Office of Inspector General

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Audit Report No. 03-039

Division of Resolutions and Receiverships' Asset Valuations at Specific Closings

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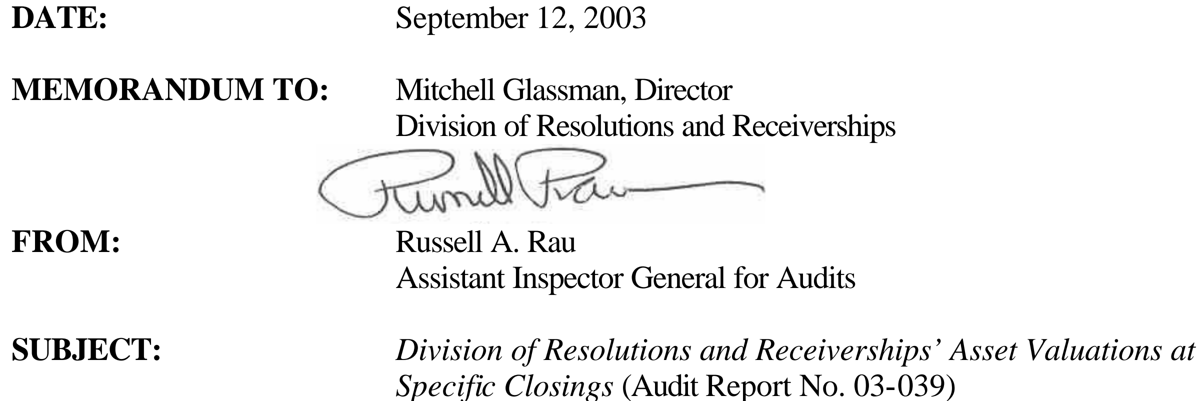
FDIC

Federal Deposit Insurance Corporation Office of Audits
Washington, D.C. 20434 Office of Inspector General



DATE: September 12, 2003

MEMORANDUM TO: Mitchell Glassman, Director
Division of Resolutions and Receiverships

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *Division of Resolutions and Receiverships' Asset Valuations at Specific Closings* (Audit Report No. 03-039)

This report presents the results of the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General's (OIG) audit of the Division of Resolutions and Receiverships' (DRR) asset valuation process used in the resolution of two failed FDIC-insured depository institutions—Hamilton Bank, N.A. of Miami, Florida (Hamilton), and Southern Pacific Bank of Torrance, California (Southern Pacific).[1] The overall objective of this audit was to determine whether DRR's asset valuation review process resulted in accurate asset valuations for specific closings. Accurate asset valuations are important because this information is used to determine the appropriate resolution structures to offer to potential bidders and is part of the FDIC's least cost test for the resolution of an institution.[2] We concentrated our work on determining whether DRR's asset valuation process resulted in reasonably accurate asset valuations for unique assets at these specific closings. Unique assets in Hamilton and Southern Pacific included international-trade loans and commercial loans involving the telecommunications, technology, entertainment, and airlines industries. The FDIC engaged outside contractors to value these unique assets. This audit was a follow-up to several earlier audits conducted by the OIG. Additional details of our objective, scope, and methodology, including our follow-up work, are presented in Appendix I.

BACKGROUND

The FDIC is charged with the resolution of failing FDIC-insured depository institutions. Specifically, when a financial institution is failing, the FDIC has a fiduciary responsibility to the institution depositors,

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[1] A financial institution fails when it is closed by its chartering authority, which rescinds the institution's charter and revokes its ability to conduct business because the institution is insolvent, critically undercapitalized, or unable to meet deposit outflows.

[2] The FDIC is required by the Federal Deposit Insurance Corporation Improvement Act of 1991, Section 143, to resolve failed financial institutions in a manner in which the total amount of the FDIC's expected expenditures is the least costly to the deposit insurance fund of all possible methods for resolving the failed institution.

creditors, and shareholders to liquidate the institution's assets and liabilities in the most expedient and least costly manner possible. The resolution process involves valuing the institution, marketing the institution, soliciting and accepting bids for the sale of the institution, determining which bid is least costly to the insurance fund, and working with the acquiring institution(s) through the closing process (or ensuring the payment of insured deposits in the event there is no acquirer). The FDIC is also responsible for managing, marketing, and selling those assets that are not sold to an acquiring institution and are, therefore, placed into an FDIC receivership.[3]

Within the FDIC, DRR has the primary responsibility for resolving failing FDIC-insured depository institutions promptly, efficiently, and responsively in order to maintain public confidence in the nation's financial system. Within DRR, the Franchise and Asset Marketing Branch (FAMB) is responsible for resolving troubled financial institutions and selling assets at the least cost and highest recovery to the FDIC insurance funds.

The FDIC identifies troubled insured depository institutions and begins its resolution efforts (such as valuing assets and identifying potential purchasers of these institutions) before the institutions fail. At failure, the FDIC is appointed receiver and succeeds to the rights, powers, and privileges of the insured depository institution and its stockholders, officers, and directors. To fulfill its responsibilities to creditors of the failed institution, the FDIC, as receiver, manages and sells the assets through a variety of strategies and identifies and collects monies for the receivership. Once the FDIC sells the assets of the receivership and resolves the receivership's obligations, claims, and any legal impediments, the receivership is terminated and final monetary distributions are made to qualified creditors of the failed institution.

Generally, a team of DRR FAMB resolution specialists visits the bank prior to closing to gather information and analyze the institution's condition. The resolution team assigns a value to all the assets of the institution, determines the resolution options the FDIC will offer, prepares an Information Package (IP)[4] for the FDIC to give to potential bidders, and plans for the closing and receivership operations. DRR uses valuation models to estimate the liquidation value of assets.

[3] A receivership is designed to market the assets of a failed institution, liquidate them, and distribute the proceeds to the institution's creditors. The FDIC as receiver succeeds to the rights, powers, and privileges of the institution and its stockholders, officers, and directors. The FDIC may collect all obligations and money due to the institution, preserve or liquidate its assets and property, and perform any other function of the institution consistent with its appointment.

[4] The information package contains detailed data on the amounts and types of assets and liabilities that the failing institution holds. The information varies depending on each institution's business strategy, as reflected in its assets and liability structure. For example, if a failing bank is involved primarily in residential mortgage lending, the FDIC will develop information on the basis of the bank's assets characteristics, such as the interest rates and the terms of the loans, as well as the performance of the portfolios.

This estimate is then used to calculate the cost of deposit payoff[5] and to estimate the loss to the Bank Insurance Fund (BIF) or the Savings Association Insurance Fund (SAIF).[6]

The sale of a financial institution's assets for the highest recovery is based on the process DRR's FAMB developed to establish asset prices used for evaluating the bids received for the purchase of a failing financial institution and/or specific assets. FAMB establishes asset prices using the Asset Valuation Review (AVR) process. Overall policies and general procedures for the AVR process are specified in the DRR Resolutions Policy Manual. The primary purpose of the AVR process is to establish an estimate of the value of the institution's assets, which is then used as the minimum price (AVR price) the FDIC is willing to accept for those assets from potential purchasers of failing institutions. Therefore, under-estimates of value could have a material effect on the sales process and, in turn, could increase the loss to the insurance funds. DRR staff submits a written recommendation, including a copy of the least-cost analysis,[7] to the FDIC Board of Directors requesting approval of the resolution transactions.

To establish the value of the institution's assets as part of the AVR process, FAMB generally values all groups of assets. When valuing assets, FAMB uses statistical sampling for asset groups (e.g., residential mortgage loans) with large numbers of assets. For all other asset groups, each asset in the particular group is valued. When valuing specific assets, FAMB generally uses the FDIC Standard Asset Value Estimation (SAVE) methodology. The SAVE methodology values traditional loans such as owned real estate, subsidiaries, and certain other assets using standard discount rates and expense assumptions to estimate the net present value of expected cash flows. The SAVE methodology, documented in the *SAVE Instruction Manual*, requires detailed documentation to support asset value estimates and at least two levels of review for individual asset valuations. However, when dealing with unique assets wherein DRR has limited expertise or experience, FAMB may choose to engage an outside contractor to provide valuation and disposition assistance. Such was the case with both Hamilton and Southern Pacific. Appendices II and III provide background information on both.

RESULTS OF AUDIT

DRR's AVR process resulted in reasonably accurate estimates of value of the traditional assets sold for both Hamilton and Southern Pacific —the two FDIC-insured depository institutions that we

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[5] The FDIC as insurer pays off all the failed institution's depositors with insured funds the full amount of their insured deposits. Depositors with uninsured funds and other general creditors (such as suppliers and service providers) of the failed institution do not receive either immediate or full reimbursement. Instead, the FDIC as receiver issues Receivership Certificates to depositors and creditors. A Receivership Certificate entitles its holder to a portion of the receiver's collections on the failed institution's assets.

[6] Estimated losses represent the FDIC's current estimate of the cost of an individual failure to the BIF. Estimated losses are derived, in large part, from estimates of future asset disposition proceeds, which are estimated by determining, through statistical sampling or recent disposition activity, the recovery rates for similar assets across all receiverships. Accordingly, the losses ultimately realized by the BIF or SAIF will likely vary from amounts estimated.

[7] FDIC's least cost calculation is expressed as (the loss on all assets less equity capital less unsecured creditor's loss) times (insured deposits over total deposits).

reviewed. However, the actual net sales proceeds of the two institutions' unique assets varied substantially from the asset valuations. Specifically, for the assets sold to date in the two institutions:

- Aggregate actual net sales proceeds for traditional assets such as mortgage loans fell within 1 percent of the asset values that DRR estimated using its SAVE methodology (see Finding A: Asset Valuations Using SAVE Methodology).

- Aggregate actual net sales proceeds for unique (non-traditional) assets such as trade finance loans varied substantially (21 percent) from the asset values that an FDIC contractor estimated using non-SAVE methodologies. The risk to the FDIC is that an inaccurate valuation may adversely impact the selection of the least costly resolution strategy. Further, if estimates of asset valuations are significantly understated, the FDIC faces the possibility that it may accept bids for assets that are too low and, thus, negatively impact the insurance funds (see Finding B: Asset Valuations for Unique Assets).

DRR personnel generally complied with the Resolutions Policy Manual in conducting their asset valuation reviews of Hamilton and Southern Pacific. Specifically, DRR documented asset valuation information, including valuation assumptions, the structure of the asset pools, and the results of the valuation. DRR documented its resolution decisions such as the least cost tests and bid approvals. Also, the FDIC's asset valuation contractors provided all required valuation deliverables.

FINDING A: ASSET VALUATIONS USING SAVE METHODOLOGY

DRR's asset valuations using its SAVE methodology resulted in reasonably accurate estimates of the value of the traditional assets sold for both Hamilton and Southern Pacific. Specifically, of approximately $381 million of traditional assets sold as of May 31, 2003 in these two institutions, DRR had estimated the assets to be worth $373 million. Therefore, with respect to the traditional assets sold for the two institutions, DRR's actual net sales proceeds for the assets were within 1 percent of the estimates of asset values. Table 1 shows the book value of the assets and compares their estimated value with actual sales proceeds for both institutions.

Table 1: Book Value of Traditional Assets and a Comparison of Estimated Value to Actual Sales Proceeds

	Book Value of SAVE Assets Sold (A)	Estimated Value of SAVE Assets Sold (B)	Actual Proceeds of SAVE Assets Sold (C)	Difference (C-B)
Hamilton Bank	$ 1,805,000	$ 1,614,000	$ 1,710,000	$ 96,000 (5%)
Southern Pacific Bank	379,332,843	370,940,282	372,858,743	1,918,461 (.52%)
Totals	$381,137,843	$372,554,282	$374,568.743	$2,014,461 (.54%)

Source: OIG Analysis of FAMB Results Summary-Receiverships.

As the data in the table above indicate, the proceeds that the FDIC received from the sales of Hamilton's traditional loan assets totaled $1.7 million. DRR's application of the SAVE methodology, which estimated the value of those same traditional assets to be $1.6 million, resulted in an estimate that was within about 5 percent of the amount received. With respect to the traditional assets at Southern Pacific, the estimate of asset values was even closer, as a percentage, to the actual sales proceeds. Specifically, for Southern Pacific the FDIC received $373 million for traditional loan assets that were valued at $371 million using the SAVE methodology. Therefore, the difference was less than 1 percent. Accordingly, in the case of both Hamilton and Southern Pacific banks, evidence indicates that for the traditional assets, the SAVE methodology was working as intended.

FINDING B: ASSET VALUATIONS FOR UNIQUE ASSETS

The actual net sales proceeds from unique assets varied substantially from the contractor- performed asset valuation for Hamilton. As of December 31, 2002, Hamilton's unique loan assets sold for $243 million, while DRR's contractors had estimated the assets to be worth $173 million. Therefore, contractor estimates of these asset values were understated by about 41 percent. In the case of Southern Pacific, as of May 31, 2003, the FDIC had received $119 million in sales proceeds for unique assets valued by the contractor at about $127 million. This $8 million difference represents an overstatement of about 6.5 percent. Table 2 shows the book value of the unique loan assets and compares their estimated value with actual sales proceeds for both institutions.

Table 2: Book Value of Unique Loan Assets and a Comparison of Estimated Value to Actual Sales Proceeds

	Book Value of Unique Assets Sold (A)	Estimated Value of Unique Assets Sold (B)	Actual Proceeds of Unique Assets Sold (C)	Difference (C-B)
Hamilton Bank	$413,025,000	$172,855,000	$242,877,000	$ 70,022,000 (40.5%)
Southern Pacific Bank	217,113,474	127,278,622	119,026,259	(8,252,363) (6.5%)
Totals	$630,138,474	$300,133,622	$361,903,259	$61,769,637 (20.6%)

Source: OIG Analysis of FAMB Results Summary-Receiverships.

Accurate asset valuations are important because this information is used to determine the appropriate resolution structures to offer to potential bidders and it is part of FDIC's least cost test for the resolution of an institution. As discussed earlier, the risk to the FDIC is that an inaccurate valuation may adversely impact the selection of the least costly resolution strategy. Further, if estimates of asset valuations are significantly understated, the FDIC faces the possibility that it may accept bids for assets that are too low and, thus, negatively impact the insurance funds by obtaining less money than otherwise possible.

On June 6, 2003, we discussed with DRR officials the sales proceeds compared to the valuations of the unique assets in both Hamilton and Southern Pacific. With respect to Hamilton, DRR officials offered the following explanations for the 41 percent variances between proceeds received and the contractor estimates:

- Asset valuations are performed using available information at a specific time. Once marketing efforts begin subsequent to valuation, updated financial information is received and placed in debtor files and is available for potential bidders to use in performing due diligence, thus assisting in the determination of asset value.

- The firm contracted to help dispose of the Hamilton assets did an effective job marketing the assets by advertising the sale of the foreign trade loans in countries where the loans originated. This marketing heightened awareness and interest in the loans offered for sale, brought in more potential investors, increased the competition, and drove up the price of the bids received.

- DRR officials familiar with the Hamilton asset valuations were satisfied with the contractor's results for two reasons: the contractor used a methodology to value the loans that was reviewed and approved by DRR, and the contractor was experienced with the types of loans Hamilton had in its portfolio.

Although these explanations seem reasonable, DRR officials did not provide any empirical evidence to support their explanations. Such evidence was not readily available because DRR had not performed post-resolution reviews of the asset valuation variances.

DRR collects information on resolution matters for each institution in an institution specific *Receivership Status Report and Action Plan* that is reviewed and approved by DRR's Senior Management Oversight Committee.[8] Each report contains an appendix with a feedback-loop section that highlights some of the "lessons learned" at closings. However, periodic asset valuation reviews were not performed, and variances between valuations and actual sales proceeds were not discussed in either the Hamilton or Southern Pacific reports. Each report is updated quarterly and contains a variance analysis section. The Hamilton updates did not address asset valuations, and DRR has not yet updated the report on Southern Pacific. DRR could begin requiring its staff to collect and analyze data on asset valuation and sales proceeds variances when dealing with unique loan assets. Information could also be collected on the different methodologies used by outside contractors to value these types of assets. The lessons learned could be used to improve future estimates and enhance outside contractor performance and accountability.

We discussed the results of our audit work with responsible DRR management officials who were satisfied that, given the circumstances, the asset marketing process accounted for the wide variances between net sales proceeds and initial asset valuations for unique assets. DRR officials stated that although the asset valuation is used for the information package that goes to prospective bidders, it is an "estimated figure" made at a certain time. According to DRR officials, by hiring outside contractors for asset valuations when DRR has limited experience or expertise, the FDIC attains a certain "comfort level" and credibility for its asset valuations. During the sales process, DRR officials are primarily concerned with a good marketing effort. The officials stated that the ultimate determination of the value of a failed institution—particularly with respect to the unique assets—rests with competition among the bidders resulting from the marketing effort. Therefore, according to DRR officials, ultimately, competition in the market place most accurately determines the value of an institution's assets.

Our work on Hamilton and Southern Pacific shows that actual net sales proceeds of unique assets can vary substantially from the asset valuations. As discussed in Appendix I, DRR has an ongoing effort to improve the efficiency and effectiveness of the AVR process for traditional assets using the SAVE methodology. We suggested to DRR Field Office management officials that the scope of their current effort could be expanded to include consideration of the asset valuation process for unique loan assets.

Recommendations

We recommend that the Director, DRR:

[8] The SMOC serves as the central forum for managing the Division's affairs. For details regarding the SMOC, see the internal management control section of Appendix I.

(1) Require the *Receivership Status and Action Plan* or Quarterly Update to include a discussion of significant variances between asset valuations and actual sales proceeds.

(2) Include an initiative to review best practices regarding the valuation of unique assets in DRR's 2004 Strategic Plan.

CORPORATION COMMENTS AND OIG EVALUATION

On September 4, 2003, the Director, DRR provided a written response to the draft report. The response is presented in Appendix V of this report. Based on subsequent discussions with DRR officials, the original recommendations were revised to more clearly correspond to the actions DRR intends to take to address the asset valuation process. DRR plans to complete the corrective actions by December 31, 2003. The following summarizes DRR's response to each recommendation.

(1) Require the *Receivership Status Report and Action Plan* or Quarterly Update to include a discussion of significant variances between asset valuations and actual sales proceeds.

DRR concurred with the recommendation. DRR indicated that by December 31, 2003, the *Receivership Status Report and Action Plan* and/or Quarterly Update will be modified to include the summary of asset valuations prepared for the Asset Marketing (confirmation) sales case. Either formal document, presented to DRR's Senior Management Oversight Committee, will discuss the reconciliation of valuation estimates and actual results.

(2) Include an initiative to review best practices regarding the valuation of unique assets in DRR's 2004 Strategic Plan.

DRR concurred with the recommendation. DRR will include an initiative to review best practices regarding the valuation of unique assets in the 2004 Strategic Plan, which is now being formulated. The Plan will be finalized and distributed by December 31, 2003.

Both recommendations are resolved but will remain undispositioned and open for reporting purposes until we have determined that agreed-to corrective actions have been completed and are effective. A summary chart showing management's responses to the recommendations is presented in Appendix VI.

APPENDIX I

OBJECTIVE, SCOPE, AND METHODOLOGY

The overall objective of this audit was to determine whether DRR's asset valuation review process resulted in accurate asset valuations at specific closings. The audit focused on determining whether DRR's pre-closing asset valuation methodologies effectively addressed unique assets. DRR's Franchise and Asset Marketing Branch (FAMB) is responsible for the asset valuation function. Our audit scope included the 13 insured depository institutions that failed after January 1, 2002. Of the 13 failed institutions, our sample included 2 failed FDIC-insured depository institutions holding unique assets: Hamilton Bank of Miami, Florida, and Southern Pacific Bank of Torrance, California. The unique assets for Hamilton Bank included trade finance loans and other types of credit to international customers. Southern Pacific Bank specialized in higher-yield and higher-risk commercial loans in the telecommunications, technology, entertainment, and airline industries.

We performed our work from February 2003 through June 2003 in accordance with generally accepted government auditing standards.

Methodology

The FDIC's roles, responsibilities, and activities associated with the resolution and management of failed insured depository institutions are outlined in pertinent governing legislation and the FDIC's policies and procedures. To gain an understanding of the legislation, policies, and procedures regarding this subject, we reviewed the:

- Federal Deposit Insurance Act;
- Federal Deposit Insurance Corporation Improvement Act of 1991;
- Government Performance and Results Act of 1993;
- The FDIC's Failed Financial Institution Closing Manual;
- DRR's Asset Disposition Manual;
- DRR's Resolutions Policy Manual;
- DRR's Resolutions Handbook;
- Division of Administration's Acquisition Policy Manual; and
- FDIC Circular 7000.1, Division of Supervision/DRR Information Sharing for Failing Institutions, dated December 1999.

Our methodology also included interviewing and/or obtaining documents from

- management and staff from DRR's Franchise and Asset Marketing Branch in Washington, D.C., and in DRR's Field Operations Branch in Dallas, Texas, and
- DOA contracting officials in Dallas, Texas.

To assess whether asset valuation decisions were properly documented and approved, we reviewed DRR's preparation and review of such key documents as the Information Package, AVR, Failing Institution Marketing Recommendation, and Summary of Bids received.

To assess whether DRR developed accurate and timely asset valuation reports, we reviewed the bank closing records for the two failed institutions in our sample. We reviewed two of the four major functions that occur with resolution of the failing institution's closing: (1) planning and preparing for the resolution project and (2) preparing the Information Package and conducting the AVR. However, we did not assess DRR's efforts to market the institutions and did not assess the selection of the bids. For our sample institutions, we compared the book value for the assets with the estimated value and compared the final net asset sales proceeds with the valuation estimates in the initial AVR.

For both Hamilton and Southern Pacific, DRR valued some asset pools in-house and contracted out the valuation of unique asset pools. We looked at the disposition of the assets for each institution, paying attention to the initial size and value of the pool of assets at closing and the net sales proceeds. We reviewed the Corporation's resolution policies and procedures and tested DRR's asset valuation practices for the two institutions. Additionally, we reviewed the Statements of Work for the FDIC's contractors engaged to assist with the valuation process. We reviewed the contractors' work products relating to the asset valuations. These work products included a valuation approach and methodology as well as a portfolio-level pricing summary showing a range of values for each asset.

It is important to note that our conclusion that asset valuations using the SAVE methodology were reasonably accurate was limited to the results of asset valuations and sales related to only two institutions. We are not projecting our results to the universe of all asset valuations. Moreover, as previously stated, we concentrated this audit on the valuation process as it related to unique assets. Therefore, the audit work performed in support of our conclusion was limited to listing book values and comparing estimated asset valuations with the actual results of asset sales. We did not independently evaluate the econometric models, assumptions, or other elements comprising the SAVE methodology or the asset valuation models, assumptions, or data from the outside contractors. Also, DRR used different contractors for Hamilton and Southern Pacific. Accordingly, our audit results cannot be projected.

Performance Management [9]

To determine whether DRR had any performance measures that we should consider in this audit, we reviewed DRR's 2003 Strategic Plan and the FDIC's 2002 Annual Performance Plan. We identified two strategic goals related to the resolution of FDIC-insured depository institutions. First, DRR has a goal to identify potential bank failures representing significant losses to the insurance fund at least 12 months in advance of failure and to gain access to the institution for resolution at least 90 days prior to failure. Second, DRR has a goal to market at least 85 percent of the book value of a failed institution's saleable assets within 90 days of failure. For the most part, DRR met these goals

[9] The Government Performance and Results Act of 1993 (P.L. No. 103-62, codified at titles 5, 31, and 39, U.S.C.) requires agencies to develop strategic plans, align programs and activities with concrete missions and goals, and manage and measure results. An agency is to prepare annual performance plans that establish connections with strategic goals and day-to-day activities and report on the extent to which the agency is meeting its annual performance goals.

for both banks we sampled. DRR was able to market 97 percent of the book value of Hamilton's assets within 90 days of failure. At the end of our field work, similar information was not yet available for Southern Pacific Bank.

Also, according to DRR's 2003 Strategic Plan, DRR has an ongoing initiative to review and revise the asset valuation methodology and AVR process. According to DRR officials, surveys were conducted of outside banks and bidders on valuation issues and methodologies. As of July 7, 2003, DRR officials from the Dallas Field Office, in an effort to improve efficiencies in the AVR process, have generated five recommendations. Two of the recommendations were forwarded to DRR headquarters for approval. So far, one has been approved. This recommendation is to modify the valuation routine in the Risk Analysis and Valuation Estimation program to retain valuation data for individual assets derived from the extrapolation of sample data.

Reliance on Computer-Processed Data

DRR uses the National Asset Inventory System (NAIS) as a repository of asset information regarding all FDIC assets currently being managed by servicers and other entities external and internal to the FDIC. The system's research and reporting facilities enable users to query the database by loan, property, or borrower information. NAIS also generates standardized reports for senior-level decision-makers and asset management groups within the FDIC. According to Division of Information Resources Management (DIRM) officials, NAIS is not 1 of the FDIC's 7 General Support Systems[10] or 12 Major Applications.[11] Therefore, DIRM does not include NAIS in a General Control Review or an Independent Security Review. DIRM's Information Security Section is in the process of finalizing its latest Sensitivity Assessment Questionnaire for NAIS.

We did not assess the reliability of computer-processed data. FDIC management is responsible for the reliability of the NAIS computer-processed data. Our focus was on management control in DRR’s resolution, management, and asset valuation efforts.

Internal Management Controls

DRR has primary responsibility for liquidating failed institution assets, including unique assets. The process requires DRR to coordinate with other FDIC divisions from the point of obtaining access to the failing institution through asset liquidation and receivership termination. Generally, DRR personnel conduct an on-site analysis to prepare for the closing and determine a resolution

[10] General support system is an interconnected set of information resources under the same direct management control, which shares common functionality. A system normally includes hardware, software, information, data, applications, communications, and people.

[11] Major applications are information technology applications that require special security attention due to the combined importance of their confidentiality, integrity, and availability to the Corporation.

strategy for the receivership. DRR management is responsible for developing controls to ensure transactions are properly documented and approved and assets are adequately safeguarded.

The DRR Senior Management Oversight Committee (SMOC) serves as the central forum for managing the DRR's affairs. The SMOC is responsible for:

- addressing operational issues,
- reviewing receivership business plans and DRR strategic plans,
- recommending changes to policies and procedures,
- taking actions for which DRR has delegated authority, and
- reviewing the quality of case memorandum.

We reviewed the SMOC-approved Receivership Status Report and Action Plans for Hamilton and Southern Pacific banks as well as the respective quarterly update. SMOC also considers significant credit, sales, and operational matters that are subject to the Delegations of Authority Relating to Receivership Management. Taken together, these activities show that DRR management has a formal decision-making process that actively oversees the resolution of the receiverships for all banks.

In the *FDIC Management Control Plan (MCP) for Year 2003*, DRR has identified Institution Sales as an accountability unit. Within this accountability unit, DRR has identified three risks and associated control objectives. The three control objectives are as follows:

(1) Accurate valuation (least-cost test) results in the selection of a resolution decision with the lowest cost option.
(2) Recovery is maximized on the sale of assets.
(3) Eighty-five percent of saleable assets are marketed within 90 days of the closing of an institution.

The MPC indicates that internal control reviews are planned for each of the control objectives during 2003. We concluded that the MCP constituted a positive management control effort.

Summary of Prior Audit Coverage

On April 30, 2002, the OIG issued a report entitled ***Asset Valuation Review Process for Sinclair National Bank*** (Audit Report No. 02-017). The report identifies problems with data integrity, the use of indirect expense rates, information security, and the FDIC's sampling methodology. (See Appendix IV for additional information on the Sinclair audit and our follow-up work on recommendations.)

Further, the OIG recently issued a report entitled ***Division of Resolutions and Receiverships' Resolution and Management of Credit Card Portfolios*** (Audit Report No. 03-029, dated April 17, 2003) that addressed DRR's management and resolution of credit card portfolios—unique assets.

The report states that DRR was not fully prepared to value and resolve the FDIC's interest in the large NextBank-securitized credit card portfolio and did not adequately oversee the contract entered into with FDIC's credit card portfolio financial advisor.

In our current audit of how DRR values unique assets, we were able to follow up on several agreed-upon corrective actions from the two prior audits directed towards improving the asset valuation process. Specifically, we verified that DRR has developed and placed on the DRR Intranet a common errors guide as an appendix to the SAVE Manual and is actively considering as part of its 2003 Strategic Goal a means of improving the efficiency of the FDIC's methodology for valuing small-dollar-value assets. Because our current audit focused on the valuation of unique assets by the contractors and we did not observe DRR operations during an institution closing, we did not address other previously reported issues, such as information security, raised during earlier work at Sinclair Bank.

Pertinent Laws and Regulations

Federal Deposit Insurance Act, as amended (codified at 12 U.S.C. §§ 1811-1835)
Pertinent sections include:
12 U.S.C. §1821(d) "Powers and duties of Corporation as conservator or receiver" at paragraph (2) "General powers," subparagraph (A) "Successor to institution," states:

> The Corporation shall, as conservator or receiver, and by operation of law, succeed to
> -(i) all rights, titles, powers and privileges of the insured depository institution, and of any stockholder, member, accountholder, depositor, officer or director of such institution with respect to the institution and the assets of the institution; and (ii) title to the books, records, and assets of any previous conservator or other legal custodian of such institution.

Subparagraph (B) "Operate the institution," states:

> The Corporation may (subject to the provisions of section 40 of this title), as conservator or receiver-(i) take over the assets of and operate the insured depository institution, with all the powers of the members or shareholders, the directors, and the officers of the institution and conduct all business of the institution; (ii) collect all obligations and money due the institution; (iii) perform all functions of the institution in the name of the institution which are consistent with the appointment as conservator or receiver; and (iv) preserve and conserve the assets and property of such institution.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),
(P.L. No. 102-242, codified at title 12, U.S.C.)
Section 143 of this act, "EARLY RESOLUTION," states:

> (a) IN GENERAL.--It is the sense of the Congress that the Federal banking agencies should facilitate early resolution of troubled insured depository institutions whenever feasible if early resolution would have the least possible long-term cost to the deposit insurance fund, consistent with the least-cost and prompt corrective action provisions of the Federal Deposit Insurance Act.

APPENDIX II

HAMILTON BANK

Hamilton Bank was closed on January 11, 2002. Hamilton was a minority-owned institution that specialized in trade financing between companies in the United States, Latin America, and the Caribbean. According to DRR's Failing Bank Case,[12] the failure of Hamilton was attributed to the institutions poor underwriting and administration of trade finance loans.[13] At the time of its closing, Hamilton had total assets with a book value of approximately $1.2 billion, which included $898 million in loans. Of $898 million in loans, less than $1 million ($626,000) was sold to the approved assuming financial institution—Israel Discount Bank of New York, New York. Hamilton's traditional loan assets were valued by the FDIC during pre-closing using the SAVE methodology at approximately 96 percent of book value.

Approximately $618 million in trade finance loans (unique assets) were not valued during the pre-closing phase of Hamilton by the FDIC and, therefore, were not offered for sale to potential bank acquirers. Rather, the trade finance loans were valued after closing by a contractor, First Financial Network, of Oklahoma City, Oklahoma.[14] Table 3 shows a comparison of book value with estimated value for Hamilton assets that were valued.

Table 3: Comparison of Book Value with Estimated Value for Hamilton Assets

	Book Value	Estimated Value	Difference
Traditional Assets	$ 12,427,915	$ 11,923,987	$ 503,928
Unique Assets	618,181,208	244,953,618	373,227,590
Totals	$630,609,123	$256,877,605	$373,731,518

Source: OIG Analysis of Data Provided By DRR

[12] According to the *Resolutions Policy Manual,* FAMB officials prepare a failing bank case on each closed institution, recommending the least cost transaction to FDIC's Board of Directors.
[13] As mandated under section 38 (K) of the Federal Deposit Insurance Act, the U.S. Department of the Treasury, Office of the Inspector General, issued Audit Report OIG-03-032, entitled *Material Loss Review of Hamilton Bank, NA*, dated December 17, 2002.
[14] The FDIC paid the contractor approximately $860,000 for asset valuation services.

APPENDIX III

SOUTHERN PACIFIC BANK

Southern Pacific Bank closed on February 7, 2003. The bank specialized in higher-yield and higher-risk commercial loans involving the telecommunications, technology, entertainment, and airline industries. According to the Failing Bank Case, the bank failed due to inferior underwriting and credit administration practices that led to major loan losses.[15] The FDIC initiated an asset valuation review of Southern Pacific on July 29, 2002, with a valuation date of June 30, 2002.

Southern Pacific had total assets of about $1.2 billion as of the valuation date. These assets consisted of traditional assets totaling about $575 million and unique assets totaling about $427 million. Table 4 shows a comparison of book value with estimated value for Southern Pacific assets that were valued.

Table 4: Comparison of Book Value with Estimated Value for Southern Pacific Assets

	Book Value	Estimated Value	Difference
Traditional Assets	$ 574,986,423	$ 508,775,514	$ 66,210,909
Unique Assets	426,915,995	250,827,102	176,088,893
Totals	$1,001,902,418	$759,602,616	$242,299,802

Source: OIG Analysis of Data Provided By DRR.

The FDIC AVR team valued the traditional loans and other assets using the SAVE methodology. The traditional loan assets consisted of, for example, real estate mortgages, consumer loans, and Small Business Administration loans. The other assets consisted of such items as securities, subsidiaries, furniture, fixtures, and equipment. The FDIC engaged a contractor, Financial Management Systems (FMS), located in Bethesda, Maryland, to value the unique assets.[16] The unique assets for Southern Pacific consisted of subprime commercial loans in the telecommunications, technology, entertainment, and airline industries. The contractor performed the asset review phase of the project from September 24, 2002 through October 11, 2002. The contractor's project team analyzed and valued the components of each credit relationship. The contractor prepared several products summarizing the results of its work. Specifically, FMS prepared a narrative report on its valuation approach and methodology. FMS also prepared a pricing summary showing the estimated value for each unique asset.

[15] The OIG conducted a material loss review of Southern Pacific Bank and issued Audit Report No. 03-036, entitled *Material Loss Review of the Failure of Southern Pacific Bank, Torrance, California,* dated August 14, 2003. Specifically, under section 38(k) of the Federal Deposit Insurance Act, the FDIC Office of Inspector General is required to report to the Congress on the cause of failure and to assess the FDIC's supervision of the institution.
[16] The FDIC paid the contractor approximately $273,000 for asset valuation services.

APPENDIX IV

RESOLUTION AND DISPOSITION OF AUDIT FINDINGS RELATED TO THE OIG'S AUDIT OF THE ASSET VALUATION REVIEW (AVR) PROCESS FOR SINCLAIR NATIONAL BANK

Finding	OIG Recommendations to Division of Resolutions and Receiverships'	Finding Disposition
SAVE manual was not followed. Base discount rate was not properly developed. AVR prices were not correctly calculated.	Provide additional guidance to be used by AVR team members when preparing valuation documents and developing discount rate assumptions. Such guidance could include a current "Common Errors" guide that the valuation file reviewers and first-level reviewers could use to avoid errors often found in the valuation process.	A "Common Errors" guide was developed and placed on DRR's Web site as Appendix D to the SAVE manual. The guide was also sent to all Franchise Marketing staff.
Valuation data were not correctly entered into the Risk Analysis and Value Estimate (RAVEN).*	Develop procedures to ensure that all valuation data are correctly recorded in the RAVEN application and all AVR prices were correctly recalculated before the final AVR reports were printed.	We did not cover RAVEN in our audit of unique assets. Accordingly, we did not ensure that all valuation data were correctly recorded in the RAVEN application and that all AVR prices were correctly recalculated before the final AVR reports were printed.
The SAVE indirect expense rates used in valuations were supported by outdated information.	Evaluate, on a periodic basis, the adequacy of the indirect expense rates used in the AVR process and modify those rates as needed.	We did not cover indirect expense rates in our audit of unique assets.
Resolution documents were not physically secured while on-site at the bank closing.	Develop guidelines to address the security of AVR documents and specifically assign an AVR team member or members the responsibility for physically securing AVR-related documents.	We did not perform on-site work at the failing institutions included in this audit of unique assets.
FDIC's sampling methodology was not efficient.	Develop a consistent methodology for valuing small-dollar-value assets offered for sale pre-closing and post-closing, including modification of asset valuation sampling requirements to create efficient sample sizes for small-dollar-value loan pools.	The SAVE Methodology Board approved five methodologies that address small assets in an AVR. Moreover, per DRR's 2003 Strategic Plan, FAMB has ongoing initiatives to reassess the SAVE and AVR processes.

* The FAMB uses the RAVEN application to support the AVR process. This application selects asset samples, calculates estimated values for individual and group assets, and determines the statistical accuracy of valuation results.

CORPORATION COMMENTS

Federal Deposit Insurance Corporation
Washington, DC 20429

Office of the Director
Division of Resolutions and Receiverships

September 4, 2003

TO: Russell A. Rau
Assistant Inspector General
Office of Inspector General (OIG)

FROM: Mitchell L. Glassman
Director
Division of Resolutions and Receiverships (DRR)

SUBJECT: DRR Response to OIG Draft Report Entitled:
Division of Resolutions and Receiverships' Asset Valuations At Specific Closings (Assignment Number 2003-021)

This audit focused on two failed banks with substantial portfolios of "unique" assets: Hamilton Bank, N.A., Miami, Florida and Southern Pacific Bank, Torrance, California. Hamilton Bank had a large portfolio of loans to companies in Central and South America, while Southern Pacific Bank was very active in asset-based lending. In general, the audit report finds that for these institutions, the DRR Asset Valuation Review (AVR) value estimate was quite accurate for traditional bank assets. However, the report suggests that the value estimate for the unique assets was not especially accurate.

As noted in the OIG report (page 12), it is our strong belief that the ultimate determination of value for these assets results from competition among the bidders in an open, competitive marketing effort. To ensure competition, the Franchise and Asset Marketing Branch, Asset Marketing Section (FAMB) took several steps following the failure of these institutions. First, a press release was issued shortly after failure indicating the FDIC would be selling the assets and providing a point of contact for companies seeking additional information. Second, advertisements were run in the *Wall Street Journal* and appropriate trade publications to reach potential purchasers; in the case of the Hamilton Bank sale, ads were also run in publications in the Central and South American countries where Hamilton Bank's customers were located. Third, the sale was posted on the FDIC's external Website (www.FDIC.gov). Fourth, the sale announcement was e-mailed to over 2,200 subscribers to the FDIC's "listserve" automated system. And finally, Asset Marketing staff in Dallas personally contacted companies who had previously bid on and/or purchased similar assets from us to invite them to participate in the sale.

In the case of Southern Pacific Bank, the DRR Asset Marketing effort yielded the following results: 171 entities conducted due diligence, including 109 through electronic review and 62 groups who actually went on site in Southern California. Each pool offered was reviewed on site by no fewer than 10 bidders. We received a total of 173 bids from 29 investors. No asset pool received fewer than nine bids, and we received in excess of 20 bids on some pools. Thus, the final recommendation from FAMB to sell these assets to the highest bidder was based not on the AVR estimate of value but rather on the belief that a true **market value** was established through our extensive sales efforts.

The OIG recommends that the Director, DRR:

(1) Require the *Receivership Status Report and Action Plan (RSR/AP) or Quarterly Update (QU)* to include a discussion of significant variances between asset valuations and actual sales proceeds.

DRR Response:

The Division of Resolutions and Receiverships agrees with the recommendation. By December 31, 2003, the RSR/AP and/or the QU will be modified to include the summary of asset valuation variances prepared for the Asset Marketing (confirmation) sales case. The RSR/AP and/or QU, presented to DRR's Senior Management Oversight Committee, will be the formal document that discusses the reconciliation of valuation estimates and actual results.

(2) Include an initiative to review best practices regarding the valuation of unique assets in DRR's 2004 Strategic Plan.

DRR Response:

The Division of Resolutions and Receiverships agrees with the recommendation and will include the initiative in the 2004 Strategic Plan which is now being formulated. The Plan will be finalized and distributed by December 31, 2003.

cc: James R. Wigand
James LaPierre

APPENDIX VI

MANAGEMENT RESPONSES TO RECOMMENDATIONS

This table presents the management responses that have been made on recommendations in our report and the status of recommendations as of the date of report issuance. The information in this table is based on management's written response to our report.

Rec. Number	Corrective Action: Taken or Planned/Status	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Dispositioned:[b] Yes or No	Open or Closed[c]
1	DRR will modify the ***Receivership Status Report and Action Plan*** **(RSR/AP) and/or Quarterly Update** (QU) and/or the QU to include the summary of asset valuation variances prepared for the Asset Marketing (confirmation) sales case. The RSR/AP and/or QU, presented to DRR's Senior Management Oversight Committee, will be the formal document that discuses the reconciliation of valuation estimates and actual results.	December 31, 2003	N/A	Yes	No	Open
2	DRR will include an initiative to review best practices regarding the valuation of unique assets in the 2004 Strategic Plan.	December 31, 2003	N/A	Yes	No	Open

[a] Resolved – (1) Management concurs with the recommendation and the planned corrective action is consistent with the recommendation. (2) Management does not concur with the recommendation but planned alternative action is acceptable to the OIG. (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] Dispositioned – The agreed-upon corrective action must be implemented, determined to be effective, and the actual amounts of monetary benefits achieved through implementation identified. The OIG is responsible for determining whether the documentation provided by management is adequate to disposition the recommendation.

[c] Once the OIG dispositions the recommendation, it can then be closed.