

Troubled bank opportunities: What you need to know about FDIC-assisted transactions

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FDIC-assisted transactions

– An overview

The economic downturn and accompanying banking crisis have spurred an unprecedented increase in the number of bank failures. As the table below illustrates, bank failures in 2009 increased nearly 500 percent from 2008, and represented approximately 70 percent of total bank failures for the past decade.

Many of these troubled banks are being acquired by healthy banks through Federal Deposit Insurance Corporation (FDIC) facilitated acquisitions. For qualified banks, acquisitions of these failed banks present unprecedented opportunities to grow aggressively – in asset size, market share and geography – with the risks potentially mitigated through FDIC loss-sharing agreements (LSAs). However, these opportunities are not limited to insured depository institutions and present opportunities for other investors to acquire loans and other assets of the failed banks at significant discounts.

Will 2010 see as many failures as 2009? Only time will tell, but the available data suggests that bank failures in 2010 may exceed 2009 failures. The number of insured institutions on the FDIC’s “Problem List” continues to grow. At the end

of December 2009, there were 702 insured institutions on the FDIC’s list, representing nearly \$403 billion in total assets. This is a substantial increase from the 2008 year-end statistics, which had 252 insured institutions representing \$159 billion in total assets.¹ Further, the FDIC’s recently proposed budget for 2010 reflects a twofold increase in receivership funding over 2009, indicating that 2010 failures may exceed 2009.²

One thing appears certain – bank failures coupled with FDIC assistance will continue to present significant opportunities with clear and unique benefits for healthy banks and other investors. However, in order to make the right investment decisions, banks and other investors must fully understand the unique aspects of these FDIC-facilitated transactions, including the accounting, tax, operational, legal, regulatory and other implications of these complex transactions.

The purpose of this white paper is to provide information about FDIC-assisted transactions – including accounting, tax and other considerations. This document will be updated periodically as new developments arise. However, due to evolving nature of FDIC-assisted transactions, readers should consult with their advisers for the most current information and interpretations.

Bank failures 2000-2009

Year	Total failed institutions	FDIC's response		
		Sale — purchase and assumption	Place into receivership and payout depositors	Other, including bridge banks
2009	148	130	9	9
2008	30	25	0	5
2000 – 2007	32	27	5	0

Source: “Historical Statistics on Banking,” FDIC.gov.

¹ “Quarterly Banking Profile,” FDIC, Dec. 31, 2009. <http://www2.fdic.gov/qbp/qbpSelect.asp?menulitem=QBP>

² Board meeting, FDIC, Dec. 15, 2009. <http://www.fdic.gov/news/board/notice15DEC2009.html>

FDIC's options for failing banks

In order to protect depositors covered under its insurance fund, the FDIC has three basic options available when it determines that a bank is destined for failure:

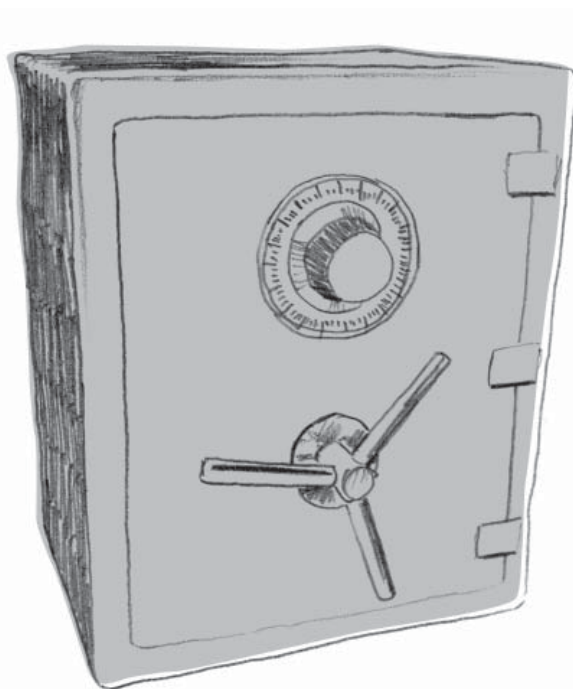
1. Place the institution into receivership and directly fund insured depositor accounts (subject to FDIC limits) from the FDIC's insurance fund.
2. Facilitate a sale of the deposits to another institution in which the depositors of the failed institution immediately become depositors of the acquiring institution. While there have been a limited number of deposit-only sales, the majority of the deposit transfers are facilitated by the FDIC through a broader purchase and assumption (P&A) arrangement that is similar to a bank acquisition. However, these P&A arrangements are unique in that not all assets and liabilities are included (even though the FDIC considers them to be "whole bank" acquisitions), and the FDIC typically provides a guarantee on certain assets acquired by the healthy bank in which the FDIC shares in the potential losses on covered assets with the acquiring institution. This guarantee is commonly referred to as a loss-sharing agreement (LSA).
3. Establish a "bridge bank" to administer the operations of the failed institution. A bridge bank is a temporary financial institution established by the FDIC to operate the failed bank until a permanent buyer can be identified.

The FDIC believes the loss-sharing program will provide a significantly higher return than liquidating the covered assets based on current market conditions. The FDIC estimated in December 2009 that the loss-sharing program will save over \$29 billion as compared with outright cash sales of the assets covered by the LSA.³

Opportunities for banks and other investors

For healthy institutions, the most common way to get involved is by bidding on FDIC sales of whole banks that include a loss-share arrangement. Other investors, such as private equity firms, can team up with an insured institution or obtain a shelf charter to be involved with these whole bank acquisitions. Non-banks should consider the FDIC's Final Statement of Policy on Qualifications for Failed Bank Acquisitions.⁴

In addition, banks and other investors can participate through FDIC auctions or asset sales of loans, real estate and other assets.



³ "Loss-Share Questions and Answers," FDIC. <http://www.fdic.gov/bank/individual/failed/lossshare/index.html>

⁴ "Final Statement of Policy on Qualifications for Failed Bank Acquisitions," FDIC, Federal Register, Vol. 74, No. 169, Sept. 2, 2009. <http://www.fdic.gov/regulations/laws federal/2009/09FinalSOP92.pdf>

Participation in an FDIC-assisted transaction

Should your bank participate in these transactions? Can you? This section provides insight into FDIC-assisted transactions, focusing particularly on the following aspects of whole bank acquisitions that include a loss-share arrangement.

- Considerations for financial institutions that are evaluating whether to participate in the bidding process
- Eligibility criteria for financial institutions that want to participate in the bidding process
- The bidding process

Considerations for financial institutions that are evaluating whether to participate in the bidding process

- FDIC-facilitated transactions provide an attractive opportunity to acquire assets whose risk is mitigated by the FDIC's loss-sharing agreement.
- These transactions occur more quickly and over a shorter timeframe than a typical business combination. Typically there is about a two-week window between when you get informed of a bidding opportunity and when the deal closes. Further, a failed institution will typically be shut down on a Friday and reopen Saturday as a branch of the acquiring institution. Acquirers will need to be quick to integrate the systems, records and operations of the failed institution.
- Acquirers should have a dedicated and diverse team prepared to address issues that arise from the moment they begin evaluating whether to bid all the way through the integration of the acquired institution. Team members should be prepared to address operational, accounting, tax, valuation, credit risk and regulatory reporting considerations related to the transaction.
- Generally, FDIC-acquired loans will have five different record-keeping requirements: loan accounting to manage the legal relationship between the debtor and creditor; GAAP accounting; regulatory reporting;⁵ FDIC reporting for loss-sharing agreements; and tax accounting. We cover the subsequent accounting and tax considerations later in this document.
- Impact to regulatory capital ratios: Due to the unique nature of each LSA, the acquirer should consult with its primary regulator to determine the appropriate regulatory capital treatment. In February 2010, the bank regulators issued a joint statement⁶ to clarify that the guaranteed portion of assets covered by an LSA may be assigned a 20 percent risk weight. In other words, if the LSA specifies that the FDIC will cover losses on 80 percent of the covered assets, a 20 percent risk weighting would apply to the amount guaranteed by the FDIC. Accordingly, the amount not covered by the LSA would be assigned an otherwise appropriate risk weight. For example, a low investment grade security would be assigned a 20 percent risk weighting for the amount covered by the LSA and a 100 percent risk weighting for the amount not covered by the LSA. In addition, it is our understanding that the acquirer shall only consider the 80 percent guarantee in determining the risk weight and that the 95 percent guarantee shall only be considered once actual losses exceed the stated threshold.
- Day one gains: In many instances, these FDIC-assisted transactions can result in significant Day One gains. As discussed in the Accounting and tax considerations section, the computation of the Day One Gain requires the application of ASC 820, *Fair Value Measurements and Disclosures* (formerly FASB Statement 157, *Fair Value Measurements*). While there does not appear to be anything to prevent an institution from including the Day One gain

⁵ Beginning in 2010, FDIC call reports and Office of Thrift Supervision Thrift Financial Report will require the carrying amount of assets covered by the FDIC LSA in Schedule RC-M, Memoranda and Schedule SI – Consolidated Supplemental Information, respectively.

⁶ <http://www.fdic.gov/news/news/financial/2010/fil10007a.html>

in regulatory capital, we understand that the bank regulators restrict the use of such capital during the measurement period (see page 8) as such amount is subject to change. In addition, we understand that the bank regulators expect that the fair values are well documented and management follows a robust process to determine the fair value of the acquired assets and liabilities assumed.

- On acquisition, the institution should have an experienced team with credit underwriting and loan file review experience that is available to complete a thorough examination of the acquired loans to determine if any are subject to fraud. Any notification adjustments made to the purchase price of the transaction due to fraudulent loans must typically be made within 180 days of the closing date.
- The FDIC provides detailed information about closed transactions on its website, including the actual P&A agreement for each transaction. That information can be accessed at <http://www.fdic.gov/bank/individual/failed/banklist.html>. Additionally, redacted unsuccessful bids can be obtained through a Freedom of Information Act request.
- As part of a few recent deals, the FDIC has begun using equity appreciation instruments for acquirers that are publically traded institutions. An equity appreciation instrument is given to the FDIC by the acquirer as additional considerations in the transaction and allows the FDIC to benefit from short-term gains in the acquiring bank's stock. So far, the details of the equity appreciation rights have not been included in the P&A Agreement; however, details of the equity appreciation rights can be found in SEC Form 8-K filings.

Eligibility criteria for financial institutions that want to participate in the bidding process

In order to participate in an FDIC-assisted transaction an institution must meet all of the following criteria:

- Total risk-based capital ratio of 10 percent or greater
- Tier 1 risk-based capital ratio of 6 percent or greater
- Tier 1 leverage capital ratio of 4 percent or greater
- CAMELS composite rating of 1 or 2
- CAMELS management rating of 1 or 2
- Compliance rating of 1 or 2
- Bank holding company composite (RFI/C) rating of 1 or 2
- Community Reinvestment Act rating of at least satisfactory
- Satisfactory anti-money laundering record

While meeting the above criteria will allow your institution to be added to the FDIC's bid list, meeting the criteria does not constitute approval to bid. Final approval must be obtained from your institution's primary federal regulator (PFR), the FDIC's Division of Supervision and Consumer Protection, and the Federal Reserve Bank if a holding company is involved in the acquisition. If your institution would like to participate in an FDIC-assisted P&A transaction, it is imperative that you have early and frequent discussions with the relevant regulators. Certain PFRs have different criteria for approving participation and some state regulators have additional requirements.

The bidding process

Identifying an institution to bid on

Once your institution is on the approved bidder list, you will indicate your areas of geographical interest to the FDIC via its *FDICconnect* website (<https://www2.fdicconnect.gov/>). The FDIC will notify selected institutions about potential failing banks via e-mail. Additionally, your institution can monitor the FDIC's website and send a notification of interest to the FDIC at institutionsales@fdic.gov.

The FDIC will consider asset size and geographic guidelines when assessing the merits of a bidder and deciding whether to invite your institution to bid. Additionally, the FDIC considers the complexity of the acquiree in relation to the acquirer's experience in determining whether to invite an institution to bid.

The FDIC will consider asset size and geographic guidelines when assessing the merits of a bidder and deciding whether to invite your institution to bid. These guidelines suggest that bidders must be at least double the asset size of the failed bank acquired when the two institutions are close in proximity. A larger total asset size is typically required when the bidder and bank to be acquired are in different states. Additionally, the FDIC considers the complexity of the acquiree in relation to the acquirer's experience in determining whether to invite an institution to bid.

Information the FDIC provides to bidders for due diligence

Institutions invited to bid will be granted access to the FDIC's IntraLinks system after they execute an electronic confidentiality agreement. IntraLinks is a website that contains the information the FDIC makes available to all bidders and includes detailed loan and deposit trial balances, but excludes customer-specific information; financial data; premises and information technology information; bid forms; instructions; P&A documents; key dates; and regulatory contact information. The FDIC also provides information about the types of transactions being offered – for example, the FDIC may accept bids on the deposits only; bids for both the deposits and certain assets of the failed institution; and bids that include or exclude an LSA. Further, we have noted that some bidders provide multiple bids that include or exclude certain things (for example, a bidder may submit bids with and without an LSA).

While the FDIC aims to allow bidders to perform on-site due diligence, potential acquiring institutions are not afforded this opportunity in every situation. If the FDIC grants a request for on-site due diligence, it is usually limited to one or two days for a team of three to five people. As such, it is imperative that your team include a diverse group of individuals who have experience with valuations, evaluating credit risks, information technology and operations.

Understanding what's included in the deal

In determining the bid, the bidder should understand the assets and liabilities included in the deal. This is usually detailed as part of the bid package and is dictated by the FDIC. Items typically included in the P&A are:

- loans, other real estate owned, and certain investment securities;
- bank-owned businesses, such as credit cards, safe deposit boxes, trusts and acquired subsidiaries;
- deposits; and
- other assets not specifically excluded.

Items typically excluded from the P&A are:

- most brokered deposits;
- bank premises; however, the acquirer may have a 90 day option to purchase;
- director and office liability claims;
- prepaid regulatory assessments;
- tax receivables; and
- loss reserves.



Mechanics of bid construction (See Appendix A)

The bid consists of two components:

1. **Deposit premium** – the amount paid in excess of the dollar amount of the deposits. The deposit premium bid is expressed as a percentage of total deposits in the bid, not as a hard figure. This is done to minimize the impact of a change in deposit levels between the bid and closing dates.
2. **Asset premium/discount** – an amount over or below the book value of the assets, which adjusts the book value of the assets to the bidder's estimate of fair value. In most cases, this number is a discount from the book value.

The FDIC provides the bidding institution with key information to make its bid, including detailed loan and deposit trial balances that exclude customer-specific information, pro forma book value financial information and the FDIC's expectation of losses (presented as a "stated threshold"). Determination of the deposit premium and asset premium/discount will require third-party valuation expertise for most institutions.

It is important to note that in FDIC-facilitated transactions the acquirer is rarely required to make a payment to the receiver (the FDIC). Rather, successful bidders determine whether the FDIC will make a payment upon closing to the acquirer (if the winning bid is negative) or whether the acquirer will be required to absorb losses through a "first-loss tranche" prior to any loss-sharing (if the winning bid is positive – meaning the acquirer would normally provide cash consideration to the receiver). The determination of whether the winning bid is positive or negative is based on the deposit premium, asset premium/discount and transactional equity, which represent the net of the acquired assets and assumed liabilities (as computed by the FDIC at closing).

Appendix A illustrates the bidding process and the determination of whether a bid is positive or negative.



Understanding loss-sharing agreements

Under an LSA, the FDIC and acquirer share in the losses of the covered assets. As discussed earlier, the FDIC provides bidders with its stated loss threshold. For losses up to the stated threshold, the FDIC typically reimburses the acquirer for 80 percent of the losses on the covered assets with the acquirer absorbing the other 20 percent. For losses above the stated threshold, the FDIC typically reimburses the acquirer for 95 percent of losses on the covered assets with the acquirer absorbing the other 5 percent. Losses are usually shared over 10 years for mortgage loans, while commercial loan losses are generally shared over five years with a three-year recovery look-back period that begins at the end of the five-year period. Losses are shared on a pro rata basis for each dollar subject to the LSA, determined and paid monthly for single-family loans and quarterly for commercial loans and other assets.

When loss-sharing begins depends on the nature of the winning bid in the P&A agreement. As previously mentioned, if the bid was negative, loss-sharing begins immediately upon the recognition of losses. If the bid was positive, instead of the winning bidder paying the FDIC, the winning bid becomes a first-loss tranche that absorbs losses before any loss sharing begins.

How does the FDIC select the winning bidder?

The FDIC utilizes a proprietary “least-cost test” to determine the winning bidder. While the specifics of this test are not made public, information on winning bids is available through the FDIC’s website for analysis. We have noted that the highest bid is not always deemed to be the least costly, and that safety and soundness considerations appear to play a key role.

If the bid was positive, instead of the winning bidder paying the FDIC, the winning bid becomes a first-loss tranche that absorbs losses before any loss-sharing begins.

Accounting and tax considerations

The accounting considerations for acquisitions of the FDIC's failed banks will depend on the actual transaction structure. As discussed earlier, the most common transaction structure is a P&A arrangement in which the acquirer purchases a "whole bank" with a loss-share agreement. The following accounting and tax discussion focuses on that type of transaction.

Day One accounting and tax considerations

Accounting considerations

The acquisitions of failed banks will be accounted for pursuant to FASB Accounting Standards Codification™ ASC 805, *Business Combinations* (formerly FASB Statement 141R, *Business Combinations*). Effective for business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after Dec. 15, 2008 (Jan. 1, 2009, for calendar year-end entities), the revised guidance in ASC 805 significantly changed the accounting for business combinations.

The following are significant changes made by Statement 141R that are especially relevant to the acquisitions of failed banks:

- Assets acquired, liabilities assumed and noncontrolling interests are recognized at fair value under ASC 820 with limited exceptions.
- None of the failed bank's allowance for loan and lease losses (ALLL) is carried over to the acquirer in purchase accounting. Each acquired loan is recorded at its fair value and there is no initial ALLL for acquired loans.
- Any direct external costs (for example, professional, legal and accounting fees) are expensed as incurred. However, costs related to issuing debt or equity securities that are used to finance the transaction continue to be recognized in accordance with the applicable GAAP.

- The FDIC's LSA is considered an indemnification asset, separate from the covered loans, which will initially be recognized and measured on the same basis as the item being indemnified pursuant to the guidance in ASC 805-20-30-18. This is the most common approach; however, the SEC and FASB have indicated that the LSA asset could be accounted for as a derivative if it also meets the definition of a derivative in ASC 815, *Derivatives and Hedging*. If the LSA is accounted for as a derivative, it will be initially and subsequently recognized at fair value, with changes in fair value recognized in earnings.
- The acquirer would record a gain in the income statement at acquisition if the fair value of the assets obtained less liabilities assumed is greater than the consideration transferred, any equity interests held in the acquiree immediately before the acquisition date, and noncontrolling interests in the acquiree. Alternatively, if the opposite is true, goodwill will be recognized.
- Acquirers will need to consider whether a retroactive adjustment to the business combination accounting is necessary as a result of information that is obtained during the measurement period about facts and circumstances that existed as of the acquisition date. The measurement period ends as of the earlier of (a) one year from the acquisition date or (b) the date when the acquirer receives the information necessary to complete the business combination accounting.

Grant Thornton has developed the Business Combinations 141R Resource Center to assist our professionals and clients in dealing with these complex issues. In addition, our banking publication, *Currency*, has featured articles such as "Business combinations: How will Statement 141R change current practices?" which discusses how the new business combination accounting literature impacts financial institutions.

Tax considerations

In response to the “thrift industry” crisis of the late 1980s and early 1990s, the government provided significant financial assistance to many troubled institutions. To clarify the taxation of this type of financial assistance, Congress enacted Internal Revenue Code (IRC) Section 597 as part of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). IRC 597 is very relevant to today’s FDIC-facilitated failed bank acquisitions and is the primary regulation that governs federally assisted transactions.

The FDIC has a great deal of latitude in providing financial assistance for buyers of failed institutions by providing loans, making capital infusions or forming new legal entities to temporarily hold assets before they are liquidated. Under the Internal Revenue Code and Treasury regulations, assistance received from the FDIC is defined as Federal Financial Assistance (FFA).

If a failed bank’s liabilities exceed the value of its assets, the FDIC might implement a “net worth assistance” payment as an inducement to the buyer of the failed bank. This concept is described as “transactional equity” in the P&A agreements, and represents the net of the assets and liabilities acquired under the LSA. Typically this amount is negative and is “funded” by the FDIC (see Appendix A). A net worth assistance payment is taxable income for the failed bank and is considered a cash asset acquired by the buyer of the bank.

The majority of FDIC purchase and sale agreements in the past year have been taxable asset transactions as opposed to the acquisition of a failed bank’s stock. In tax regulations, the purchase price in a taxable asset sale generally equals the cash paid plus any liabilities assumed. If no cash is paid by

the acquirer (as is often the case), the purchase price may approximate the assumed liabilities. For tax purposes, when liabilities are assumed as consideration from the buyer, they are determined by the contractual amounts due to the failed bank’s depositors and other debts assumed by the buyer. This amount can be different from the measurement of liabilities determined under purchase accounting.

Taxable asset acquisitions allocate the purchase price among the acquired assets based upon categories of assets using the “residual method” as provided in IRC Sections 338 and 1060. The tax rules for FDIC-assisted sales do not allow for the allocation of any purchase price to an LSA. As previously discussed, an acquirer recognizes an LSA asset for accounting purposes. However, for tax purposes a Day One book-versus-tax temporary difference is recognized since the LSA asset is not recognized for tax purposes. Such a book-versus-tax difference is reallocated from the LSA to loans and other acquired assets – such as branches and core deposit intangibles – consistent with the residual method.

Under the residual method, the purchase price is allocated to the acquired asset pursuant to seven different asset classifications. The first two asset classes are cash and certain general deposit accounts (Class I) and actively traded personal property (Class II). Acquired loans subject to an LSA are considered Class II assets. In FDIC-assisted sales, if the fair market value of the Class I and II assets exceeds the allocated purchase price, the difference may be considered FFA and may be considered taxable income for the acquirer ratably over six years. This income is often referred to as “phantom income.” This possibility needs to be considered as a Day One tax issue.

Subsequent accounting and tax considerations

Accounting considerations

ASC 805 provides limited specific guidance on the subsequent accounting for acquired assets and liabilities assumed in a business combination. Rather, ASC 805 states that “in general, an acquirer shall subsequently measure and account for assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination in accordance with other applicable GAAP for those items, depending on their nature.” In the acquisition of a failed bank, the most significant items that require subsequent accounting considerations are the acquired loans and the related LSA.

Accounting for acquired loans

At acquisition, the acquirer would need to evaluate each individual acquired loan to determine if the loan has both evidence of deterioration of credit quality since origination and it is probable at acquisition that the acquirer will be unable to collect all contractually required payments from the borrower. If the individual loan has both of those characteristics, it shall be accounted for in accordance with ASC 310-30, *Receivables - Loans and Debt Securities Acquired with Deteriorated Credit Quality* (formerly SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*). Under ASC 310-30, the expected cash flows that exceed the initial investment in the loan (fair value) represent the “accretable yield,” which is recognized as interest income on a level-yield basis over the life of the loan. The accretable yield is not recognized in the statement of financial position, but is disclosed in the notes to the financial statements. At each subsequent reporting date, the acquirer is required to update its cash flow expectations.

If the individual loan does not have both characteristics discussed in the previous paragraph, the difference between the fair value of the loan at acquisition and the amortized cost of the loan would be amortized or accreted into income using the interest method as specified in ASC 310-20, *Receivables - Nonrefundable Fees and Other Costs* (formerly FASB Statement 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*).

In applying the aforementioned guidance, acquirers should consider the following:

- A loan identified by the acquiree as impaired or nonperforming is a good starting point for determining whether the loan meets the scope of ASC 310-30. However, the acquirer will need to evaluate each individual loan to determine if it meets the scope of ASC 310-30.
- Once it has been determined that a loan meets the scope of ASC 310-30, the acquirer will have an accounting policy election for subsequently accounting for each loan within its scope individually or with other similar loans as a pooled single asset. Due to the complexities and frequency of updating cash flow estimates, it may be operationally easier to aggregate loans with common risk characteristics. However, this decision could impact disclosures and regulatory reporting.
- Since the subsequent accounting and required reporting to the FDIC can be complex, entities should establish policies and procedures that cover the acquired covered assets and the LSA.
- Many accounting systems are not able to handle the accounting requirements of ASC 310-30 and therefore, the acquirer may need to upgrade its financial reporting suite.

- ASC 310-30-55 provides various illustrative examples that are helpful in understanding the unique accounting requirements in ASC 310-30.
- The SEC’s “Areas of Frequent Staff Comment – Financial Institutions”⁷ includes areas of staff comment related to FDIC-assisted transactions.
- The AICPA recently posted to its website a letter⁸ the AICPA Depository Institutions Expert Panel (DIEP) sent the SEC’s Office of the Chief Accountant summarizing its understanding of the SEC staff’s view of how discounts related to loan receivables acquired in a business combination or asset purchase should be accreted into earnings. The letter indicates that two divergent views have developed regarding loans that are not in the scope of ASC 310-30 but have the following three characteristics: they are acquired in a business combination or asset purchase; they result in the recognition of a discount attributable, at least in part, to credit quality; and they are not subsequently accounted for at fair value. The disagreement lies in whether the loan discount should be accreted using ASC 310-20 or ASC 310-30. The letter documents the DIEP’s understanding that the SEC, absent further standard-setting in this area, would not object to an entity’s use of either ASC 310-20 or ASC 310-30. The SEC would expect an entity to disclose the accounting policy election and apply the policy consistently. Further, if an entity elects a policy based on expected cash flows, it should follow all of the accounting and disclosure guidance in ASC 310-30. Acquirers should consult with their auditors or accounting advisers as to the application of such an accounting policy election.



⁷ “Areas of Frequent Staff Comment – Financial Institutions,” Stephanie L. Hunsaker, Division of Corporate Finance, SEC, December 2009. <http://www.sec.gov/news/speech/2009/slides1209slh.pdf>
⁸ Confirmation letter, AICPA Depository Institutions Expert Panel, Dec. 18, 2009. <http://aicpa.org/download/acctstd/Confirmation-letter-on-Day-2.pdf>

Accounting for an LSA

An LSA asset should be reported on the balance sheet separately from the asset(s) to which it corresponds. If the LSA is accounted for as an indemnification asset, it is subsequently remeasured each reporting date on the same basis as the indemnified asset or liability, subject to any contractual limitations on its amount. Although the covered assets may be carried at various bases (for example, available-for-sale investment securities will be recognized at fair value, some loans will be accounted for under ASC 310-20 and other loans under ASC 310-30), the indemnification asset represents a single asset. Amounts that are subsequently measured on a basis other than fair value are also subject to management's assessment of collectability.



Interaction of subsequent accounting for acquired loans and related LSA indemnification asset

The following examples illustrate the interaction of the subsequent accounting for the acquired loans and the related LSA indemnification asset.

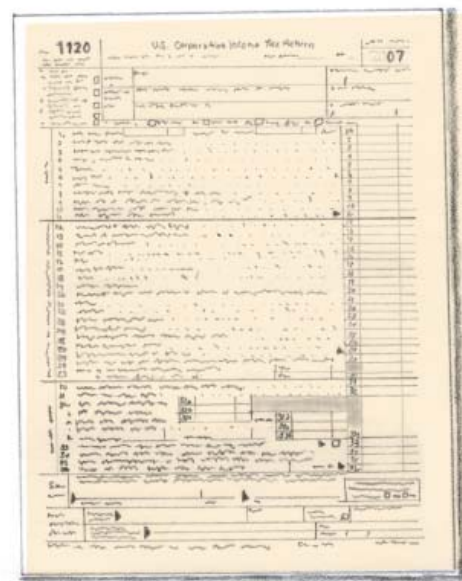
- If there is credit deterioration in the expected cash flows of the loans covered by the LSA, the acquirer would recognize an ALLL and corresponding provision for loan and lease losses related to the loans. In addition, the acquirer would re-evaluate the indemnification asset and recognize in non-interest income an increase in the indemnification asset for the portion covered by the FDIC. The amounts recognized in earnings would be reported gross. This treatment is the same regardless of whether the loan is accounted for under ASC 310-20 or ASC 310-30.
- For loans accounted for under ASC 310-20, an improvement in the credit quality of the loans covered by the LSA would result in the reduction of any ALLL established after the acquisition. The amortization or accretion of any premium or discount paid on the loan would not be impacted unless the loan is returned to accrual status. The acquirer would re-evaluate the indemnification asset and recognize through a charge to non-interest income a decrease in the indemnification asset.
- For loans accounted for under ASC 310-30, an improvement in the credit quality of the loans covered by the LSA would also result in the reduction of any ALLL established after the acquisition. However, if the acquirer determines that the expected cash flows are greater than its estimate at acquisition, the acquirer would compute a revised effective yield and recognize the increase in the accretable yield amount over the remaining life of the loan. The acquirer would re-evaluate the indemnification asset and recognize through a charge to non-interest income a decrease in the indemnification asset.

Tax considerations

Tax reporting requirements have several components and issues, each with their own set of complexities. Under current tax rules, interest income is generally based upon the contractual relationship with the debtor and is computed using the principal amount outstanding, the original interest rate and other terms of the loan. This amount will be different from income recognized under ASC 310-20 or ASC 310-30 and will create a book-versus-tax difference that will need to be tracked.

Loans acquired for an amount below the face value are purchased with a market discount. The market discount represents potential taxable income that must be accrued as earned. For example, if a \$100,000 loan was acquired for \$80,000 and the debtor refinanced the loan for the full amount, some or all of the \$20,000 of market discount taxable income must be recognized. Absent a refinancing or similar event, the accrued market discount for acquired loans must be tracked until the loan matures, is sold or charged off. Acquirers can elect to recognize the market discount in taxable income under either a constant interest rate method or ratably over the life of the loan.

Under current tax rules, interest income is generally based upon the contractual relationship with the debtor and is computed using the principal amount outstanding, the original interest rate and other terms of the loan.



A payment received under an LSA is considered FFA and recognized as taxable income. If an acquired loan is either sold or charged off, payments received from the FDIC must be considered realized when paid. Assume the \$100,000 loan described earlier is charged off by the acquirer and \$80,000 is received from the FDIC under the LSA. The determination of the acquirer's taxable income would include the FDIC payment of \$80,000 offset by the charge-off expense deduction of \$80,000.

As with any acquisition, an FDIC-assisted purchase can increase a bank's tax footprint to include new state and local taxing jurisdictions. In some cases, new consolidated or unitary group reporting may be required, revenue sourcing methodologies will need to be considered, and previously recorded deferred tax amounts may need to be revalued.

Complying with the FDIC reporting requirements

FDIC-assisted transactions with LSAs impose significant reporting requirements on acquiring institutions, including:

- A monthly single-family loan-loss certificate detailing each single-family loan subject to the LSA for which a loss amount is claimed; any recoveries made during the period; total monthly losses; cumulative losses; a calculation of the FDIC's and acquiring institution's share of the losses claimed; and a detailed computerized servicing file, in addition to other information.
- A quarterly commercial loan-loss certificate detailing charge-offs; recoveries and net charge-offs during the quarter; any shared losses on covered investment securities; and a detailed computerized listing if required by the FDIC.

These reporting requirements are proving to be time- and systems-intensive, frequently requiring acquiring institutions to bring in additional personnel to administer the reporting requirements, as well as invest in additional system resources and implement new internal controls to produce accurate and timely reports. Management should be prepared to support the reports it provides to the FDIC, as the reports will likely be subject to review.



The LSA requires that the acquirer provide to the FDIC an auditor's report addressing the accuracy of the computational provisions of the LSA within 90 days after the end of its fiscal year. The LSA also states that "it is the intention of this audit requirement to align the timing of the audit required under this LSA with the examination audit required pursuant to 12 CFR Section 363." In July 2009, the timing of the audit requirement in 12 CFR 363 was changed for institutions that are neither public companies nor a subsidiary of a public company from 90 days after the end of its fiscal year to 120 days after the end of its fiscal year. The LSA has not yet reflected this change. We understand that the FDIC would not object to an institution that has a 120-day filing deadline for its audited financial statements to also utilize the same time period in order to comply with the audit requirement in the LSA. However, institutions should review the actual audit requirement in its LSA and discuss the timing of the audit requirement with its primary regulator.

In February 2010, the AICPA published "Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions" to address how auditors might respond to the FDIC requirement. The example reports are available at www.aicpa.org/download/acctstd/TIS_9110_16.pdf.

Grant Thornton is here to help

For these and any other questions you may encounter, you'll receive integrated service delivery from a team that consists of professionals from our Audit, Tax, Regulatory Compliance, Business Advisory, Information Technology and Valuation groups. We can help in a number of ways:

- Evaluate whether your institution meets the FDIC's qualifications to bid
- Evaluate the failed bank acquisition under the compressed FDIC due diligence period
- Decipher the relevant accounting and tax issues related to failed bank acquisitions
- Implement the processes and controls necessary for ongoing FDIC loss-sharing agreement reports
- Determine bid components
- Determine the fair value of the assets and liabilities acquired in the business combination
- Evaluate the impact of an acquisition on income tax positions, capital ratios and other key metrics

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Our professionals are dedicated to monitoring the current economic environment and new legislative developments. Visit our Economic Crisis Resource Center at www.GrantThornton.com/econcrisis for more information.

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Appendix A

Whole bank with loss-share bid construction

As previously indicated, there are two steps that need to be taken in order to determine the appropriate bid amount under these types of arrangements with the FDIC. This example walks through the first two steps and gives an example of the determination of transactional equity (step 3), and whether the winning bidder would receive a payment from the FDIC or would be required to absorb losses through the establishment of a first-loss tranche (step 4).

This example is not prescriptive as to its methodology or form and is primarily intended to illustrate the bidding process.

Step 1 – Determine the deposit premium

The first step is to calculate the deposit premium, which represents the bidder's estimate of the value of the failed bank's core deposits. It is important to consider factors, such as:

- whether the assumed deposits are a cheaper funding source (for example, as compared to the institution going out and issuing jumbo certificates of deposit at a special interest rate);
- the ability to cross-sell other products to the depositors;
- whether it is cheaper to enter a new market by acquiring another institution as compared with building a new branch; and
- costs to service the new deposits and deposit runoff.

In this example, we assumed a one percent premium whereby the stated percentage is multiplied by the estimated core deposits.

Step 2 – Determine the asset premium/discount

The second step is to calculate the asset premium/discount, which represents an amount over or below book value of the assets, which adjusts the assets to the bidder's estimate of fair value. This calculation should consider factors such as credit risk and the differences in contractual loan interest rates as compared with current market interest rates. The determination of the asset premium/discount may also be reduced or increased for the administrative costs of the transaction. As it relates to credit risk, a bidder should compare its estimate of the expected losses to the FDIC-stated threshold provided, taking into consideration the credit losses the institution will absorb.

The table (on page 17) provides an example of the asset premium/discount. This calculation assumes that the FDIC and acquirer will share in the losses up to the stated threshold on an 80/20 basis and any losses above the stated threshold will be shared on a 95/5 basis.

Asset Premium/Discount Calculation

Acquiring institution's estimated losses	\$240	80/20 split up to FDIC-stated threshold	
FDIC-stated threshold	<u>\$200</u>	FDIC (200 x .80)	\$160
Excess over threshold	\$40	Acquiring bank	<u>\$40</u> (A)
			\$200
		95/5 split on excess over threshold	
Estimated expenses*	\$5 (A)	FDIC (40 x .95)	\$38
		Acquiring bank	<u>\$2</u> (A)
			\$40
Asset premium/discount		(\$47) Sum A	

*Expenses will vary by institution and potential transaction, but typically include transaction expenses such as legal and other advisers, increased operational expenses resulting from costs to administer a new entity and FDIC reporting requirements, as well as potential IT system upgrades.

Step 3 – Calculate the transactional equity based on the FDIC

The third step is to calculate the transactional equity which represents the difference between the book value of the acquired assets and assumed liabilities included in the bid. This number is computed by the FDIC at closing, however the bidder will receive pro forma information as part of the bidding process. The following table provides a condensed pro forma balance sheet of the acquiree that demonstrates how the transactional equity would be computed:

Step 4 – Determine the amount from the FDIC at closing (if negative) or the first-loss tranche (if positive)

In this example, the overall bid is negative, which means the FDIC will pay cash to the winning bidder at the closing of the transaction. If the overall bid had been a positive number, that amount would be considered the first-loss tranche, and the winning bidder would absorb losses up to that amount prior to any loss-sharing.

Condensed Pro Forma Balance Sheet of the Acquiree

	At closing
Cash	\$100
Securities	\$500
Loans	\$900
Other assets	\$25
Total assets	\$1,525
Deposits	\$1,400
FHLB borrowings	\$200
Other liabilities	\$50
Total liabilities	\$1,650
Transactional equity (B)	(\$125)

Bid Summary

Step 1: Calculate the deposit premium (1% x 1,400):	\$14
Step 2: Calculate the asset discount/premium (A above):	(\$47)
Step 3: Calculate transactional equity (B):	(\$125)
Amount due from FDIC at closing	(\$158)

Appendix B

Acquiring institution post-acquisition

Beyond estimating the fair value of the assets and liabilities of the failed institution in order to determine a proper bid, the acquiring institution must also evaluate the impact of the acquisition on its statement of position and regulatory capital post-acquisition. The following illustrates the potential impact on the acquiring institution.

	Acquiring Bank (Pre-Acquisition)	Failed Bank at Fair Value	Combined Entity
Assets			
Cash	\$200	\$100	\$300
Cash from FDIC at closing	\$0	\$158	\$158
Securities	\$700	\$575 (A)	\$1,275
Loans	\$2,000	\$725	\$2,725
Indemnification asset	\$0	\$150	\$150
Other assets	\$40	\$25	\$65
Core deposit premium	\$0	\$14	\$14
Total assets	\$2,940	\$1,747	\$4,687
Liabilities			
Deposits	\$2,500	\$1,390	\$3,890
FHLB borrowings	\$120	\$210	\$330
Other liabilities (including deferred taxes)	\$50	\$93	\$143
Total liabilities	\$2,670	\$1,693 (B)	\$4,363
Equity	\$270	\$54	\$324
Liabilities and equity	\$2,940	\$1,747	\$4,687

(A) Difference between carrying amount of securities in Appendix A of \$500 and the fair value of \$575 in this Appendix relates to the fair value adjustment related to held-to-maturity securities.

(B) Includes an adjustment to recognize a deferred tax liability as further explained in Appendix C and an adjustment to measure other liabilities at fair value.

Appendix C

Tax impact

Below is an illustration of the potential tax impact of an acquisition under an FDIC-assisted transaction.

	Failed Bank at Fair Value Beginning	GAAP Adjustment	Failed Bank at Fair Value Post-Adjustment	Tax Basis	Temporary Difference	DTA (DTL) @ 37%
Cash	\$258		\$258	\$258		
Securities	\$575		\$575	\$575		
Loans	\$725		\$725	\$825 (C)	\$100	\$37
Indemnification asset	\$150		\$150		\$(150)	\$(55)
Other assets	\$25		\$25		\$(25)	\$(9)
Core deposit premium	\$14		\$14		\$(14)	\$(5)
Total assets	\$1,747		\$1,747	\$1,658		
Deposits	\$1,390		\$1,390	\$1,400	\$(10)	\$(4)
FHLB borrowings	\$210		\$210	\$200	\$10	\$4
Other liabilities	\$62		\$62	\$50	\$12	\$4
Deferred taxable income				\$8	\$(8)	\$(3)
Deferred taxes		\$31 (A)	\$31			
Total liabilities	\$1,662	\$31	\$1,693	\$1,658		
Equity		\$54 (B)	\$54			
Liabilities and equity	\$1,662	\$85	\$1,747		\$(85)	\$(31) (A)

Gain \ Loss – GAAP Adjustment		
	Book	Tax
Purchase price		
Cash paid		
Liabilities assumed	\$1,662	\$1,650
Purchase price	\$1,662	\$1,650
FV of assets acquired	\$1,747	
FMV allocated to Class I & II		\$1,658
Gain (loss)	\$85	\$8
Tax @ 37% rate	\$(31) (A)	
Net income	\$54 (B)	

Loans Tax Market Discount	
Loans at face value	\$900
Loans at tax basis	\$825 (C)
Tax market discount	\$75
Class I & II Assets – Determination	
Cash	\$258
Securities	\$575
Loans – highest guaranteed value	\$825
Total Class I & II assets	\$1,658

Liabilities Assumed	Tax	At Fair Value
Deposits	\$(1,400)	\$(1,390)
FHLB borrowings	\$(200)	\$(210)
Other liabilities	\$(50)	\$(62)
Total liabilities	\$(1,650)	\$(1,662)

Loss Sharing Allocations	FDIC	Buyer
Share on of first \$200 of loss	\$160	\$40
FDIC @ 95% to 5 % > \$200	\$665	\$35
Total	\$825	\$75

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