CALCULATED RISK: ENTERING INTO A "LOSS SHARE" AGREEMENT WITH THE FDIC

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The recent financial collapse has provided a strategic opportunity for healthy financial institutions, and non-traditional investors, to capitalize on the misfortune of failing banks. The FDIC is accelerating this process by revamping its loss share program. This program gives prospective buyers of failing institutions billions of dollars in government guarantees for risking the purchase of a failing bank, inclusive of all "toxic" assets. By agreeing to absorb 80% of the acquiring banks immediate losses, the FDIC entices the healthy investor to take on limited risk in anticipation of future reward. After the initial purchasing stage, the FDIC will assume up to 80% of additional losses in connection with the acquired loan portfolio.

The loss share agreement protects the buyer from the brunt of purchasing a troubled loan and asset portfolio. This combined with the discount from the stated value of the failed bank's positive assets, generates a strong incentive to snap up failed institutions. The healthy acquiring bank will immediately expand its customer base and geographic footprint. As well, many of these failed banks' assets will include first-rate loan portfolios. Indeed, a buyer who can hold onto the target banks portfolio well into the future will reap significant unanticipated revenue without running into typical risks.

From the FDIC's standpoint, the loss share program will allow for the sale or restructuring of trouble assets in an orderly fashion instead of being sold at steep discounts in a poor market. This will reduce government costs in keeping these toxic loan portfolios in the private sector. As well, this will lessen the impact on the local market by keeping more of the failed bank's debtors within the banking environment.

The upside of entering into a loss share agreement is clear. However, these transactions are complex and will demand a significant amount of expertise and responsiveness. Accordingly, investors should not jump onto FDIC-assisted deal without careful planning and foresight. Vigilant planning is necessary from the initial stages of setting up the bid down to seeking profit from each acquired loan portfolio.

Acknowledging that the demand for FDIC-assisted transactions are high, the time frame for the bidding process is short. The acquiring investor must be prepared to act quickly, at times without full disclosure of the failing bank's information. Accordingly, the acquiring investor must be fully informed of the accounting implications, the loss sharing process, and the regulatory and tax implications. The loss share arrangements also pose newfound operational and compliance challenges that simply cannot be overlooked by an acquiring investor.

All loss-sharing agreements require changes to existing operations. An acquiring bank must be able to quickly implement a new management team and alter the previously botched banking platform. As well, acquisition and loss-sharing accounting generates a newfound need to manage multiple accounting bases. These challenges can place considerable strain on the acquiring bank to successfully integrate the failed institution's system and customer base.

The FDIC has begun to reduce the amount of losses it is willing to share with buyers of failed banks. This indicates the agency's increasing confidence that these banks' assets will be purchased in the private sector. The FDIC's reduced assistance, however, increases the risk, and consequently the amount of due diligence, associated with bidding on loss share transactions. Nonetheless, the overall ability to expand market share for a wholesale price is still evident. The FDIC is still seeking to place these banks into the private market in order to divert another financial crisis. As Sheila Bair, Chairman of the FDIC states, "Bringing responsible new investors into the failing banking system is an important step towards a strengthened banking system."[1]

With over 400 banks still on the FDIC's problem bank list, the number of failed banks in 2010 will undoubtedly surpass the 140 institutions which were sold by the program in 2009. As the FDIC continues to close down and sell more failed banking institutions, Diaz Reus will closely monitor the risks and opportunities arising from each presented bank.

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[1] Matthias Rieker, FDIC Offers Failed-Bank Buyers Fewer Guarantees, March 26, 2010, available at http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=201003261750dowjonesdjonline000596& title=update-fdic-offers-failed-bank-buyers-fewer-guarantees