Examinations of Banks with FDIC Assisted Acquisitions

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Definitions

Indemnification Asset – The present value of estimated payments from the FDIC for losses on covered assets.

Covered Assets – These are the assets on the assuming institution's books that are protected by the Shared Loss Agreement.

Non-Covered Assets – These are the assets on the assuming institution's books that are not protected by the Shared Loss Agreement.

Legacy Loans – These are loans that were originated by the assuming institution as part of their regular book of business.

Loss Share Certificates – These are submitted by the assuming institution at least quarterly to the FDIC for loss claims.

Certificate Loan Balance – This is the balance on which the Shared Loss protection is based on. It is the loan amount owed by the borrower, as if the loan was still on the failed bank's books. This balance is adjusted for any charge-offs taken or payments made after acquisition.

Examination Guidance

Most state nonmember banks that are involved in FDIC-assisted failed bank acquisitions are subject to the following supervisory requirements:

- A visitation or limited scope examination by risk management examiners within 30 days of the failed bank transaction date. The primary purpose of the examination activity is to determine how cash received in the failed bank transaction is being used and whether the bank is operating in accordance with any applicable assistance agreement.

- A second visitation or limited scope examination within six months of the transaction date.

- A full-scope examination should be conducted within twelve months of the transaction date. Thereafter, standard examination frequency schedules apply.

- In addition, for larger acquirers or multiple acquirers, ongoing visitations may be needed to ensure the bank is effectively integrating the acquired institutions and complying with relevant regulatory requirements.

Examination Process

- Primary focus of a safety & soundness examination or visitation is the financial condition of the Assuming Institution (AI).
- Examiners typically review over 25% of the legacy loan portfolio.
- Loan sample of covered loans typically includes those loans that comprise a material portion of the AI's capital account.
- Examiners also review a small sample of loss share claims, but generally rely on the Division of Resolutions and Receiverships (DRR) reviews to determine compliance with the Shared Loss Agreements (SLA).
- Examiners ensure that the AI's staffing, expertise, and information systems provide for the proper integration and administration of loss share assets.

Examination Process

- Examiners ensure that the AI's accounting for these transactions, including ongoing adjustments, are being done correctly.

- Examiners also compare the AI's collection/charge-off policies and practices for covered loans to its collection/charge-off policies for legacy loans.

- Examiners will review and analyze the quality of reports that bank management uses to evaluate credit risk and capital risk associated with the SLA transactions.

  - ➢ It is expected that management will monitor the composition of the indemnification asset in order to fully understand the collectability of the asset and to track the potential impact to capital at the expiration of the SLA.

  - ➢ As the expiration of a SLA approaches, Board reporting should also include various scenarios regarding the resolution of problem assets. These reports should reflect the potential increase in adversely classified asset totals due to the expiration in SLAs, including comparisons to Tier One Capital plus the Allowance for Loan and Lease Losses.

Examination Process

- In conjunction with DRR, we ensure that acquiring institutions are not using the benefits of loss share to justify or accelerate a decision on foreclosure or loss recognition.
- Communication with DRR is regular and ongoing.
- Examiners also review the results of any DRR or 3rd party audits, as this is a factor to consider when determining the scope of any safety & soundness examination and for evaluating overall management of the bank.
- Types of examination issues that are communicated to the DRR Regional Manager include the following:
  - AI not making sufficient effort to work out covered loans;
  - Inconsistencies between application of credit risk management policies, and loss recognition standards, for covered assets and legacy assets; and
  - Any other matter affecting loss share and the FDIC.

Adverse Classification of Assets Covered by SLAs

- When evaluating a covered asset for classification purposes, examiners first consider whether the asset should be classified without regard to the protection afforded by the SLA.
- Examiners then evaluate the collectability of the amount at which the covered asset is reported on the balance sheet, not its unpaid principal balance.
- If adverse classification is warranted, examiners then consider the extent of the protection provided by the SLA.
- Identifying the classified amount may become complex if the SLA has multiple loss tranches.
- As SLAs approach expiration, examiners will discuss with management the likelihood that underlying adversely classified assets will be resolved prior to expiration of the SLA in making a determination as to how the assets will be classified in the report of examination.

Safety & Soundness Focus

- Expiration of the SLA and levels of unresolved problem assets
    - Whether Adversely Classified Items will likely increase at expiration of the SLA
    - Whether the AI will be required to charge-off the remaining balance of the indemnification asset
- Alleged "dumping" of assets and the impact on other banks
- Unsupported claims under SLAs
- Noncompliance with the SLA
  - Possible DRR action:
    - Removal of assets from loss share
    - Enforcement Actions
- Proper accounting for improved cash flows on indemnified loans

How the FDIC Ensures Satisfactory Supervisory Oversight of these Issues

- Continued training and awareness with examiners and the industry
- Reviewing covered loan renewal practices compared to legacy loan renewals
- Performing more in-depth reviews of the indemnification asset and its components
- Developed examination tools to assist in the RMS examination process
- Tracking levels of non-performing assets and the potential impact on capital adequacy at expiration
- Developing an off-site monitoring report using data from the Certificate database, Call Reports and the Reports of Examination to identify institutions with potential RMS issues
- Communicating regularly with DRR during exams and working closely with them to identify issues prior to expiration

Questions????

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