AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Loss-Sharing Agreements Between the FDIC and Acquiring Banks: Advice for the Borrower

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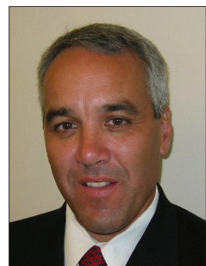
Just imagine that your bank has failed and the assets, including your commercial loan, have been sold to another bank. This is an increasingly common occurrence in the current economic times. In the upcoming weeks, you will probably receive advice from many sources as to how to manage your banking relationship to gain the best possible advantage or mitigate your exposure under your existing loan(s). You will hear everything from "my brother-in-law settled his loan for 10 cents on the dollar" to "the FDIC will make the bank pursue every penny of debt until you are bleeding on the floor of the bankruptcy court." In reality, while both statements may be true, neither may be applicable to you and neither statement reflects any obligation of the acquiring bank under a loss-sharing agreement or the intent of the Federal Deposit Insurance Corporation (FDIC) under the loss-sharing program.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Originally introduced in 1991 as a creative solution to mitigate the risk associated with one bank acquiring another failed bank, the loss-sharing agreement is a financial concept that has remained relatively unchanged over the last 19 years of dramatic changes in financial instruments. The concept behind a loss-sharing agreement is based on the premise that banks are uniquely positioned to maximize the total dollar recovery on a portfolio of distressed loans. While this statement will cause many to scream that the banks are the last people who can effectively recover these loan proceeds, the reality is that when measured on a basis of total dollars recovered, this statement has historically proven true and remains so today. The significant phrase in this statement is "total dollars recovered."

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Feature

While there are many methods and strategies for liquidation of distressed assets, most rely on expensive capital, and thus success is measured in terms of the internal rate of return (IRR) rather than dollars recovered. An investment measured by internal rate of return will be sensitive to the timing of cash flows with longer term recoveries being discounted more heavily than near term cash flow. In cases where the investor's IRR expectations are high, the sensitivity to timing of cash flows has a dramatic impact on the value of an asset. For example, assuming a desired IRR of 20 percent on a $100,000 investment, an investor would require recovery of $120,000 on a one-year investment. Likewise, assuming a desired IRR of 3 percent on the same $100,000 investment, an investor would require recovery of $103,000 on a one-year investment to achieve the targeted return. The determination of a given investor's required IRR is driven by two components: (1) the cost of the investor's capital plus (2) the investor's required return based on the risk of the investment (the risk component). A bank operating under a loss-sharing agreement is able to dramatically reduce the risk component of its investment, and is able to significantly reduce its cost of capital through favorable treatment of the loss share assets under risk based capital guidelines used to measure capital adequacy of banks.

In my experience of distressed-debt practice, most distressed-debt investors have little to no leverage and are seeking equity returns in excess of 20 percent. Banks, on the other hand, are generally leveraged 88 to 90 percent with customer deposits, at an average cost of funds of less than 3 percent. As such, banks can justify a longer term hold in exchange for a greater dollar recovery while still achieving a mid-teens return on equity and minimal increase in risk. In essence, a bank operating under a loss-sharing agreement is able to take advantage of a much more favorable capital structure than a non-bank distressed-debt investor. Likewise, banks in today's market are capable of managing significant levels of distressed assets and have the experience, systems, policies, procedures and professional networks to manage these assets in a fashion that can facilitate orderly liquidation while being monitored by the FDIC, the ultimate risk-holder in a loss-sharing agreement.

What exactly is a loss-sharing agreement? Simply stated, a loss-

sharing agreement exists between the FDIC (or the receiver appointed by the FDIC over a failed bank) and the bank (the "acquiring bank") that purchased all or a significant portion of the assets and liabilities of a failed bank.[1] Under the agreement, the acquiring bank agrees to purchase the assets subject to a commitment from the FDIC to reimburse it for a portion of any losses incurred on the assets. Generally, the agreement provides for up to three tranches of loss reimbursement, but these can vary with each transaction. The *first loss tranche*[2] allocates some level of losses that must be absorbed by the acquiring bank before any reimbursement will be paid by the FDIC. Losses above the first loss tranche are reimbursed at 80 percent of the actual loss until aggregate losses exceed a *stated threshold*.[3] Losses incurred in excess of the stated threshold are reimbursed at 95 percent.

In essence, the FDIC retains the risk of substantially all losses on the portfolio (assuming some discount in the original purchase price), and the acquiring bank assumes the responsibility for management and recovery of the assets with some expectation of moderate return in investment. To explain, assume a $1 billion portfolio of loans is acquired under a loss-share agreement for $600 million, the first loss tranche is established at $300 million, and the stated threshold is set at $500 million. If, during the term of the loss-sharing agreement, the bank is able to collect (net of collection related expenses and advances) a total of $450 million, see Chart 1.[4]

In theory, this structure allows the acquiring bank to absorb the assets and deposits of a failed institution without impacting its own stability or causing undue strain on its own capital. Accordingly, as the theory goes, the acquiring bank will have every incentive to focus on the orderly resolution of the portfolio and, in turn, the highest possible recovery without the pressure on its earnings or capital. Sounds great, doesn't it? How often have we pined for a lender who would use common sense and patience in the resolution process without regard to pressure from regulators and investors to get distressed assets off the books?

Unfortunately, like many well-intended government programs, all too often the loss-sharing agreement concept falls victim to bureaucracy. However, in this case, the fault does not lie with the FDIC. The culprit lies in the agreement itself and human nature. Unlike many legal documents that are so restrictive in their terms that there is no opportunity for the application of common sense, the loss-sharing agreement anticipates and even *requires* the acquiring bank, in the management, administration and collection, of the loss-sharing assets to:

- exercise "*usual and prudent business and banking practices*;"[5]
- act in accordance with the acquiring bank's practices and procedures, including its internal credit policies;[6]
- exercise its "*best business judgment*;"[7] and,
- use its "*best efforts to maximize collections*."[8]

That's all there is to it. Once you sort through the legal jumble, the procedures for protective advances, requesting reimbursement and resolving disputes, the main responsibility of the acquiring bank in prosecuting the collection of debt is that they use common sense. God Bless America! What could possibly be easier than this? Just do the right thing and you will have no problems. Not so fast, George Bailey—this is not the Bailey Building and Loan Association we're talking about here, and if you make a mistake, chances are the FDIC will not come and sing Christmas carols with you the way the examiners did in *It's a Wonderful Life*.

While the rules are pretty simple, the fact that the rules can be listed in four bullet points is probably why the Dispute Resolution Section[9] of the loss-share agreement takes up almost three full pages. In reviewing the rules, note that, other than the adherence by the acquiring bank to its internal credit policy (which generally does not dictate resolution strategies), all of the other rules are based on subjective factors that cannot be easily measured on a monthly report or spreadsheet. Why should this be a problem? In dealings with the FDIC in general, and with those who developed and monitor the loss-sharing program specifically, the author has found them to be highly experienced, intelligent and creative and they will not do our work for us. Under engagements with the FDIC, we are paid to make decisions and recommendations. After doing so, the FDIC, as our client, will judge our work to ensure that it meets their expectations. In the case of loss-sharing agreements, the FDIC has contracted with the acquiring bank to do what the acquiring bank does best: manage loans. As the party that must absorb the losses, the FDIC expects nothing more than the exercise of good judgment in the collection process and reserves the right to judge those efforts.

In spite of the elegant simplicity of the loss-sharing agreement, it is not being consistently or efficiently executed in a large percentage of cases. The reason for this failure is in the interpretation of the "rules." The biggest source of concern by the acquiring banks is rule #4: "*best efforts to maximize collections*." In banking terms, this means that the bank should analyze all available resolution alternatives and select the alternative that provides the greatest recovery, taking

Chart 1

Unpaid balance of loans acquired	*$1,000,000,000*
Less net collections	*450,000,000*
Losses Incurred (A-B)	*550,000,000*
Less First Loss Tranche	*300,000,000*
Stated Threshold	*500,000,000*
80 Percent Reimbursable Losses ((C-D) capped at (E-D))	*200,000,000*
95 Percent Reimbursable Losses (C-E)	*50,000,000*
*Loss Share Reimbursement paid to bank (F*80 percent)+(G*95 percent)*	*207,500,000*
Total cash recovery by acquiring bank (B+H)	*$657,500,000*

1 The agreement for any specific loss-sharing transaction, typically entitled a "Shared-Loss Agreement," is usually referenced in Article IV, §4.15 of the applicable Purchase and Assumption Agreement between the FDIC and the acquiring bank and attached as Exhibit 4.15A (residential loans) or Exhibit 4.15B (commercial loans). The Purchase and Assumption Agreement and related exhibits and schedules can be obtained on the FDIC's Web site at www.fdic.gov. From the Web site, select the "Industry Analysis" tab, then select "Failed Banks," "Failed Bank Information" and then "Failed Bank List." Select the failed institution and then select the "Purchase and Assumption Agreement" document. The Commercial and Other Assets Shared-Loss Agreement will be listed as Exhibit 4.15B of this document. The specific terms of each agreement may vary slightly, but the format is uniform on most agreements.

2 Purchase and Assumption Agreement—Whole Bank Article VII.

3 Commercial and Other Assets Shared-Loss Agreement Article I, II, §2.1(b)(i).

4 The values provided are for illustrative purposes and not intended to reflect an actual transaction.

5 Commercial and Other Assets Shared-Loss Agreement Article III, §3.2(a)(i).

6 Commercial and Other Assets Shared-Loss Agreement Article III, §3.2(a)(i).

7 Commercial and Other Assets Shared-Loss Agreement Article III, §3.2(a)(ii).

8 Commercial and Other Assets Shared-Loss Agreement Article III, §3.2(a)(iii).

9 Commercial and Other Assets Shared-Loss Agreement Article II, §2.1(f).

into consideration the timing, cost and risk associated with each alternative.

Unfortunately, this process requires foresight and decisions that, even with an ideal fact set, may prove to have been incorrect when viewed in hindsight. Sound familiar? This is how this whole mess started. In boom times, real estate lending was a breeze and all loans were repaid on time. Most real estate loans made between 2002 and 2007 would have easily passed muster under the four "rules" previously outlined. In hindsight, we know that this was not true.

For an acquiring bank, the loss-sharing agreement is a great opportunity to grow market share in a difficult environment without adding significant risk to the balance sheet. The only way it can lose on this arrangement is to be called on a bad decision, and the only way to avoid making a bad decision is to not make any decisions. As such, the acquiring banks typically adopt a passive approach to asset resolution. Rather than making difficult decisions that would likely increase the total dollar recovery under a given loan, an acquiring bank will opt to exercise only the legal remedies provided under the loan. After all, who can criticize a decision to follow the legal remedy checklist when that is what the documents require?

More importantly, assuming the consistent application of collection strategies that are focused on avoiding difficult decisions, the losses will undoubtedly exceed the stated threshold, triggering the 95 percent reimbursement rate. If the net cost of taking the easy path is only 5 percent of the incremental lost revenue, any prudent lender would avoid the risk associated with the 5 percent incremental recovery.

Who loses under this deal? Logically, one would expect that the borrowers who are forced into liquidation or bankruptcy suffer the greatest losses. While this is true to some degree, the impact is not as significant as one would expect. The irony of the situation is that the passive-collection approach often relieves borrowers of the moral obligation to stick with a failed project to assist in recovery efforts and maximize recovery on behalf of the acquiring bank.

Acquiring banks often interpret the phrase "best efforts to maximize collections" to mean that they must "exhaust all available collection efforts." The distinction is that "best efforts" implies a subjective judgment while "exhaust all available" implies a procedure. Banks like procedures because they are easy to communicate, quantifiable and can usually be reduced to a checklist. To explain the distinction, consider this example.

Assume a borrower offers a voluntary settlement proposal that provides the acquiring bank a total recovery of 60 percent of the outstanding debt. The offer is rejected by the acquiring bank out of concern that absent quantifiable evidence, the FDIC will not deem the settlement offer to reflect the best effort to maximize collection. Further assume that after extended litigation, including foreclosure, deficiency actions and ultimately bankruptcy, the borrower is eventually discharged from bankruptcy with total recovery by the acquiring bank, net of collection expenses, coming in at 50 percent of the outstanding debt. With the benefit of hindsight, we can easily determine that the acquiring bank failed to maximize collections, but they did successfully exhaust all available collection efforts, and in doing so have a defendable right to seek reimbursement of losses under the loss-sharing agreement.

Wouldn't it be interesting if the FDIC used a common-sense hindsight test in its evaluation of reimbursement requests, and in this scenario, the FDIC, upon reviewing the file, deemed the acquiring bank negligent in failing to accept the settlement proposal? While this would obviously get the acquiring banks to sharpen their pencils before making resolution decisions, it would likely damage the integrity of the loss-sharing process and provide an unacceptable risk to acquiring banks. In the end, we have a system of "checklist management" that mitigates the risk of violating the quantifiable components of the loss-sharing agreement with minimal regard for the un-measurable common-sense component.

The diligent pursuit of all legal remedies generally results in nominal, if any, incremental collection from the borrower and this collection is almost always more than offset by increased losses or expenses associated with the liquidation of the collateral. It does, almost always, result in the foreclosure of the underlying collateral and the loss of borrower assistance and cooperation in the liquidation of the asset. Once accomplished, the bank is left to deal with the real estate and the borrower is free to start over.

Obviously, the FDIC is losing 80 to 95 percent of the lost recovery, plus 80 to 95 percent of the expenses incurred in these ineffective collection efforts, but there are other victims. The real estate market is impacted by the unnecessary foreclosure activity driven by the unwillingness of acquiring banks to seek alternative resolution strategies, but most concerning is the impact on non-loss-sharing banks that are still aggressively seeking resolution strategies that maximize the recovery of their loans.

Therein lies the paradox of the loss share. The decision by an acquiring bank *to exhaust all available collection efforts* rather than *maximize collections* ultimately results in the bankruptcy of the borrower (the definitive exhaustion all available collection efforts). Unfortunately, these borrowers typically have debts with numerous banks that are included in the bankruptcy. Generally, non-loss-sharing banks, having a significant financial incentive and no disincentive to creative resolution strategies, are the most severely impacted by actions taken by an acquiring bank based on misinterpretation of the loss-sharing agreement. As such, this obvious dichotomy of strategies employed by loss-sharing banks vs. non-loss-sharing banks begs the question: Which group is following *usual and prudent business and banking practices*?

The positive news is that most acquiring banks will adapt their strategies once they become more comfortable with the requirements of the agreement and come to the conclusion that the FDIC is not seeking to ambush them by second-guessing every decision. This transition usually begins to occur six to eight months into the agreement and continues to improve as time goes by. For this reason, the author's advice to borrowers of a bank that has been acquired under a loss share agreement is:

- Keep a low profile until the bank figures out its strategy. This could take six to eight months.
- If your debt is current, do everything possible to keep it that way as long as possible.
- When contacted by the bank, ask a lot of questions and propose alternatives.
- Do not force any decisions on the part of the bank.
- Obtain and read the purchase and assumption agreement from the FDIC Web site[10] to understand the

10 *See* www.fdic.gov/bank/individual/failed/banklist.html.

acquiring bank's obligations under the agreement.

- Conduct an honest assessment of all resolution alternatives available to the bank, and be prepared to document and present your case for an amicable resolution that provides a quantifiable benefit to the bank in terms of dollars recovered.
- Aggressively challenge any attempt by the bank to justify its actions by blaming the FDIC or the loss-sharing agreement.
- Seek the advice of counsel before executing any financial affidavits or prenegotiation agreements. While often legitimate, many banks use unauthorized or unreasonable formats of these documents as an intimidation tool.
- Finally, be prepared with the facts. Understand the bank's position and seek a solution that addresses the banks' needs.

Most importantly, keep communications open. In almost every instance, a solid business case can be made that borrower cooperation adds more to the recovery than litigation. Ultimately, the borrower, bank, and FDIC all desire the same result: the successful resolution of the debt. ■

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