TESTIMONY OF

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ON

FDIC MANAGEMENT OF FSLIC ASSISTANCE AGREEMENTS

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

2:00 PM
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Room 2128, Rayburn House Office Building

Mr. Chairman and members of the Committee, as Director of Accounting and Corporate Services at the Federal Deposit Insurance Corporation, I have responsibility for the FDIC's new Division of FSLIC Operations. After eight months of dramatic change, I am pleased to report on the FDIC's progress in managing FSLIC assistance agreements.

OVERVIEW

The FDIC Division of FSLIC Operations (DFO) was created immediately following enactment of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). As of August 9, 1989, this Division administered 219 assistance agreements involving covered assets of approximately $53 billion. In administering these agreements, we have worked diligently to complete the opening inventory audits of all assistance transactions, and to establish appropriate accounting systems and controls which will enable us to finalize the total cost of obligations of the FSLIC Resolution Fund.

The following statistics indicate the number of assistance transactions and concomitant workload:

ASSISTANCE AGREEMENTS

SELECTED STATISTICAL & FINANCIAL DATA

	12/31/88	8/9/89	12/31/89
Number of Agreements	222	219	202
Estimated Number/Covered Assets	254,000	244,000	225,000
Estimated Book Balance ($/Billions)	$ 57.5	$ 53.4	$ 35.9

We are not yet comfortable with our ability to provide accurate cost estimates of the obligations of the FSLIC Resolution Fund until the completion of all audits in May. However, we are not optimistic that the costs projected in FIRREA accurately reflect the size of the FSLIC Resolution Fund's obligations. We will report our findings to you as soon as our assessment is completed and we obtain the concurrence of the General Accounting Office.

FDIC IMPROVEMENTS

Since August, FDIC has taken many steps with respect to management of the assistance agreements which resulted from transactions approved by the Federal Home Loan Bank Board (FHLBB). Our testimony highlights four major steps.

First, we drafted a strategic plan to assure that FDIC's philosophy and direction are understood by staff and the assisted institutions. A definitive set of three year goals and objectives will be presented for FDIC Board action in May. A draft of the strategic plan is contained in Exhibit I.

Second, we have added resources to deal with the enormous workload. This includes a major management and staff commitment including authorization of 70 positions for the field offices and adding an experienced bank regulator to strengthen liaison with supervision in the Office of Thrift Supervision (OTS) and the FDIC's Division of Supervision (DOS). Additionally, we created special teams to supplement DFO staff to assure completion of audits and implementation of financial and management information systems.

Third, we have assessed the tremendous impact of certain FIRREA provisions on these transactions and their potential for an unintended increase in the cost of resolutions. Division of FSLIC Operations and FDIC's legal staff have worked with the Office of

the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) to seek an exemption from loan-to-one-borrower provisions on the basis that assets covered by assistance agreements are secured by guarantees from the government. This effort is being undertaken in order to reduce the additional cost that these restrictions could create by severely limiting the assisted institutions' ability to restructure or dispose of covered asset portfolios. We are pleased to report that the OCC has provided a favorable opinion dealing with this issue. We are hopeful that OTS will provide a similar exception.

Finally, we have implemented a program to renegotiate capital instruments. The FSLIC Resolution Fund holds various capital instruments purchased or acquired by the former FSLIC to facilitate case resolutions. These capital instruments include: 1) preferred stock (mostly cumulative) with a book value of $507 million; 2) subordinated debentures of $185 million; 3) capital and net worth certificates of $353 million; and 4) stock warrants generally representing a 20 percent ownership position in each of 17 assisted institutions. The capital instruments portfolios are assets of the FSLIC Resolution Fund. The income derived from these instruments -- interest, dividends, and potential value of appreciation -- reduces the cost of assistance provided.

With the enactment of FIRREA, these capital instruments no longer qualify for primary capital purposes. As a result, the FDIC has been presented with requests to negotiate exchanges of existing instruments for instruments that qualify as primary capital, and/or

to consider the redemption of the securities at discounted values. Additionally, in some cases, the existence of governmental equity positions has created impediments to additional private capital infusions due to anti-dilution provisions in our securities agreements.

The FDIC has contracted the firm of Donaldson, Lufkin & Jenrette to act as the FDIC's advisor in the evaluation of securities liquidations and restructuring transactions. The FDIC's objectives in these transactions are to: 1) facilitate the sale of FSLIC Resolution Fund-owned securities at fair values; 2) facilitate compliance with acquirers' FIRREA Capital Requirements; and 3) facilitate mutual-to-stock conversions.

OBSERVATIONS REGARDING FHLBB RESOLUTIONS

The Committee has asked for a discussion of the mechanisms employed in past FHLBB resolutions compared to the mechanisms employed in resolutions by the FDIC. My colleague, Mr. Stone, will discuss the types of resolutions employed by the FDIC. However, it is too early to provide the Committee with more than the impressions we have gained over the past six months of administering the 1988 FHLBB transactions, pending completion of the FIRREA-mandated review by the Resolution Trust Corporation.

These observations would suggest that the FDIC's commentary over the past year holds true -- that the absence of cash to conclude transactions limits the list of potential bidders and

results in transactions which are too long in duration, lacking in incentives and geared toward problem asset income maintenance rather than a less costly means of asset resolutions. It also would appear that some acquirers were motivated by tax-driven opportunities rather than a desire to enter the S&L business. In any event, the RTC Study is now underway and the RTC will reach a final position on the 1988 transactions by the end of the summer.

Mr. Chairman, your invitation letter of March 9, 1990 asked the FDIC to respond to several specific questions regarding the FSLIC Resolution Fund. We will respond to each question in the order they were raised and then will be pleased to answer any additional questions you or other Members of the Committee may have.

QUESTIONS AND FDIC RESPONSE

Questions:

In regard to the FSLIC assistance agreements, has FDIC developed an overall strategy for covered asset disposition?

FDIC Response:

The FDIC has developed a strategic plan for management of assistance agreements which includes guidance on covered asset disposition. Implementation of the strategic plan requires

development of goals and objectives and specific policy directives. A set of three-year goals and objectives will be presented for FDIC Board action in May.

We recognize the strategic plan cannot be static. The results of the RTC review of 1988 case resolutions and resolutions of issues resulting from FIRREA changes may significantly affect the process of managing the financial liability associated with the assistance agreements. A planning process which includes a quarterly review was initiated by DFO in December. This planning process will continue.

Question:

Has the FDIC developed any formal guidance or criteria to be used for approving/disapproving various asset plans submitted by acquirers?

FDIC Response:

Yes. Guidance and criteria are set forth in our overall delegations of authority. In addition, a committee structure was imposed immediately following FDIC's assuming responsibility for the FSLIC Resolution Fund. Detailed manuals for acquirers and case managers guide the submission and approval process for asset business plans and budgets.

Recently, revisions to the business plan and budget formats were made to improve the quality of information used in the decision-making process. These revisions significantly expand income and expense information. In addition, for markets in Texas in which there is an extremely heavy concentration of commercial and multifamily assets, income and expense budget standards have been developed. Utilization of these standards will allow comparisons of acquirer proposals against regional norms.

In this process there is no substitute for analysis and evaluation by staff with real estate, financial, and appraisal expertise. Staffing levels have been greatly enhanced with the addition of 70 positions in field offices to allow more complete analysis and to assure follow up to determine that acquirers are operating within approved parameters. This will have the additional benefit of reducing reliance on contractors. We anticipate reducing costs associated with the use of contractors by approximately one third at the end of 1990.

Question:

How are asset management plans that propose sale of assets with financing from assisted thrifts treated?

FDIC Response:

A policy on this topic has been developed. Plans that propose financing are reviewed to determine whether maximum value is being

obtained for the asset and that risk and cost to the FSLIC Resolution Fund is minimized.

Our analysis requires that non-cash considerations be valued on a cash-equivalent basis. A critical factor in this process is the use of an appropriate discount rate in determining the present values of cash flows. In no case will the discount rates be less than the FDIC's cost to carry the asset.

Another factor we have addressed is submarket rate financing and the requirement that the sales price be sufficiently high to compare favorably on a cash-equivalent basis.

While cash transactions or those financed by third parties are clearly desirable, it is unrealistic to expect disposition of the troubled real estate and loan portfolios covered by assistance agreements without some financing by the assisted institutions. Exhibit II contains policy direction regarding financed vs. cash sales.

Question:

Has FDIC fully implemented a Management Information System (MIS) for tracking the amount of covered assets in assisted thrifts - or made progress in meeting the goals outlined in various asset management plan submissions?

FDIC Response:

A senior level MIS Task Force has been established to meet DFO's management information needs. Several significant efforts have been completed and others are in process. General ledger data for the FSLIC Resolution Fund has been transferred from the FHLBB's Controller's records into the FDIC's Financial Information System (FIS). Subsidiary ledgers and more detailed financial information is in the process of being transferred. DFO staff have been transferred from the former FHLBB computer system to FDIC's network system. Implementation of a PC based authorization tracking system is nearing completion in the Dallas office. This system will track property, business, and collection plans. The system includes features that will allow monitoring of assisted institutions' compliance with approved plans. The task force is evaluating this effort to determine whether it will require mainframe support.

Plans for the conversion of other specialized FSLIC systems from the OTS mainframe to FDIC's system continue on target. FDIC systems include features that will enhance information available for management of assistance agreements and related financial obligations.

Question:

<u>What progress has been made in completing the already overdue initial inventory audits</u>?

FDIC Response:

The Committee asked that we provide a progress report on the initial inventory audits of thrift institutions acquired or merged with FSLIC assistance. These audits provide an independent validation of the asset inventory and the negative net worth of failed thrifts acquired under these assisted case resolutions. The audits therefore confirm initial information needed to establish the covered assets eligible for various forms of financial assistance under terms of the agreements.

Most of these audits were begun while the program was administered by the Inspector General of the former Federal Home Loan Bank Board. Some of these unfinished audits administered by the Bank Board involve cases resolved before 1988. In November 1989, shortly after the organizational transfer of former FSLIC staff to FDIC, responsibility for the 191 unfinished audits was assigned to FDIC's newly formed Division of FSLIC Operations. This placed administration of the audits in the hands of the division with direct knowledge of and responsibility for the financial assistance program. Since then, we have completed 49 audits. The pace has accelerated in recent weeks. Significantly, there are now draft audit reports in hand for 129 of the 142 remaining unfinished audits.

To further expedite the process, we have formed a dedicated project team of agency staff whose sole duty is to complete the

audits. Project team members will meet as appropriate with our contract audit firms to reduce the time needed to complete the final audit reports. We expect the majority of the remaining audits to be completed by the end of May, 1990.

In addition to the initial inventory audits, periodic compliance audits will be performed by the FDIC Office of Inspector General over the term of the assistance agreements. Compliance audits provide us an independent assurance that the amounts of assistance claimed by the acquirers is supported by proper documentation and is consistent with the terms of the agreements.

As we have indicated, results from a few of the initial audits completed determined that the extent of insolvency in a number of the failed thrifts in the Southwest region is greater than originally projected. We candidly expect this increase to loss estimates to continue as the remaining initial inventory audits are completed. However, at the present time, we are unable to quantify the amount for the Committee.

This concludes my prepared statement. I will be pleased to respond to any questions the Committee may have.

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FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

MISSION STATEMENT AND POLICY GUIDANCE FOR ADMINISTRATION OF ASSISTANCE AGREEMENTS UNDER THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION (FSLIC) RESOLUTION FUND

MISSION STATEMENT

With respect to assistance agreements under the FSLIC Resolution Fund, the FDIC prudently administers and manages financial assistance agreement cases to minimize the costs associated with the liquidation of the acquired institutions' covered asset portfolios. The FDIC manages its duties and obligations under these agreements as a total portfolio to minimize any adverse effects that asset disposition and inter-institution legal actions may have upon (1) maintaining asset values, (2) ensuring Acquiring Association accountability (3) supporting the regional and local economies, and (4) maintaining public confidence in Federally insured institutions

GOALS AND OPERATING PRINCIPLES

The FDIC has identified the following major goals:

1. To dispose of assets within the term of the assistance agreements to ensure orderly liquidation at minimum cost while maximizing asset value.

2. To assess effects of FIRREA on assisted institutions' ability to carry out duties and responsibilities under Assistance Agreements.

3. To establish and implement an improved process to monitor the Associations' asset management performance and ensure compliance with the terms, conditions and standards of the Assistance Agreements.

4. To develop and implement an enhanced management information system that is an effective resource in the management decision making process.

5. To periodically assess the delegations of authority to ensure that the organization prudently and efficiently exercises its authority.

6. To evaluate performance of the Contractors and develop a plan to reduce reliance on the Contractors in the future.

7. To establish operational relationships with outside regulatory agencies which affect the responsibilities of the FDIC.

In developing FDIC's policies for administering the assistance agreements, there are several principles that will serve as operational guidelines that should be apparent in every aspect of operations. They are designed to demonstrate the FDIC's commitment to carrying out prudently the significant responsibilities entrusted to it. These principles include:

- Accountability: In carrying out its responsibilities, the FDIC is aware of its fiduciary responsibilities to the taxpayers. This concept translates into how the FDIC applies proven management practices, attention to details and employment of sound business judgement with a view toward the impact its activities may have upon the financial and real estate communities. In the achievement of its mission, the FDIC will remain fully accountable to those relying upon its management decisions.

- Cost Minimization: Every FDIC activity should be sensitive to the federal cost-conscious environment. This translates practically into diligence in ensuring it carries out its responsibilities in the manner that provides the least cost and liability ~~to the taxpayer within the constraints of the~~ assistance ~~agreements~~.

- Internal Controls: The FDIC will be diligent to ensure that proper controls are in place to avoid any improprieties and to prevent any waste, fraud or abuse. Given the visibility of the assisted segment of the savings and loan industry, it is imperative this theme be actively employed throughout every aspect of the FDIC's endeavors. It translates to compliance with the Federal Managers' Financial Integrity Act (FMFIA), as well as any other applicable OMB or GAO circulars, guidelines or requirements;

- Management Integrity and Conflict of Interest: Given the broad scope and complex nature of FDIC's responsibilities, it is important that there be standards of conduct. This concept of standardization and integrity will include the ethics of employees and contractors, the uniformity of decisions regarding the cases and the attention to conflict

of interest provisions in asset management and other important areas, FDIC will take steps to ensure that there is no element of a conflict of interest in carrying out its responsibilities; and

- Information Technology: As the FDIC's responsibilities mature, it will need to enhance the role of information technology in all aspects of its operations. Given the vital role that this component of the FDIC's operations will play, it is necessary that it be stated as an overall operational guideline.

POLICY GUIDANCE

1. BACKGROUND

The FDIC is responsible for administering all assistance agreements and related contracts under the FSLIC Resolution Fund arising from assisted mergers and acquisitions of failed thrifts. Typically, the terms of these assistance agreements range from five to ten years and vary considerably in complexity and degree of standardization. As of January 1990, the FDIC is responsible for administering approximately 200 assistance agreements that provide for oversight and disposition of the failed institutions' covered assets. Included in the FDIC's covered asset oversight responsibilities are approximately $36 billion of covered assets, primarily troubled real estate, real estate loans and investments in subsidiaries.

In addition to the oversight responsibilities for assistance agreements, five of the Southwest Plan institutions were not acquired by private investors. Consequently, these institutions (Stabilized Institutions) are managed by individuals and firms approved by the FDIC. For these institutions, the FDIC is responsible for administering the assistance agreements, overseeing the operations and for affecting a permanent resolution of the institution.

In addition to the administration of assistance agreements, the FDIC is responsible for administration of FSLIC's obligations under the Guaranteed Advance Program and for the administration of Capital Instruments purchased or acquired during the acquisition of thrifts (Capital Instruments include preferred stock, capital and net worth certificates, warrants and subordinated debt). The Guaranteed Advance Program provided needed liquidity at reduced risk compared to market alternatives in the form of advances or loans made to insured members who lack sufficient collateral to secure loans.

2. ASSIGNMENT OF RESPONSIBILITY

The FDIC assigns management authority for the assistance agreements to its Division of FSLIC Operations (DFO). The FDIC is a decentralized organization and, as such, must take steps to ensure its procedures and operations reflect sound and ethical management practices that are adapted to decentralized management. From a policy perspective, this assignment includes the following operational responsibilities:

- Adherence and attention to the Federal Managers' Financial Integrity Act (FMFIA), applicable OMB circulars, as well as GAO and other applicable requirements and regulations;

- Utilization of an independent case assessment approach, where appropriate, to ensure objective, professional review of practices and a strict adherence to sound and ethical actions in the case management and related areas; and

- Assurance that there will be sufficient review of the managerial decisions to ensure integrity. Given the visibility and importance of this program, it is essential that strict attention be given to the vital areas of internal controls and management integrity.

3. ASSIGNED FUNCTIONS

The major functions assigned to DFO are:

a. Management of assistance agreements and oversight and disposition of Stabilized Institutions.

b. Oversight of the management, marketing and disposition of covered assets.

c. Review and coordination of litigation matters, including review and approval of all indemnifications and reimbursements requested by the Acquiring Associations.

d. Periodic projections of future assistance payments and cash flows related to the assistance agreements.

e. Interpretation of Assistance Agreements.

f. Administration of capital instruments purchased or acquired by the old FSLIC to facilitate the acquisition or rehabilitation of troubled institutions.

g. Administration of unique assistance plans to financially troubled institutions, to include such programs as Guaranteed Advances and open institution assistance.

h. Development of responses to Congressional and public inquiries.

4. ROLE OF ACQUIRING ASSOCIATIONS

The assistance agreements provide a framework for the management and liquidation of covered assets, settlement of legal matters and the consolidation of business operations. The guidelines of the agreements help ensure that both DFO and the Acquiring Associations meet their respective responsibilities. While DFO is responsible for ensuring compliance with the contractual terms stipulated within each of these agreements, the Acquiring Associations are responsible for the implementation and management of the individual assistance transactions.

The Acquiring Associations have assumed the responsibility to use their appropriate expertise to manage the resulting business and acquired assets and liabilities in order to:

- Operate a thrift in accordance with applicable laws and regulations;
- Consolidate and ~~reduce operating costs, thereby increasing~~ net profitability; and
- Liquidate or convert to earning assets the non-core business and assets of the acquired or consolidated thrift(s).

Each of the Acquiring Associations is responsible for administering and dealing with all covered assets and liabilities assumed pursuant to the terms of the Acquisition Agreements. Each Acquiring Association is required to employ the higher of the standard of prudent business practice in administering the acquired assets and liabilities or the standard employed in the savings and loan industry in administering similar assets and liabilities. Furthermore, the Acquiring Association is expected to use its best efforts to minimize losses and maximize gains and recoveries for the FDIC and the Acquiring Association.

The Acquiring Association is expected to provide at its own expense the executive and managerial resources, along with adequate supporting staff, to manage and implement the terms of the assistance agreement.

5. COVERED ASSET MANAGEMENT

The DFO oversees the management and disposition of assets related to financial assistance agreements. The following policies relate to covered asset management:

- Asset Disposition Strategy: The Acquiring Associations are required to maximize asset value and thus minimize resolution costs for the covered assets. To ensure attainment of this objective, DFO will utilize a comprehensive asset disposition strategy. This strategy will address issues such as the timing of asset disposition, loans to facilitate financing, market absorption, hold versus sell decisions and the disposition of marketable and non-marketable assets. The strategy will be communicated to all Acquiring Associations and used as a management tool to gauge their success;

- Management Oversight: DFO personnel assure that proposed transactions comply with applicable assistance agreement provisions and represent the most likely alternative available to minimize costs and maximize gains and recoveries. Certain decision making authority is delegated to the Acquiring Associations through specific provisions contained in the assistance agreements. Further authority is delegated through approved business plans, asset plans and collection plans. To assist in this process, DFO has developed expanded asset plan and budget formats and standards to ensure that Acquiring Associations submit documentation suitable for DFO decision making. DFO regularly monitors the Associations' compliance with assistance agreement terms, management processes and standards, and periodically tests specific asset and special reserve account transactions;

- Acquiring Associations' Asset Management Processes: Due to the magnitude of the transactions (both dollar value and number of assets), DFO is dependent on the Acquiring Associations' compliance with prudent asset management processes. Therefore, each Acquiring Association is required to develop and submit written asset management policies and procedures. DFO reviews these policies and procedures and tests for compliance on a regular basis;

- Compliance: DFO utilizes a number of programs to monitor the Acquiring Associations' compliance with the terms, management standards and intent of the assistance agreements. Compliance monitoring activities will include:

- Case Compliance Reviews: This activity involves the periodic review of a case by an independent group of DFO personnel from another case management section. The case compliance scope will include reviewing the Association's compliance with asset management processes, as well as DFO Contractor and Case Manager compliance with DFO's internal operating policies and procedures;

- Structured Evaluations of the Association: Periodically the Case Manager and DFO Contractor review individual Association Asset Managers to assess the quality of the Association's asset management, monitor compliance with Association policies and procedures and evaluate the Asset Manager's general and specific management of the assets;

- Examination Liaison: In connection with examinations by the Office of Thrift Supervision and the FDIC's Division of Supervision, DFO will coordinate additions to the development of the examinations' scope to include special concerns regarding compliance with Assistance Agreements;

- Special Investigations: Based on findings and conclusions, complaints, and/or general concerns, special investigations (often performed without the knowledge of the Acquiring Associations) will continue to be performed to ensure that the Acquiring Associations are disposing of assets in compliance with the terms and conditions of the assistance agreement for the highest and best price available;

o Assistance Agreement Interpretation: DFO, with the assistance of the Legal Division, is responsible for interpreting the provisions of the assistance agreements. Due to the unique nature of the agreements, resolution of an interpretation issue may result in the development of specific policies or assistance agreement modifications. DFO is developing an assistance agreement issues resolution process for tracking, disseminating and referencing interpretations. Examples of issues include disposition financing, marketing, appraisals, loan participations and management standards.

6. LITIGATION

DFO will monitor all legal proceedings to ensure the Acquiring Associations are using their best efforts to preserve the interests of the FDIC and to minimize costs and expenses in all

litigation matters. The Acquiring Associations will also strive to maximize any potential recoveries through pursuit of related claims. DFO will coordinate the approval of all litigation matters with the FDIC's Legal Division. Since indemnification for major settlements requires the Legal Division's concurrence, DFO's role is to analyze and consider the effect of any proposed actions upon the ultimate costs to the FSLIC Resolution Fund.

To facilitate DFO's ability to monitor the status of legal activity, the Acquiring Associations, as directed by the assistance agreements, must submit litigation schedules, plans and budgets on a regular basis. Any expenditure of Acquiring Associations' funds for legal matters that are reimbursable by the FDIC must ultimately be approved by the FDIC, either by written consent of DFO, through the approval of plans/budgets, or the approval of transactions through the Special Reserve Accounts.

DFO has the authority to intervene in the conduct of any litigation matter to protect the FDIC's best interests. More specifically, DFO has the right to:

- Monitor and direct the defense or prosecution of the matter;
- Defend or prosecute the matter with FDIC attorneys; and
- Require the Acquiring Association to assign its right, title or interest in the matter, any defense related to the matter, or proceeds from the matter to the FDIC.

Additionally, the Acquiring Associations must cooperate with DFO in defense or prosecution of legal matters. The Acquiring Associations may also be required to provide DFO with all applicable books, records or other relevant information in its control.

The Acquiring Associations may take immediate action concerning a litigation matter if that action is required to protect the interests of the FDIC and the Acquiring Associations. The Acquiring Associations may take such emergency steps only if it is unable, due to time or other constraints, to obtain verbal or written approval of DFO.

The Acquiring Associations are expected to pursue all related claims and, when appropriate, file actions with respect to potential recoverable claims. These legal actions should be pursued in an effort to reduce or minimize the indemnity payments the FDIC will be required to pay. If necessary, the

FDIC may direct the Acquiring Association to pursue or prosecute potential claims. DFO will coordinate with the Legal Division with respect to the assignment of and pursuit of claims acquired through the agreements.

Any significant settlement for a litigation matter must be approved by DFO with concurrence from the Legal Division. DFO will coordinate the approval of settlements in an expedient manner to eliminate any potential economic loss that may result from delays in approval processing.

7. TAX, AUDIT, FINANCIAL MANAGEMENT AND REPORTING

FDIC oversees the following financial areas:

- Tax: Where applicable, the tax-related provisions of Assistance Agreements vary widely and many are technically detailed in nature. Within the framework of each agreement, FDIC's intent is to maximize the U.S. Government's share of net tax benefits. Acquiring Associations are responsible for providing FDIC copies of their tax returns filed with the Internal Revenue Service. Each agreement specifies the information that Acquiring Associations shall submit to FDIC in support of tax-related credits and/or payments to the agency.

- Audits: FDIC has a priority goal to expedite completion of remaining opening inventory audits of assisted associations. These audits help FDIC to determine negative capital and the inventory of covered assets. FDIC will also periodically initiate compliance audits to ensure that an Acquiring Association's claim for reimbursement and related activities are consistent with the terms of the agreement. Acquiring Associations are responsible for cooperating fully with the auditors and providing on a timely basis such background work papers and schedules as the auditors may require.

- Payment of Claims: FDIC will generally pay all valid and properly documented claims in cash upon receipt, in lieu of accruing such obligations at interest. Where agreements allow, the agency may elect to defer such payments with interest. This option will normally be applied only during periods when the FSLIC Resolution Fund's cost of financing (i.e., cost of U.S. Treasury borrowings), is less than the interest cost to defer payments of claims.

- Reporting: FDIC will maintain a financial reporting system to track the Government's actual and projected costs under the Assistance Agreements. Costs will be separated among a number of individual expense categories. The reporting system will include a variance analysis capability to compare estimated with actual costs. The system will also include cash flow forecasting of the timing and amounts paid under Assistance Agreements. This will assist the U.S. Treasury to minimize its cost of financing funds that are transferred to the FSLIC Resolution Fund.

8. RESOURCES

DFO relies on staff members located in Washington, D.C., and field staff in Dallas and Houston, Texas, and Irvine, California to carry out its oversight responsibilities. In addition, DFO leverages itself through the judicious use of independent contractors to provide specialized expertise.

In carrying out its mission with respect to assistance agreements, DFO has adopted policy perspectives with regard to two important organizational/administrative components:

- Contractors: While currently there is a significant reliance upon contractors to assist DFO in carrying out its responsibilities, DFO envisions this reliance will decrease as its own staff members continue to expand in size and increase in capability; and

- Technology: The development of an accurate and reliable information resources management capability is an important goal for DFO. DFO will place increased emphasis upon this component of its operations to gauge programmatic needs and to assess the efficient employment of resources. While this portion of DFO's capability is still in the early developmental stages, DFO intends to place continued emphasis upon it as a vital component of its operation.

9. MANAGEMENT REPORTING

To properly evaluate and monitor the performance of the Acquiring Associations and to determine the overall performance of the consolidated DFO portfolio, a reliable, accurate management information system is critical. The development of a comprehensive covered asset management and compliance monitoring system continues to be a high priority of DFO. A number of information processes have been, or are being, developed to address those needs.

DFO collects monthly and quarterly Acquiring Association activity data, from which a series of management reports will be generated. This information includes data on covered asset status, disposition activity , submission activity, financial performance, staffing, assistance paid, litigation and consolidation activities. The reports generated provide two-levels of management information: general information to track overall asset management progress and specific information to identify potential problems at institutions that may require special action and additional monitoring.

DFO will produce periodic reports on the status of DFO's current caseload, the disposition of covered assets, the Acquiring Associations' relative assistance agreement compliance, the Acquiring Associations' financial performance (e.g. watch list), and corrective actions underway. Reports will also be provided on the status of opening inventory and compliance audits, as well as on total assistance expenditures to date and projected cash flows.

To provide the level of management information necessary for effective reporting and control purposes, DFO requires mainframe support from the FDIC. The current developmental efforts represent interim or prototype processes that are designed to provide the high level information required to manage the assistance transactions over the short-term.

POLICY STATEMENT
TRANSACTIONS INVOLVING NONCASH CONSIDERATIONS

PURPOSE: To provide policy guidance with respect to the sale of Covered Assets in which consideration other than cash is received.

INTRODUCTION: Since all-cash transactions minimize future financial exposure to the FSLIC Resolution Fund (FRF), cash transactions are preferred over seller financing transactions. Nevertheless, due to the depressed nature of the real estate market in many sectors of the country and competition for third-party financing resulting from large foreclosed real estate portfolios, seller financing is sometimes necessary to achieve maximum values on the disposition of many Covered Assets. Additionally, factors such as the reduction in the universe of lenders for most commercial type properties as a result of the capital requirements of FIRREA and the poor quality of certain properties have contributed to the need for Acquiring Associations to consider and evaluate purchase offers that include seller financing. Accordingly, most Assistance Agreements require the Acquiring Association to offer financing in connection with the marketing of Covered Assets to assure that Covered Assets are liquidated in a manner that maximizes the values of the assets while minimizing losses to the FRF.

In many instances the consideration received upon the sale of a Covered Asset will include a note from the purchaser in addition to cash. In some instances, other forms of noncash consideration may be received. Under most Assistance Agreements, such notes or other noncash consideration can themselves be treated as Covered Assets.

In cases in which a note or other noncash consideration is received upon the disposition of a Covered Asset and, such consideration itself becomes a Covered Asset, three separate questions arise under the typical Assistance Agreement:

1. Does such a transaction qualify as a sale within the meaning of the Liquidation provision of the Assistance Agreement so as to give rise to a "Covered Asset Loss" or "Covered Asset Recovery" and a potential "Gain Share Payment" or "Loss Sharing"?

2. If the transaction does constitute a Liquidation, at what value is the noncash consideration to be taken into account in determining whether the transaction should be consummated, and in calculating the Covered Asset Loss or Covered Asset Recovery?

3. If the noncash consideration is itself to be a Covered Asset, what effect does that have on the payment of Gain Share or Loss Sharing?

Many Assistance Agreements have similar provisions dealing with Covered Asset Losses, Covered Asset Recoveries, Gain Sharing and Loss Sharing. This policy assumes that they are all consistent with the description below. However, each Agreement must be reviewed to determine that the analysis reflected herein is applicable to the particular Agreement.

POLICY:

1. CHARACTERIZATION AS A LIQUIDATION OF A TRANSACTION IN WHICH NONCASH CONSIDERATION IS RECEIVED

Under most Assistance Agreements, an Acquiring Association can debit the Special Reserve Account for a Covered Asset Loss if such loss results from a Liquidation of a Covered Asset. A Liquidation of a Covered Asset is normally defined to be a sale of the asset; thus, in order to constitute a Liquidation, a Covered Asset must be sold. The requirement of a sale was intended to require a disposition of a Covered Asset to a third party.

If the consideration received for the Covered Asset in the transaction is other than cash, and will itself become a Covered Asset under the provisions of the Assistance Agreement, the transaction may not constitute a sale, but merely an exchange of one Covered Asset for another. In order to constitute a sale, a significant cash payment must be received in addition to any noncash consideration. As a matter of policy, the FDIC will operate on the general rule that in order for a transaction involving a Covered Asset to be considered a sale and, therefore, a Liquidation within the meaning of the Assistance Agreement, at least 20% of the total consideration to be received for such Asset must be cash. This is only a general rule and exceptions may be made on a case-by-case basis. Exceptions should be isolated and infrequent transactions that are justified by facts peculiar to the particular situation.

2. VALUATION OF NONCASH CONSIDERATION FOR DETERMINING APPROVAL OF TRANSACTIONS AND THE AMOUNT OF A COVERED ASSET LOSS OR COVERED ASSET RECOVERY.

The FDIC considers the independent valuation (e.g., the appraisal) of the Covered Asset, or of the underlying collateral in the case of loans, to represent the Covered Asset's present cash equivalent value. Asset plans for the disposition of Covered Assets generally utilize appraised value in establishing an acceptable sales price and, therefore, such sales price, regardless of terms, should

compare favorably to the appraised value. In any disposition of a Covered Asset, FDIC would expect that the total consideration to be received has a cash value at least equal to the minimum sales price. If the consideration to be received includes noncash consideration, such consideration must be valued on a cash equivalent basis to determine whether cash value equal to the minimum sales price has been received.

By far, the most common noncash consideration likely to be received upon the disposition of a Covered Asset is a Loan to Facilitate provided by the Acquiring Association. The cash value of such a Loan to Facilitate is equal to the present value of the cash flows to be generated by such Loan. In determining the present value of such cash flows, a market discount rate should be used. That rate should be determined by taking into account all relevant factors, including, but not limited to, prevailing interest rates, loan to value ratio, type of asset, market conditions, assumability and subordination. In some cases, a true market discount rate would be so high that a disposition cannot be effectuated. In such cases, the advisability of the transaction should be reconsidered. If it is nevertheless determined that the transaction should be consummated, judgment must be used to determine a fair discount rate. However, in no event should the discount rate be less than the FDIC's cost to carry the Covered Asset. In most cases, the cost to carry will be equal to the Guaranteed Yield Rate applicable at the time of the transaction as set forth in the Assistance Agreement.

In any event, if a Loan to Facilitate the sale of a Covered Asset is to be made by an Acquiring Association on sub-market terms, the stated sales price must exceed the minimum sales price set for the Covered Asset by an amount such that the cash equivalent of the Loan to Facilitate, when added to the cash to be received, will at least equal the minimum sales price.

To illustrate, assume the following facts:

. Book Value	$ 14,200,000
. Appraised Value	$ 11,500,000
. Minimum Sales Price	$ 11,000,000
. Terms of Sale:	
Gross Sales Price	$ 11,600,000
Cash Down Payment	$ 3,600,000
Face Amount of Loan to Facilitate	$ 8,000,000

. Terms of Loan:

Term	5 Years
Interest Rate	10% Fixed
Payment Date	Interest only due monthly; principal ballon payment at end of 5 years
Guarantor	None; non-recourse loan

. Assumed "Market" Interest Rate	11.5%
. NPV of Interest Payments @ 11.5%	$ 3,031,337
. NPV of Principal Payment @ 11.5%	4,642,112
. NPV of Loan	7,673,449
. NPV of Cash Down Payment	3,600,000
. Gross Proceeds from Sale	$ 11,273,449

Since the net present value of the cash flows of $11,273,000 exceeds the minimum sales price of $11,000,000, this transaction would come within the guidelines outlined above and would be considered favorably by the FDIC.

Conversely, if the asset was offered for sale at the appraised value of $11,500,000, the transaction would not be within the guidelines and would require additional justification.

This discounted cash flow analysis is applicable to whatever type of loan that is made. Payments under the loan should be scheduled by payment date and then discounted back at the market discount rate.

Transactions meeting these guidelines will NOT receive automatic approval. Each case will be decided upon its own merits. Nevertheless, for those transactions that do fall within the guidelines, the Acquiring Association can be confident that the transaction will not be rejected solely on the grounds that terms of the Loan to Facilitate are not satisfactory to the FDIC. Similarly, those transactions that fail to meet the guidelines will not be automatically rejected, but it is incumbent upon the Acquiring Association to justify the deviation.

For those approved transactions that qualify as Liquidations under the above guidelines, the same discounted present value will be used to determine the amount of Covered Asset Loss or Covered Asset Recovery realized upon the disposition of a particular Covered Asset. Under most, if not all Assistance Agreements, a Covered Asset Loss or Covered Asset Recovery is measured by the proceeds received upon Liquidation of the Asset. The term "proceeds" is not further defined, but can only mean cash equivalent value. Accordingly, for such purposes, the gross proceeds received

will be equal to the sum of the cash received, plus the discounted present value of any other noncash consideration received. Under the illustration above, the Covered Asset Loss would equal $2,926,551.

If a Loan to Facilitate itself becomes a Covered Asset, its Book Value will be equal to the discounted present value of its cash flows, not its face amount, and its actual yield rate will be equal to the discount rate utilized in determining that value, not its coupon rate.

3. EFFECT OF TREATMENT OF NONCASH CONSIDERATION ON THE PAYMENT OF GAIN SHARE.

As an incentive for the Acquiring Association to maximize the value received upon the disposition of Covered Assets, and thereby minimize cost to the FDIC, many of the Assistance Agreements negotiated in 1988 contain provisions for Gain Sharing. These provisions permit the Acquiring Association to debit the Special Reserve Account for a percentage share of that portion of the net proceeds from the sale of a Covered Asset which exceeds a certain bench mark amount. This payment is independent of any debit for a Covered Asset Loss realized upon the sale.

Gain Share will also be calculated using the discounted cash flow principles set forth herein. To illustrate, assume in the above illustration that the Acquiring Association is entitled to 10% of that portion of the net proceeds received from disposition of the Covered Asset in excess of 75% of its Book Value. The Acquiring Association's Gain Share amount would be calculated as follows:

. Proceeds from sale (NPV)	$ 11,273,449
. Bench Mark Value (75% of $14,200,000)	10,650,000
. Excess Subject to Gain Share	$ 623,449
. Acquiring Association's Share (10%)	$ 62,345

The purpose of paying Gain Share is to provide an incentive to the Acquiring Association to maximize the value realized from a disposition of a Covered Asset and thereby minimize cost to the FDIC. Therfore, if the disposition involves a loan from the Acquiring Association that itself becomes a Covered Asset, the disposition only reduces FDIC's cost to the extent the terms of the loan are sufficient to cover the cost to carry the loan, and the loan is paid according to its terms. Thus, if the loan subsequently goes into default and a loss is suffered on its Liquidation, the Gain previously calculated was not, in fact, realized. Accordingly, any Gain Share paid must be subject

to recapture to the extent that the full value of the new loan is not fully realized. This is especially true with respect to non-recourse loans where the lender must look solely to the security property for repayment of the debt.

To illustrate, assume that in the above example all interest is paid, but the principal of the loan is not paid at the end of year 5 when due. Assume further that negotiations result in the transfer of the asset to a new purchaser for cash of $4,400,000 which is received at the end of year 6, one year after the loan principal was due and payable. Assume the $4,400,000 had a discounted present value on the date when the loan principal was due of $4,000,000. Under this scenario, the Acquiring Association only received proceeds from the sale of the original Covered Asset as follows:

. NPV of Interest Payments	$ 3,031,337
. NPV of Down Payment	3,600,000
. NPV of Final Cash	4,000,000
	$ 10,631,337

Since the $10,631,337 is less than the bench mark value of $10,650,000, no amount is subject to Gain Share and the Acquiring Association must credit back the $62,345 previously received. In contrast, if the net present value of the cash received had been $4,068,663, then the total net present value realized would have been $10,700,000 and a Gain Share of $5,000 [10% x ($10,700,000 - $10,650,000)] would have been earned. In this event, a net $57,345 should have been credited back.

Thus, in cases in which the proceeds received upon the disposition of a Covered Asset includes a loan made by the Acquiring Association that is itself a Covered Asset, although Gain Share may be paid at the time of the transaction, such payment is subject to repayment in the event the loan is not paid off according to its terms. Moreover, because it is highly likely that if such a loan becomes delinquent, it will not result in the Acquiring Association receiving the cash equivalent value assumed, any Gain Share paid should be credited back in full <u>immediately</u> upon default as that term is defined in the loan documents.

With respect to those Assistance Agreements that contain provisions for Loss Sharing, the Gain Sharing principles discussed above would apply.