

STATEMENT OF

**BRET EDWARDS
DIRECTOR, DIVISION OF RESOLUTIONS AND RECEIVERSHIPS
FEDERAL DEPOSIT INSURANCE CORPORATION**

on

**OVERSIGHT
of the
STRUCTURED TRANSACTION PROGRAM**

**SUBCOMMITTEE ON OVERSIGHT AND
INVESTIGATIONS
COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES**

**May 16, 2012
Washington, D.C.**

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, we appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) on the FDIC's role as receiver for failed insured depository institutions. As requested, our testimony will focus on how structured transactions are used as a strategy to maximize the value of assets secured by real estate for the benefit of the Deposit Insurance Fund (DIF) and the depositors and other creditors of the failed institutions.

As described in more detail below, an FDIC structured transaction refers to a resolution strategy that involves the creation of a legal structure to manage failed banks' assets. This type of transaction has been used for approximately 4 percent of \$668.8 billion of the book value of failed bank assets inherited from bank closures from January 2008 through May 12, 2012.

The Challenging Environment for FDIC-Insured Institutions

The banking industry has undergone a difficult process of balance sheet strengthening. Capital has been increased, asset quality has improved and banks have bolstered their liquidity. However, levels of troubled assets and problem banks are still high. While the economy is showing signs of improvement, downside risks remain a concern.

Nationally, through May 11, 2012, there have been 437 bank failures since the beginning of 2008. While still high, the current pace of failures is slowing. There have been 23 failures so far this year compared to 40 failures at this same point last year.

The FDIC is keenly aware of the significant hardship bank failures impose on communities across the country. The FDIC's supervisory goal is to avoid bank failures whenever possible by initiating timely corrective measures. Historically, most problem banks do not fail and continue to serve their communities. In addition, most banks across the country are in sound condition, well capitalized, and profitable.

FDIC's Duty to Resolve Failed Banks

Throughout the financial crisis, the FDIC has worked to maintain financial stability and public confidence in the banking system by giving depositors of failed banks quick and easy access to their funds. When the chartering authority closes an FDIC-insured institution, the law requires the FDIC to use the least costly method of resolving the failing institution. The least costly method minimizes the cost of bank failures not only to the DIF but also to the thousands of banks and thrifts that fund the DIF through insurance premiums.

In resolving failing banks consistent with the least cost mandate, the FDIC returns as many of the bank's assets and liabilities to the private-sector as quickly as possible. Hence, we strive to effect a "purchase and assumption" agreement for the whole bank, in which the receiver transfers all of the failed bank's deposits, assets and certain liabilities immediately after the bank closing to an acquiring bank. This type of transfer includes performing and non-performing assets at a competitive price. Unfortunately, the FDIC is

not always successful in resolving banks in this manner. Often, failing banks with little or no franchise value and poor asset quality do not attract sufficient interest from viable bidders to allow for a whole bank purchase and assumption. In those instances, insured depositors are paid the full amount of their insured deposits. Uninsured depositors and other general creditors are given receivership certificates entitling them to a share of the net proceeds from the sale and liquidation of the failed institution's assets. The FDIC as receiver then uses an alternative disposition strategy for these failed bank assets, such as cash sales, structured transactions and securitizations, to maximize recoveries to the receivership.

Disposition of Failed Bank Assets

During the last banking and savings and loan crisis in the late 1980s and early 1990s, the FDIC retained many of the failed bank assets it could not sell to acquirers and managed those assets utilizing in-house resources. This practice often resulted in selling assets into distressed markets at prices below their intrinsic value and also required that the FDIC maintain a costly asset management infrastructure that was less efficient and not as nimble as that of the private sector. As a result of these experiences, the former Resolution Trust Corporation (RTC) entered into various joint ventures and partnerships with the private-sector to sell a significant number of failed thrift assets, and those programs proved successful. Consequently, the FDIC initiated its own structured transaction sales program in May 2008 patterned after the program used by the former RTC. For the 32 structured transactions completed to date, the FDIC estimates savings of

over \$4 billion versus the recoveries it would have realized in cash sales at the time these structured sales transactions were consummated.

The structured transactions allow the FDIC to facilitate the sale of many assets that are difficult to market and sell. The FDIC as receiver generally retains a majority interest in the proceeds from the assets, while transferring a minority interest in the net recovery and day-to-day management responsibility to private-sector experts. Because they have an ownership interest in newly formed limited liability companies (LLCs) that own the assets, and because they share the costs and risks of managing those assets, the private-sector experts have a vested interest in maximizing the assets' realizable value.

What is a Structured Transaction Sale?

In structured transactions, the FDIC pools a group of similar assets, such as single-family, commercial real estate, or construction-type loans from one or more failed bank receiverships and transfers them to a newly formed LLC. In exchange for contributing the assets, the FDIC receives all of the ownership interests, or equity, in the LLC. Through a competitive bid process, the FDIC offers a portion of the equity in the LLC to pre-qualified private-sector asset management experts. Once a pool of real estate assets has been identified, the FDIC engages a financial advisor to evaluate the portfolio and market the equity interest in the transaction. The financial advisor analyzes the portfolio and recommends to the FDIC an optimum structure and terms for the transaction. Of the \$25.5 billion in assets originally included in structured transactions, \$16.4 billion or 64 percent were nonperforming as of the respective closing dates.

Structured transactions are only offered to sophisticated counterparties that are qualified to engage in the types of transactions offered by the FDIC, and only to those counterparties that are able to demonstrate to the FDIC that they can bear the economic risk associated with the acquisition of an equity interest in the LLC (including the potential that they may suffer a complete loss of their equity investment in the LLC).

The Structured Transaction Entity or LLC

Prior to marketing the transaction, the FDIC determines the amount of equity interest in the LLC to be sold. The interest sold has ranged from 20 to 50 percent. The winning bidder in a structured transaction sale pays cash for its equity interest in the LLC and takes on responsibility for day-to-day management of the LLC and its assets. The price paid by the winning bidder for its equity interest in the LLC reflects its valuation of the entire portfolio of assets held by the LLC. The percentage of book value that the winning bidder's valuation represents should not be attributed to an individual asset.

Since September 2009, many of the structured transactions have included leverage in the form of purchase money notes (PMNs) issued by the LLC to the FDIC receiverships for partial payment of the assets sold by the receiverships to the LLCs. The FDIC's decision to offer structured transactions with leverage was driven by the severely distressed credit market, which affected the costs and availability of credit and liquidity. Leveraged transactions helped ensure a robust and competitive bidding process for the LLC equity. In the majority of the structured transactions, the transaction agreements require that, if the LLC issues a PMN, cash proceeds generated

from the operation and sale of the LLC's assets, after deducting certain costs, generally must be used to pay down the PMNs and any other debt outstanding (such as a construction lending facility) before the LLC's members receive any distributions on their equity interests. Costs deducted to manage the LLC before payments on the PMN include taxes and insurance, property protection expenses, the fees of document custodians and similar third party contractors, and the management fee paid to the managing member (discussed more fully below).

The PMNs constitute debt owed by the LLC, and do not finance the cash purchase price paid by the winning bidder for its share of the LLC's equity. Upon issuance, the PMNs are issued to the FDIC as receiver. Some PMNs are guaranteed by the FDIC in its corporate capacity and may be sold to third party investors. In the case where FDIC corporate guarantees the PMNs, it receives a guarantee fee. Because the amount of leverage is based on the risk profile of the underlying pool of assets, the FDIC, in its corporate capacity, has not experienced any losses to date and does not expect any future losses as a result of its guarantee of the PMNs. The amount of debt the LLC issues will depend on the transaction's expected cash flows and the ability of the LLC to repay the debt. In the aggregate, for the 29 structured transactions closed through September 2011, the managing members project the total distributions to the FDIC, as of March 31, 2012, to be \$13.8 billion.

Managing Member Responsibilities

Managing members are responsible for the servicing and disposition of the LLC assets as well as all credit decisions. The managing member is required to hire a

qualified servicer to service the assets, prepare and provide tax information to members, to prepare LLC financial statements and reports, to retain an auditor to audit the LLC's financial statements, and to provide other resources necessary to conduct the LLC's business.

The managing member receives a monthly management fee from the LLC, specified prior to the bid date and calculated as a percentage of the unpaid principal balance of the loans or the net fair value of real property owned by the LLC. This is the only compensation received by the managing member for its asset management obligations, which include the obligation to pay servicers and any sub-servicers, general and administrative overhead costs, and any other costs associated with its asset management responsibilities. The management fee and property expenses, such as brokerage, preservation, and leasing fees, are paid by the LLC.

Monitoring Structured Transactions

The FDIC actively monitors these transactions through its staff and third-party contractors. On a regular basis, the FDIC conducts on-site compliance reviews of each LLC's operations, including the obligation to service loans in compliance with the transaction agreements, applicable law, and the terms of the loan documents.

Additionally, the managing member must comply with stringent monthly, semi-annual, and annual reporting requirements, including providing audited financial statements for the LLC, auditor attestations, and certifications that it is in compliance with all transaction agreements.

In addition, the FDIC's Office of the Inspector General (OIG) conducts periodic audits of selected structured transactions to assess the managing member's compliance with the transaction agreements and the FDIC's monitoring of the managing member. To date, the OIG has completed audits for ANB Venture, LLC and Corus Construction Venture (CCV), LLC. The FDIC agreed with all of the OIG recommendations and has implemented or is in the process of implementing them. Specifically, the ANB Venture, LLC audit questioned claims have been resolved. The CCV Venture, LLC audit corrective actions are in process and all are expected to be resolved by September 30, 2012.

One important result of FDIC contractor reviews and these OIG audits is the FDIC undertook a comprehensive review of the transaction documents and revised certain provisions to clarify their intent for future transactions. The FDIC's main revisions to transaction agreements in response to the OIG's recommendations were to clarify the calculation of the management fee and to expand on the requirements for documented policies and procedures. These revisions were implemented beginning with transactions that closed in July 2010. Further, field work is ongoing for the audit of the two LLCs managed by an affiliate of Rialto Capital Management and its report is expected to be delivered in late third quarter of this year.

In the event of a managing member's uncured default or its uncured noncompliance with the transaction agreements, the FDIC can declare a default and pursue certain contractual remedies, including removing the managing member or its servicer and appointing a replacement, foreclosing the assets of the LLC or the equity interest of the managing member, initiating a buy-out of the equity interest of the

managing member, accelerating the payment due on a PMN, drawing on deposited cash or letters-of-credit posted by the managing member, seeking indemnity for losses, and offsetting costs against amounts otherwise due the managing member. The FDIC has not found the need to exercise such remedies in connection with any of the LLCs.

Treatment of Borrowers/Guarantors

The FDIC understands how disruptive bank failures are to the borrowers of the failed entity and strives to ensure all borrowers are treated fairly and respectfully. Every borrower with a loan from a failed bank in receivership is sent a notice within a few days of the bank's failure that their loan will be sold, with instructions on where to direct their loan payments, and who to contact with any questions. Depending on the type and status of the borrower's loan, a second notice may be sent shortly after the first notice. For example, borrowers that have missed payments or have unfunded commitments will receive further instructions from the FDIC. To the extent borrowers are in the midst of negotiating a workout or resolution of their loan with the FDIC or its interim servicer, borrowers are strongly encouraged to finalize those negotiations before the structured sale cut-off date. In addition, borrowers are also notified when the structured sale is completed and their loan is transferred to the managing member's servicer.

The managing members are required by the transaction agreements to maximize the return on assets of the LLCs. Under the right circumstances, reasonable pay-offs or loan modifications represent the highest net present value disposition options, and we fully expect the managing members to pursue pay-offs and loan modifications, when financial analysis indicates those options would result in the highest return to the LLC.

With respect to single-family owner-occupied residences, the managing members and their servicers are obligated to follow a federally mandated loan modification program designed to assist troubled borrowers in managing their mortgage obligations. Where a pay-off or modification is not feasible or fails, there are other loss mitigation methods available, such as short sales and acceptance of deeds-in-lieu of foreclosure, which may be least loss alternatives to more expensive litigated foreclosures. However, when these loss mitigation methods are not an option, the managing member is left with no other choice but to enforce the terms of the loan contracts, including enforcing any mortgages and guarantees, through the courts and other legal means.

The FDIC clearly communicates its expectations to all managing members that all borrowers or guarantors are to be treated fairly and respectfully and that any concerns the borrowers or guarantors raise are to be addressed in a timely manner. Nevertheless, a number of borrowers and guarantors have raised concerns about the managing members not achieving the resolution the borrower or guarantor would desire. The FDIC investigates every borrower or guarantor inquiry and works with the managing member to address any of the concerns raised. It is important to note that the legal rights and obligations of borrowers and guarantors do not change for any loans or other assets transferred to the LLC. The managing members are only seeking to enforce the default remedies in the loan documents in order to maximize the recovery value of the assets. Borrower and guarantor cooperation with respect to distressed credits is a key to achieving a cooperative resolution. The managing member must have timely and current financial information from the borrowers and guarantors in order to assess their abilities to make a meaningful contribution to any settlement. Additionally, the

managing member must assess the current market value of the collateral, and borrower cooperation in this regard can accelerate the time to a mutually agreeable resolution.

Conclusion

As the FDIC does with any resolution of a failed bank, we strive to implement the least costly resolution method in a manner that is the least disruptive to depositors, borrowers, and communities. Further, structured transactions minimize the FDIC's holding and asset management expenses for the assets by transferring the management responsibility to private-sector asset management experts. As the managing member has a significant financial interest in the assets and shares in the costs and risks associated with ownership of the LLC, the managing member's interests are aligned with the FDIC's interests in maximizing the value of the LLC's assets. As noted above, the estimated savings to the FDIC of having entered into the structured transactions instead of selling assets for cash is approximately \$4 billion. To ensure the FDIC receives the highest return on the assets and that the managing members treat failed bank borrowers fairly, it monitors the managing member's compliance with the transaction agreements by reviewing regular reports, measuring actual performance against performance projections in the consolidated business plans, conducting regular site visitations, and thoroughly investigating borrower or guarantor complaints with regard to the servicing and dispositions of their loans by the managing members.

Thank you, I would be pleased to respond to any questions.