



# Office of Inspector General

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For Release on  
Delivery Expected at  
2 p.m. Wednesday,  
May 16, 2012

## Testimony

Before the Committee on Financial Services  
Subcommittee on Oversight and Investigations  
U.S. House of Representatives

## Hearing on Oversight of the FDIC's Structured Transaction Program

**Statement of Jon T. Rymer  
Inspector General  
Federal Deposit Insurance Corporation**

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Inspector General, Federal Deposit Insurance Corporation  
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**House Financial Services Committee  
Subcommittee on Oversight and Investigations**

Chairman Neugebauer and Members of the Subcommittee:

Thank you for your interest in the work performed by the Office of Inspector General (OIG) of the Federal Deposit Insurance Corporation (FDIC) relating to the Corporation's structured asset sales program. The FDIC uses structured asset sale transactions as a part of a broader resolution strategy for the assets of failed financial institutions.

The OIG is an independent office within the FDIC, established to conduct audits and investigations to prevent and detect waste, fraud, and abuse relating to the programs and operations of the FDIC, and to improve the efficiency and effectiveness of those programs and operations. I was appointed as the Inspector General of the FDIC by President Bush, and confirmed by the Senate in June 2006.

The OIG conducts audits that address FDIC programs and operations. Some of these audits are required by law; others are initiated based on our assessment of various risks confronting the FDIC. These audits assess such things as program effectiveness, adequacy of internal controls, and compliance with statutory requirements and corporate policies and procedures. We perform our work using internally available resources, supplemented by contracts with independent accounting firms when expertise in a particular area is needed or when internal resources are not available. Our work, as well as that of our contractors, is performed in accordance with Government Auditing Standards.

During the current crisis, the OIG has issued nearly 100 reviews of failed financial institutions. These reviews, pursuant to statute, describe the events that contributed to the institutions' failures and the FDIC's supervision of those failed institutions. While we will continue to review each failure of an FDIC-supervised institution, our approach to that work evolved to taking a more comprehensive view of common characteristics and trends. We communicated those trends to FDIC management, and in response, the FDIC undertook a number of initiatives to enhance the supervision program.

In early 2010, we began to focus our audit attention on the Corporation's rapidly growing resolution and receivership management activities, including such risk-sharing arrangements as shared loss agreements (SLA) and structured asset sale transactions. The FDIC's financial risk exposure pertaining to these risk-sharing arrangements is significant, and we designed our audits to assess compliance with the arrangements and the internal controls that the FDIC has established and implemented to protect the interests of the Deposit Insurance Fund (DIF) in these arrangements.

I am pleased to discuss the results of our work. As requested in your invitation to testify, I will be describing the findings and recommendations of my office's two completed audits of structured asset sale transactions; the scope and methodology of my office's ongoing work on these types of transactions; and, to the extent possible, our review of the complaints filed by borrowers impacted by these transactions. In addition, I will briefly discuss our planned work in this area. Before I begin describing the OIG's work, I would like to discuss, at a high level, the FDIC's resolution process and the tools that it has been using during the financial crisis.

### **The FDIC's Resolution of Failed Banks**

FDIC-insured financial institutions can fail for a number of reasons, including a lack of capital or liquidity, poor management, or fraud. When an institution fails, the FDIC serves as the receiver for the institution's assets and liabilities. Since January 1, 2008, the FDIC has been appointed as receiver for 437 failed institutions, with total assets at inception in excess of \$670 billion.

As required by the Federal Deposit Insurance Corporation Improvement Act of 1991, the FDIC must use the least costly alternative when it resolves a failed institution. Specifically, the law requires the FDIC to maximize the net present value return from the sale or disposition of assets of a failed institution and to minimize the amount of loss realized in the resolution of the institution. To fund the cost of resolutions and pay insured depositors when a bank fails, the FDIC maintains the DIF, which has experienced an estimated loss of \$88 billion as a result of these 437 failures.

In resolving failed institutions, the FDIC markets failing institutions to all interested and qualified bidders, offering multiple alternative resolution structures. The FDIC's preferred approach is to sell all or a part of the failing institution's assets to an open financial institution that also assumes the failed institution's deposit liabilities. To incentivize the acquiring institution to take on some of the assets of the failed institution, the FDIC may enter into an SLA, a risk-sharing arrangement discussed below.

Any remaining unsold assets become part of the receivership. The FDIC may later market and sell those residual assets to qualified purchasers through a variety of means, including a structured asset sale transaction. This type of risk-sharing arrangement is also discussed below.

### **Shared Loss Agreements**

An SLA, which is part of a purchase and assumption agreement with an acquiring institution, includes provisions under which the FDIC agrees to absorb a portion of the losses experienced by an acquiring institution on a specified pool of assets. While the FDIC generally absorbs 80 percent of certain losses, in some SLAs during the crisis, the FDIC agreed to absorb up to 95 percent of certain losses. As of March 31, 2012, the FDIC reported that it had entered into 285 SLAs with an original principal balance of \$212.7 billion in assets.

Given the number of SLAs and the associated risks to the DIF, we initially identified individual, large SLA transactions that, in our judgment, presented significant financial risk to the FDIC, and from which we believed we could derive lessons that would help management to develop

and improve controls. We conducted seven audits of individual SLAs, resulting in 93 recommendations, of which numerous recommendations related to the establishment of program level controls. With the development by FDIC management of more robust internal control structures at the transaction level, we later shifted the focus of our work with regard to these agreements to the FDIC's controls at a higher program level. This approach is consistent with the one we undertook for our reviews of failed institutions—that is, a more individual focus followed by a more global view of trends.

### **Structured Asset Sale Transactions**

Not all assets from the failed institutions are sold to acquiring institutions. These residual assets consist largely of distressed and non-performing single-family and commercial real estate loans and real property that pass into and are held in FDIC receiverships. It is the FDIC's objective to return these assets to the private sector as promptly as possible, while maximizing the net present value return from the sale and minimizing loss to the DIF, consistent with the FDIC's statutory obligations.

The FDIC utilizes multiple vehicles to sell these assets, among which are structured asset sale transactions. Structured asset sale transactions involve pools of assets from one or more FDIC receiverships. The FDIC sells or contributes assets to a limited liability company (LLC) formed by the FDIC as receiver. These transactions are competitively bid to prequalified purchasers. The receiver then sells an interest in the LLC to a private third-party, which manages the LLC. The receiver retains either an equity interest in the LLC or a participation interest in the net cash collected through the servicing and liquidation of the LLC's assets. Once ownership of the assets is conveyed to the LLC, control over the LLC is passed to the private third-party.

The FDIC, acting as receiver for failed banks, reported that it has consummated 32 structured sale transactions involving 42,314 assets with a total unpaid principal balance of approximately \$25.5 billion, as of April 25, 2012. My testimony today addresses the work my office has completed on two of these structured asset sale transactions and describes the scope and methodology of our ongoing audit of two other such transactions.

### **Completed OIG Audits of Structured Asset Sale Transactions**

The OIG has completed performance audits of two structured asset sale transactions that we selected based on their size and the types of assets involved. The first audit was of ANB Venture, LLC (ANB). ANB involved 1,112 individual assets with an unpaid principal balance at closing of \$1.167 billion. The Managing Member of ANB is Kingston Management Services, LLC. We issued a report on this audit in November 2010 and discussed its findings in our semiannual report to the Congress, for the period October 1, 2010 through March 31, 2011.

The second audit my office performed on a structured asset sale transaction was of Corus Construction Venture, LLC (Corus). Corus involved 101 individual assets with an unpaid principal balance at closing of \$4.4 billion, and contained an advance funding mechanism of up to \$1.15 billion to fund the construction of incomplete buildings and provide other asset-related working capital. The Managing Member of Corus is ST Residential. We issued a report on this

audit in April 2012, and summarized its results in an executive summary posted on our public Web site.

My office contracted with CliftonLarsonAllen LLP to conduct the audits of ANB and Corus. The objectives of the audits were to assess compliance with the structured asset sale agreements, and to assess the FDIC's monitoring of the agreements. Specifically, to assess compliance, we:

- reviewed the terms and conditions of the structured asset sale agreements;
- tested the completeness and accuracy of the initial recording of the assets on the books and records of the LLC and the monthly financial reports submitted to the FDIC (including management fees and servicing expenses reported by the Managing Member);
- determined whether the Managing Member employed "customary and usual standards of practice" with respect to managing and liquidating assets; and
- reviewed the allocation of cash flows for compliance with the agreements.

In assessing the FDIC's monitoring of these transactions, we:

- reviewed the FDIC's policies, procedures, and guidance pertaining to structured asset sale transactions;
- interviewed legal and resolutions personnel responsible for negotiating and overseeing the transactions; and
- reviewed the work of FDIC contractors engaged by management to perform quality control services.

We concluded that ANB, Corus, and their respective Managing Members complied with certain provisions of the structured asset sale agreements, and that the FDIC had implemented certain controls for monitoring the transactions. We also noted that the FDIC had planned or was in the process of implementing significant control improvements at the time of our audits. However, our audits identified a number of control deficiencies involving both compliance and monitoring that warranted FDIC management's attention.

With respect to compliance with the agreements, both reports included questioned costs relating to servicing expenses and management fees. In the case of ANB, questioned costs of \$634,412 consisted primarily of expenses incurred by the LLC that were inappropriately treated as liquidation costs instead of servicing costs covered by the management fee. In addition, questioned costs included management fees charged on assets that had no value but that had not been written-off by the Managing Member. The report also noted that the FDIC could prospectively achieve an estimated \$3.1 million in funds put to better use by addressing issues involving ANB's accounting practices for servicing costs paid to contractors and for worthless assets. The Corus report included \$6.3 million in questioned costs, consisting primarily of unallowable servicing costs, such as professional services provided by real estate development firms and travel, meals, and entertainment expenses that were prohibited under the terms of the structured asset sale agreement.

Both audit reports, particularly the report on Corus, found that the policies and procedures used by the Managing Members to service and liquidate the LLC's assets were not consistent with customary and usual standards of practice. The reports also noted that loan servicing practices were not compliant in certain key respects with the servicing standards defined in the agreements. We also concluded that ANB and Corus did not implement customary and usual standards of practice for safeguarding sensitive, personally identifiable information.

With regard to the Corus audit, we determined that the Managing Member for Corus received significant management fees pertaining to nonaccrual and capitalized interest. In the experience of CliftonLarsonAllen, who performed this work on our behalf, paying such fees is not a customary or usual practice. However, the terms of the agreement were not clear on this matter. Because of this lack of clarity, the fees were not questioned, but we recommended that the FDIC review the matter further and provide additional clarification regarding the treatment of nonaccrual or capitalized interest in future structured asset sale agreements.

In the ANB audit, we determined that the Managing Member of ANB did not maintain sufficient documentation regarding its asset disposition strategies, and that for more than a year, the Managing Member did not have ample accounting staff to ensure proper separation of duties when authorizing, recording, reconciling, and reviewing accounting entries and expenses.

Based in large measure on these compliance-related findings, we determined that the FDIC's controls for monitoring structured asset sales needed improvement, particularly in the areas of policies, procedures, and guidance, and compliance monitoring program controls and practices. During or subsequent to our field work on the Corus audit, the FDIC advised us that it had either established or planned a number of control improvements related to its structured asset sale transactions. Such improvements included, among other things, issuing policies and procedures for monitoring structured asset sale transactions, engaging compliance monitoring contractors to perform periodic compliance reviews of LLCs and Managing Members, assigning additional resources for monitoring, and beginning a process for quarterly reporting to the FDIC's Audit Committee, an FDIC Board-level committee.

To summarize, the ANB report contained 10 findings and 24 recommendations. According to the FDIC, actions had been taken to address all of these recommendations, as of October 2011. The Corus report contained 7 findings and 10 recommendations. Corrective actions for all of these recommendations are expected to be completed by September 30, 2012.

### **Ongoing Work Relating to Rialto Structured Asset Sale Transactions**

We are presently conducting an audit of two structured asset sale transactions, both of which are being managed by Rialto Capital Management, LLC (Rialto). The first transaction involves 5,166 residual assets with an unpaid principal balance of \$2.3 billion. The majority of these assets pertain to residential acquisition, development, and construction (ADC) projects. The second transaction involves 345 residual assets (primarily commercial ADC projects) with an unpaid principal balance of \$799 million.

This audit was requested by FDIC management on October 13, 2011, based on inquiries or complaints that the FDIC had received concerning the transactions. As of April 30, 2012, the FDIC reported that it had received a total of 57 inquiries or complaints associated with approximately 65 loans, from members of the Congress, the public, or the media. The inquiries and complaints dealt with Rialto's aggressiveness in pursuing balances owed on the loans; an unwillingness to compromise with borrowers; Rialto's treatment of the borrowers or guarantors; the FDIC's handling of the loans prior to their transfer to Rialto; the servicing of the loans by the loan servicer engaged by Rialto; and other general inquiries regarding Rialto's operations.

The objectives of the Rialto audit include the same two objectives of the ANB and Corus audits, namely to assess compliance with the structured asset sale agreements and to assess the FDIC's monitoring of the agreements. In addition, we will assess the FDIC's bidding and selection process, and the terms and conditions of the structured asset sale agreements themselves. Based on the nature of some of the inquiries and complaints pertaining to these transactions, we placed particular emphasis on the Managing Member's controls over transactions with affiliates in designing our audit procedures for this audit. We also selected a representative sample of assets that were the subject of the inquiries and complaints of which we were aware at the time we initiated our work.

Field work for this audit is scheduled to be completed in June 2012. We plan to issue a draft report in July, and a final report incorporating FDIC management's comments will be issued at the end of August 2012. Consistent with our practices, the final report will not be publicly available, but the report's Executive Summary will be posted on our Web site.

### **Audit Work Going Forward**

We intend to continue audits of individual SLA and structured asset sale transactions going forward because of the dollar value of the transactions and to provide a deterrent effect as it relates to the risk of fraud. However, we also anticipate a shift in the focus of our work regarding structured asset sale transactions. That is, we have not yet assessed the effectiveness of all of the control improvements we recommended for that program and that the FDIC has advised it has implemented. As the structured asset sale program matures and as resources permit, we plan to elevate our focus to a program-level review that assesses overall monitoring and oversight controls. Such an approach is consistent with our earlier work examining institution failures and our more recent review of the SLA program. Upon completing such a review, as a next step, we are considering taking a broad, comparative look at the various resolution strategies that the FDIC has employed during the crisis in order to assist the Corporation in carrying out future resolution and receivership activities.

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This concludes my prepared statement. Thank you for the opportunity to discuss our work in these areas. I am prepared to answer any questions that you may have.