a result of a lack of consistency between the SLA provisions and guidance provided by DRR regarding loan modifications and the disclosure of gains. DRR agreed with 80 recommendations, partially agreed with 3 recommendations, and disagreed with 2 recommendations. The five recommendations for which DRR partially or fully disagreed pertained to policy and reporting matters. DRR provided a sufficient explanation to the OIG regarding its disagreement with these recommendations and they were subsequently closed out.

The FDIC implemented corrective action to address 79 of the 85 recommendations and plans to address the remaining recommendations by March 31, 2012. The FDIC had recouped \$29.8 million of the \$67.4 million of questioned costs as of September 2011. DRR did not pursue \$6.2 million of questioned costs from three AIs.²¹ DRR has been working with the five AIs to resolve the outstanding questioned costs and expects to resolve these issues by March 2012. Table 7 shows the status of the recommendations.

Table 7: Status of Recommendations, as of January 26, 2012

Assuming Institution	Report Date	Number of Recs	Closed Recs	Percentage of Closed Recs
1	5/11/2010	20	20	100%
2	9/10/2010	18	18	100%
3	9/10/2010	20	19	95%
4	1/10/2011	14	11	79%
5	6/9/2011	13	11	85%
Total		85	79	93%

Source: OIG analysis of audit reports and related documentation.

²¹ For the following reasons, DRR did not collect \$6.2 million of the identified questioned costs: (1) Certain questioned costs resulted from claims the AIs made based on estimated expenses. The SLA requires claims to be made against actual expenses. After the related audit reports were issued, the AIs incurred the actual expenses and therefore DRR did not pursue the related questioned costs. (2) Due to a misinterpretation of the SLAs, the FDIC erroneously informed AIs that certain claims related to accrued interest were eligible and therefore did not pursue the related recoveries. (3) Upon further review, certain questioned costs were found to be eligible for reimbursement or unsupported.

Trends in Report Findings. While each report included findings unique to the AIs reviewed, the reports also included several common findings. Table 8 summarizes the common findings.

Table 8: Summary of Common Findings in Prior OIG SLA Reports

Finding and Frequency of Finding	Description of Finding	Total Questioned Costs*	FDIC's Share of Questioned Costs*
Improperly Calculated Losses <hr/> 4 reports	<ul style="list-style-type: none"> • Using questioned collateral value; • Using unsubstantiated collateral value; • Using questioned asset value; • Rounding the collateral appraisal value; • Using a fixed charge-off calculation instead of performing a repayment analysis; • Using an incorrect loan balance; • Estimating expenses incorrectly; • Submitting duplicate charge-off claims; and • Manual input errors. 	\$45,212,999	\$36,170,399
Improperly Accrued and Claimed Interest <hr/> 3 reports	<ul style="list-style-type: none"> • Claiming losses for accrued interest on loans that were classified as real estate owned, a designation that requires loans to be non-accrual for accounting purposes. • One of the three institutions also claimed accrued interest losses for periods in excess of the maximum allowable 90 days specified in the SLAs. 	\$12,309,119	\$9,847,295
Unsupported Claims <hr/> 2 reports	<ul style="list-style-type: none"> • Missing documentation that the charge-off calculation had been properly computed and supported for 17 of 38 loss claims reviewed at one AI. • In another case, the AI could not find two of the loan files requested for testing. The report concluded that the AI's poor record retention practices could compromise the accessibility and integrity of its loss claims. 	\$10,222,577	\$8,178,062
Notification and/or Timeliness of Claims <hr/> 5 reports	<ul style="list-style-type: none"> • 4 AIs failed to notify the FDIC within timeframes required for full or partial charge-offs. • 1 AI failed to submit loss claims for single-family loans within timeframes required under the SLA. 	N/A	N/A
Policies and Procedures <hr/> 5 reports	<ul style="list-style-type: none"> • DRR had not finalized key internal procedures for overseeing AIs' compliance with SLAs, at the time the OIG reports were issued. • DRR could clarify or provide additional guidance to the AIs pertaining to certain program requirements. • DRR could improve the consistency of its communications with the AIs. • DRR could strengthen internal controls regarding its process for reviewing and paying loss claims. 	N/A	N/A

Source: OIG analysis of five previously issued SLA audit reports.

*Represents the total questioned costs and the FDIC's share of those costs for the reports where findings were identified.

OIG EVALUATION OF MANAGEMENT COMMENTS

After we issued our draft report, DRR management provided additional information and informal comments for our consideration and we revised our report to reflect this feedback, as appropriate. The Director, DRR, provided a written response, dated February 10, 2012, to a draft of this report. The response is presented in its entirety in Appendix IV. Management concurred with the report's five recommendations and agreed to work with DOA to address issues involving joint responsibility. DRR expects to address recommendation 1 of the report by April 30, 2012 and the remaining four recommendations by July 31, 2012. The planned actions were responsive to the recommendations. A summary of management's responses to our recommendations is presented in Appendix V.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

The objectives of the evaluation were to (1) evaluate DRR's overall efforts to monitor and ensure compliance with the terms and conditions of the SLAs and (2) summarize the findings and recommendations in the five OIG reports on SLA compliance issued to date and associated actions that the FDIC has taken.

We performed our evaluation between May 2011 and October 2011 in accordance with the *Council of Inspectors General on Integrity and Efficiency's Quality Standards for Inspection and Evaluation*.

Scope and Methodology

To accomplish our objectives, we:

- Gained an understanding of how the SLA program works and how FDIC monitors the program, including its process for storing and organizing SLA information.
- Reviewed the existing SLA framework in order to gain an understanding of the FDIC's process for identifying and mitigating risks associated with the SLAs.
- Reviewed prior OIG, GAO, and DRR Internal Review reports that covered the SLA program to identify potential areas of risk and the FDIC's actions to mitigate such risks.
- Determined what the FDIC has done to ensure a consistent approach to the way in which SLAs are monitored and claims for reimbursement are considered and processed. This included a review of the FDIC's selection of a data aggregator contractor.
- Reviewed the FDIC's process for selecting, training, and overseeing the CMCs.
- Analyzed the FDIC's process for tracking and following up on findings and recommendations pertaining to the assuming institutions' compliance with SLA provisions.
- Interviewed DRR headquarters and regional office officials responsible for monitoring and ensuring compliance with the SLA program.
- Interviewed officials in DOA, RMS, DOF, and the Legal Division.
- Interviewed GAO officials and contractors hired by the FDIC to assist with SLA monitoring activities, including the CMCs.
- Performed tests to determine the FDIC's compliance with SLA policies and procedures.

OBJECTIVES, SCOPE, AND METHODOLOGY

- Reviewed and summarized pertinent findings and the disposition of the 85 recommendations contained in 5 OIG reports on SLA compliance. We also followed up with FDIC officials to determine what actions the FDIC has taken to close recommendations and recoup questioned costs identified in these reports.

CMC FEEDBACK ON THE SLA PROGRAM

The CMCs provided several areas of positive feedback regarding the SLA program. The CMCs said the program was working well, is meeting its objectives, has been accepted in the marketplace, has kept the United States out of a greater recession, and is preferable because it allows the AIs to manage the SLA assets. The CMCs were generally satisfied with the level of communication they had with DRR officials and found that DRR's use of a secure virtual data room to share information with the CMCs and AIs is very useful. The CMCs also commented that the consistency of DRR's guidance has improved as the program has matured and the FDIC has clarified ambiguous terms present in earlier versions of the SLAs. The CMCs also stated that DRR or the FDIC should do the following to improve the SLA program:


- Continue to ensure that the guidance provided to the CMCs and AIs is consistent. In particular, some CMCs noted that TOOMs sometimes provided conflicting information and that some TOOMs were more helpful than others.
- Provide additional training to the CMCs.
- Compile and share a list of best monitoring practices with the CMCs.
- Provide the CMCs with additional lead time regarding when it plans to issue a task order. The lead time would enable the CMCs to better plan for the task orders by ensuring appropriate staffing.
- More quickly provide legal opinions regarding specific questions raised about the terms of the SLAs.
- Allow the CMCs to post the loans they select for sample testing on the FDIC's secure virtual data room, so the TOOMs can readily review this information.
- Ask a small number of AIs to beta test proposed changes to the FDIC's electronic process for reviewing claims from AIs.

CHANGES IN THE GENERAL STRUCTURE OF SLAs SINCE NOVEMBER 2008

Overview of the Shared-Loss Program

How has the general structure of Shared-Loss Agreements changed over time?

	Nov 2008	April 2010	June 2010	Sept 2010
<p>After the First Loss Tranche (if any) FDIC pays 80% on all losses up to the Stated Threshold. Above that, FDIC pays 95%.</p> <p>80/20 with 95/5</p>	128 deals	95% stopped end of March 2010.		
<p>After the First Loss Tranche (if any) FDIC pays 80% on all other losses.</p> <p>80/20 only</p>		80% is the maximum starting April 2010	107 deals	
<p>FDIC no longer assigned set numbers such as 80%. After the First Loss Tranche (if any) FDIC pays a % that the bidding AI decides, as long as it is 80% or below.</p> <p>Flex</p>			Flex introduced June 18, 2010	6 deals
<p>Large banks get "Donut." Small bank get "Flex." Donut is a three tranche system where the middle tranche is bid by the AI</p> <p>Tier</p>				Donut introduced Sept 2010 20 deals
<p>First Loss Tranche, if any</p>		First Loss Tranche stopped as of June 18, 2010		



Source: Excerpt from FDIC PMO report, as of September 30, 2011.

MANAGEMENT COMMENTS

550 17th Street NW, Washington, D.C. 20429-9990

Division of Resolutions and Receiverships

DATE: February 10, 2012

TO: Stephen M. Beard
Deputy Inspector General for Audits and Evaluations
/Signed/

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

SUBJECT: Response to Draft Audit Report Entitled, *Evaluation of the FDIC's Monitoring of Shared-Loss Agreements* (Assignment No. 2011-062)

This memorandum is in response to the recommendations in the subject draft audit report dated, December 20, 2011.

DRR appreciates the many relevant observations and recommendations provided by the OIG. We look forward to working with the OIG to ensure that the oversight of the SLAs meets the program's objectives.

DRR has notified all program areas impacted by the findings of the subject audit and has been working in consultation with them in order to prepare this response. DRR anticipates continuing participation from the program areas in order to establish a corrective action plan and to address all recommendations.

OIG Audit Recommendation 1: Review the current process for issuing task orders to determine whether there are opportunities for streamlining and then establish a goal for the timeframe within which a Compliance Monitoring Contractor (CMC) task order should be issued.

DRR Response: DRR agrees with this recommendation. DRR, in conjunction with DOA, will review the current process for issuing task orders to determine whether there are opportunities for streamlining and establishing the goal(s) for the timeframe(s) from the point in time the P&A Agreement is signed to the issuance of a CMC task order. DRR expects to complete the above actions by April 30, 2012.

OIG Audit Recommendation 2: Evaluate the Division of Administration (DOA) and DRR evaluation processes and related forms and determine whether there are efficiencies that can be gained in how CMC contractor performance is monitored and assessed, and take appropriate action.

DRR Response: DRR agrees with this recommendation. DRR will evaluate, in coordination with DOA, the DRR evaluation process and related forms and determine whether there are efficiencies that can be gained in how CMC contractor performance is monitored and assessed, and will take appropriate action. DRR expects to complete the above actions by July 31, 2012.

MANAGEMENT COMMENTS

OIG Audit Recommendation 3: Conduct a review of the CMC and DRR monitoring and visitation plans to identify best practices, testing areas, and core elements that should be included in all of the monitoring and visitation plans and develop and issue additional guidance.

DRR Response: DRR agrees with this recommendation. DRR will conduct a review of the CMC and DRR monitoring and visitation plans to identify best practices, testing areas, and core elements that should be included in all of the monitoring and visitation plans and develop and issue additional guidance. DRR expects to issue the guidance by July 31, 2012.

OIG Audit Recommendation 4: Issue guidance to DRR staff and the CMCs on how to evaluate whether AIs are sufficiently pursuing and reporting recoveries on covered assets. Guidance should include procedures for testing whether recoveries have been made on any zero balance covered assets.

DRR Response: DRR agrees with this recommendation. DRR will issue guidance to DRR staff and the CMCs on how to evaluate whether AIs are sufficiently pursuing and reporting recoveries on covered assets. Guidance will include procedures for testing whether recoveries have been made on any zero balance covered assets. DRR expects to issue the guidance by July 31, 2012.

OIG Audit Recommendation 5: Update written guidance to define (1) criteria for placing an Assuming Institution (AI) on the Watchlist, (2) types of actions DRR should take in response to different levels of non-compliance, (3) when to issue formal letters of non-compliance to AIs, and (4) criteria that demonstrate appropriate corrective actions. The guidance should also discuss the role of the CRC in reviewing the Watchlist reports, frequency of updates, and the distribution of reports to DRR and the Division of Risk Management Supervision (RMS) staff on a routine basis.

DRR Response: DRR agrees with this recommendation. DRR will update written guidance to define (1) criteria for placing an AI on the Watchlist, (2) types of actions DRR should take in response to different levels of non-compliance, (3) when to issue formal letters of non-compliance to AIs, and (4) criteria that demonstrate appropriate corrective actions. The guidance will discuss the role of the CRC in reviewing the Watchlist reports, frequency of updates, and the distribution of reports to DRR and RMS staff on a routine basis. DRR expects to issue the guidance by July 31, 2012.

SUMMARY OF MANAGEMENT'S RESPONSE TO THE RECOMMENDATIONS

This table presents management's response to the recommendations in our report and the status of those recommendations 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	DRR, in conjunction with DOA, will review the current process for issuing task orders to determine whether there are opportunities for streamlining and establishing the goal(s) for the timeframe(s) from the point in time the P&A Agreement is signed to the issuance of a CMC task order.	April 30, 2012	\$0	Yes	Open
2	DRR will evaluate, in coordination with DOA, the DRR evaluation process and related forms and determine whether there are efficiencies that can be gained in how CMC contractor performance is monitored and assessed, and will take appropriate action.	July 31, 2012	\$0	Yes	Open
3	DRR will conduct a review of the CMC and DRR monitoring and visitation plans to identify best practices, testing areas, and core elements that should be included in all of the monitoring and visitation plans and develop and issue additional guidance.	July 31, 2012	\$0	Yes	Open
4	DRR will issue guidance to DRR staff and the CMCs on how to evaluate whether AIs are sufficiently pursuing and reporting recoveries on covered assets. Guidance will include procedures for testing whether recoveries have been made on any zero balance covered assets.	July 31, 2012	\$0	Yes	Open
5	DRR will update written guidance to define (1) criteria for placing an AI on the Watchlist, (2) types of actions DRR should take in response to different levels of non-compliance, (3) when to issue formal letters of non-compliance to AIs, and (4) criteria that demonstrate appropriate corrective actions. The guidance will discuss the role of the CRC in reviewing the Watchlist reports, frequency of updates, and the distribution of reports to DRR and RMS staff on a routine basis.	July 31, 2012	\$0	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) for recommendations that the OIG determines to be particularly significant, when the OIG confirms that corrective actions have been completed and are responsive.