Office of Inspector General

August 2005
Report No. 05-028

DRR's Pre-Closing Planning Process

AUDIT REPORT

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Background and Purpose of Audit

The FDIC is charged with the resolution of failing FDIC-insured depository institutions. Specifically, when a financial institution is failing, the FDIC has a responsibility to the institution's depositors, creditors, and shareholders to plan for and liquidate the institution's assets and liabilities in the least costly manner possible. The resolution process involves valuing the institution, marketing it, soliciting and accepting bids for the sale of the institution, determining which bid is least costly to the insurance fund, and working with the acquiring institution(s) through the closing process (or ensuring the payment of insured deposits in the event there is no acquirer). The FDIC is also responsible for managing, marketing, and selling those assets that are not sold to an acquiring institution before bank closure and are, therefore, placed into an FDIC receivership.

The objective of the audit was to determine the adequacy of the Division of Resolutions and Receiverships' (DRR) pre-closing planning process. The scope of our audit included all near and actual financial institution failures from January 1, 2003 through December 31, 2004, for which DRR expended time and resources. During this 2-year period, DRR expended resources monitoring 38 institutions of which 7 institutions actually failed and were placed into receivership.

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Results of Audit

Overall, we found that DRR's pre-closing planning process is adequate. The duties and responsibilities of the resolution process are clearly described in manuals, checklists, job aids, and flow charts with associated time tables. In addition, the FDIC has established formal procedures and an interagency agreement for the collection and sharing of information between DRR and the Division of Supervision and Consumer Protection (DSC) and other federal regulators. Further, our review of DRR's pre-closing planning efforts for three financial institutions—one failure and two near-failures with assets of about $166 million—showed that DRR completed key tasks and conducted the resolution in a timely and efficient manner. Further, DRR management reports indicated that resolution problems were identified, discussed, and addressed. Finally, we noted evidence of adequate communication, coordination, and cooperation between DRR and other federal and state regulators during the pre-closing process.

Formal Procedures and Agreements for Communication and Coordination

The FDIC has established formal procedures for the collection and sharing of information between DRR and DSC for institutions that appear likely to fail. The procedures call for DSC to seek the failing institution's consent to allow DRR access to the institution and its records to facilitate the resolution process. In addition, an interagency agreement between the FDIC and the other primary federal regulators (the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Reserve Board) also deals with FDIC access to institution-related information.

DRR Pre-Closing Planning Process for Three Institutions

For the three institutions in our sample, DRR adequately planned for the closings by successfully: (1) conducting on-site visits to the failing institution, (2) performing the required Asset Valuation Reviews for use in making a least-cost determination, (3) preparing the necessary Information Packages for prospective bidders, and (4) marketing the failing institution and individual institution assets. Further, our review of DRR's files and management reports showed that DRR had timely and appropriate access to the three failing institutions.

Recommendations

We made no recommendations in this report. However, we did include a matter for future DRR consideration. Specifically, DRR is in the midst of a significant staff reduction and realignment as well as a transition to a new business model focused on a smaller, more specialized workforce. Therefore, DRR may need to reconsider the existing internal control structure that we reviewed during this audit in light of the substantive changes in its operations.

Federal Deposit Insurance Corporation
801 17th Street NW, Washington, DC 20434

Office of Audits
Office of Inspector General

DATE: August 8, 2005

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

FROM: for Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *DRR's Pre-Closing Planning Process*
(Report No. 05-028)

This report presents the results of the Federal Deposit Insurance Corporation (FDIC) Office of Inspector General's (OIG) audit of the Division of Resolutions and Receiverships' (DRR) pre-closing planning process for resolving troubled and failed FDIC-insured financial depository institutions. The resolution process encompasses various activities covering three separate but related phases: (1) pre-closing, (2) closing, and (3) post-closing. This audit focused on DRR activities in the pre-closing phase.

The objective of the audit was to determine the adequacy of DRR's pre-closing planning process. The scope of our audit included all near[1] and actual bank failures from January 1, 2003 through December 31, 2004 for which DRR expended time and resources. During this 2-year period, DRR monitored 38 institutions, with assets totaling about $24 billion, of which 7 institutions, with assets of $1.4 billion, actually failed and were placed into receivership. Additional details on our objective, scope, and methodology are in Appendix I.

During the survey phase of the audit, we gained an understanding of internal controls, reviewed pertinent policies and procedures, interviewed cognizant DRR officials, and reviewed 3 of the 38 near and actual failures for the 2-year period of review. Based on our survey work, we found that DRR had a structured and efficient bank resolution process and concluded that, overall, DRR's pre-closing planning process was adequate. Accordingly, we decided to conclude our field work after completion of the audit survey, and we make no recommendations in this report.

BACKGROUND

The FDIC is charged with the resolution of failing FDIC-insured depository institutions. Specifically, when a financial institution is failing, the FDIC has a responsibility to the institution's depositors, creditors, and shareholders to plan for and liquidate the institution's

[1] The resolution process includes banks that eventually fail and problem banks that require DRR monitoring but do not fail. These latter problem banks are referred to as "near-failures."

assets and liabilities in the least costly manner possible. The resolution process involves valuing the institution, marketing it, soliciting and accepting bids for the sale of the institution, determining a least-cost strategy, and working with the acquiring institution(s) through the closing process (or ensuring the payment of insured deposits in the event there is no acquirer). The FDIC is also responsible for managing, marketing, and selling those assets that are not sold to an acquiring institution before bank closure and are, therefore, placed into an FDIC receivership.

The FDIC's DRR is responsible for planning and efficiently handling the resolution of failing FDIC-insured institutions and for providing prompt, responsive, and efficient administration of failing and failed FDIC-insured institutions in order to maintain confidence and stability in the nation's financial system. DRR's Franchise and Asset Marketing Branch is responsible for resolving troubled financial institutions by selling or liquidating the institution's assets in a manner that results in the least cost and highest recovery to the deposit insurance funds and other creditors of the failed institutions. Within the Franchise and Asset Marketing Branch, the Franchise Marketing Section is responsible for managing the sale of the failing institution franchise, and the Asset Marketing Section is responsible for the sale of individual institution assets.

DRR's actions are governed by the Federal Deposit Insurance (FDI) Act, the FDIC's implementing regulations, and DRR's procedures. For example, under DRR's procedures, a typical resolution due to a financial institution's capital insolvency will extend for a period of 90 days or less. The 90-day time frame is partially due to the Prompt Corrective Action (PCA) provisions of the FDI Act. These provisions require, in general, that the appropriate federal banking agency, or the FDIC, either close an institution within 90 days after determining that the institution is "critically undercapitalized" or take other appropriate action. According to Part 325 of the FDIC Rules and Regulations and consistent with the Act, a critically undercapitalized institution is one that has a tangible equity-to-average-total-assets ratio of 2 percent or less. The FDI Act also requires that when the FDIC, as conservator or receiver, sells or disposes of property, it shall do so in a manner that, among other things, maximizes net present value return and minimizes losses of such resolutions and ensures adequate competition and fair treatment of offerors.

From DRR's perspective, the resolution process generally begins when DRR becomes aware of the primary regulator's written or oral notification to an institution that it is critically undercapitalized or that some non-viability exists such as an unsafe and/or unsound practice. DRR then has up to the 90-day PCA limit to collect information from the failing institution and plan for and execute the resolution. In some cases, the condition of a failing institution may necessitate an expedited closure. For example, if fraudulent activities have occurred, DRR may need to initiate immediate closing activities.

Primary guidance for the resolution process is in DRR's *Resolutions Policy Manual*. Key resolution responsibilities include:

- planning and preparing for the resolution process;

- preparing the Information Package provided to potential bidders, which describes the assets and liabilities held by the failing institution;
- conducting the Asset Valuation Review, which establishes an estimated value of the institution's assets;
- marketing the failing institution and soliciting bids; and
- selecting the successful bidder.

Based on these efforts, DRR is required to make a formal recommendation to the FDIC Board of Directors concerning the least costly resolution strategy to pursue upon the date of bank failure. The recommendation is documented in a Failing Bank Case presented to the FDIC Board.

Additional pre-closing guidance is contained in DRR's *Failed Financial Institution Closing Manual* (Closing Manual), which describes procedures for conducting the closing of an FDIC-insured financial institution at resolution and contains sections on pre-closing planning activities for various DRR functions such as Asset Claims, Asset Management, and Investigations. Appendix II contains a more detailed description of the pre-closing resolution planning process and the key events leading to a potential bank closing.

RESULTS OF AUDIT

Overall, we found that DRR's pre-closing planning process is adequate. The duties and responsibilities of the resolution process are clearly described in manuals, checklists, job aids, and flow charts with associated time tables. In addition, the FDIC has established formal procedures and an interagency agreement for the collection and sharing of information between DRR and the Division of Supervision and Consumer Protection (DSC)[2] and other federal regulators. Further, our review of DRR's pre-closing planning efforts for three financial institutions—one failure and two near-failures—showed that DRR completed key tasks and conducted the resolution in a timely and efficient manner. The three institutions had assets totaling about $166 million. Further, DRR management reports indicated that resolution problems were identified, discussed, and addressed. Finally, we noted evidence of adequate communication, coordination, and cooperation between DRR and other federal and state bank regulators during the pre-closing process.

Formal Procedures and Agreements for Communication and Coordination

The FDIC has established formal procedures for the collection and sharing of information between DRR and DSC for institutions that appear likely to fail. The procedures call for DSC to seek the failing institution's consent to allow DRR access to the institution and its records to facilitate the resolution process. In addition, an interagency agreement between the FDIC and

[2] DSC is responsible for examining and supervising insured financial institutions to ensure they operate in a safe and sound manner.

the other primary federal regulators (the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Reserve Board) also deals with FDIC access to institution-related information. The interagency agreement addresses a variety of issues, including information sharing among the financial institution regulatory agencies, FDIC participation in the examination of financial institutions that present a heightened risk to the deposit insurance funds, and FDIC involvement in the supervision of certain large insured depository institutions.

DRR Pre-Closing Planning Process for Three Institutions

For the three institutions in our sample, DRR's Franchise and Asset Marketing Branch adequately planned for the closings by successfully: (1) conducting on-site visits of the failing institution, (2) performing the required Asset Valuation Reviews for use in making a least-cost determination, (3) preparing the necessary Information Packages for prospective bidders, and (4) marketing the failing institution and institution assets. Further, our review of DRR's files and management reports showed that DRR had timely and appropriate access to the three failing institutions.

A summary of the pre-closing work DRR performed for the three institutions follows. Two of the institutions we reviewed did not close. We are not referring to any of the institutions by name.

Institution A (Near-Failure)

For Institution A, DRR began receiving significant information about the bank's condition and planning for a possible closing even before the primary regulator formally delivered the PCA notice to the bank. Within a week of the PCA notice, DRR began receiving bank financial information and soon afterwards, began soliciting qualified bidders through IntraLinks[3] and prospective buyers began performing due diligence. While DRR was actively marketing the bank and working towards placing it into receivership, the bank owners found a buyer and sold the bank. Overall, the sale took place less than 3 months after the PCA notification was given, falling within the 90-day PCA guideline.

Institution B (Near-Failure)

The decision to close Institution B was dependent on a determination by a federal agency as to whether certain loan guarantees would be honored. DRR's planning for the possible closing of the bank proceeded in response to information provided by DSC and the state regulator. DSC first notified DRR that the bank was at risk of failing almost 7 months before official PCA notice was given. Within a month after the PCA notification, DRR began work on the required Asset Valuation Review and Information Package (AVR/IP). Then, several months later (while the federal agency was deciding on the loan guarantee issue), DRR was again notified that the bank

[3] IntraLinks is a private Internet-based company DRR engaged to assist in the marketing of failing institutions. The purpose of establishing a secure Web site is to provide information in an expeditious manner on failing financial institutions to potential acquirers on the resolution process. IntraLinks is also used to describe and market the types of transactions that are being offered for a failing institution.

might be closed and began updating its AVR/IP. DRR provided updated information about the bank on IntraLinks for potential bidders. While DRR was planning for, and working towards, a possible bank closing, the bank found a financing source and was able to recapitalize. Given the circumstances, DRR's pre-closing efforts were effective and timely.

Institution C (Failure)

For Institution C, DRR marketed and sold the failed bank 81 days after DSC first notified DRR that the bank was in danger of failing. For this bank closing, DRR performed key tasks in a timely manner. Specifically, DRR's AVR/IP team began its work in the bank about 14 days after PCA notification and completed its work 25 days later. Further, DRR activated IntraLinks 44 days after DSC first provided the PCA notification, and buyer due diligence began about 57 days after the notification. Overall, DRR's efforts were timely and led to the successful closing of the bank within the 90-day PCA guideline.

Matter for Future DRR Consideration

DRR is in the midst of a large workforce restructuring and transition effort. This effort includes a significant staff reduction and realignment as well as the transition to a new business model focused on a smaller, more specialized workforce that leads, directs, and serves as an expert resource for resolution and closing activities for the FDIC. Significantly, the new business model calls for increased reliance on DSC resources and, as necessary, contractor support. Therefore, DRR may need to reconsider the existing internal control structure that we reviewed during this audit in light of the substantive changes in its operations.

CORPORATION COMMENTS AND OIG EVALUATION

A written response was not required for this report. DRR advised the OIG that it had no official comments.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of the audit was to determine the adequacy of DRR's pre-closing planning process. The audit focused on institutions that were failing or closed for reasons other than fraud. The scope of our audit included all 38 near and actual failures[4] from January 1, 2003 through December 31, 2004, for which DRR had expended resources. The asset size of the 38 institutions ranged from $7 million to $14 billion.

To gain an understanding of the resolution process, we interviewed DRR officials in Franchise Asset Marketing, Asset Management, Receivership Operations, and Internal Review. Also, we reviewed the following pertinent policies and procedures and gained an understanding of internal controls:

- DRR's *Resolutions Policy Manual*;
- DRR's *Failed Financial Institution Closing Manual*;
- DRR's *Bridge Bank Manual*;
- DRR Senior Management Oversight Committee reports for 2003 and 2004;
- DRR Management Status Reports for 2003 and 2004;
- various job aids, file checklists, resolution flow charts, time tables, and lessons-learned reports; and
- Strategic Resolution Plans, Post-Closing Reports, and DRR Failing Bank Reports for the Chairman.

To assess the adequacy of DRR's pre-closing planning, we reviewed documentation supporting DRR's resolution efforts for a sample of 3 of the 38 near and actual failures for which DRR had expended resources during our audit period. Specifically, for the three institutions we sampled, we determined when (1) DRR received the first PCA notification of a potential pending failure and thus began the resolution process, (2) DRR began its AVR/IP preparation process, (3) bidder information was made available on IntraLinks, (4) buyer due diligence began, and (5) the institution was resolved. Because of the unique circumstances surrounding each institution's failure or near failure, we recognize that there can be no specific time requirements for DRR's resolution activities. Therefore, we based our conclusion regarding the adequacy of pre-closing planning on our professional judgment as to whether DRR was able to accomplish these activities within a reasonable time (using the established 90-day PCA period as a guide).

Computer-based data was not significant to our findings, conclusions, and recommendations. Specifically, we limited our use of computer-based data to a DRR-provided list of financial institutions that failed or were near-failures during the period of our review. Although we used this list as the basis for our sample selection, we considered the risk of potential misinformation on the list to be low. Nonetheless, we performed a limited reasonableness check of the accuracy of the information provided by DRR by confirming that the list included the seven institutions that were known to have failed during the 2-year period.

[4] Of the 38 near and actual failures during our audit period, 7 banks actually failed of which 4 failed due to fraud-related issues.

We performed our work at DRR offices in Washington, D.C., and Dallas, Texas, from March through June 2005 in accordance with generally accepted government auditing standards.

PRE-CLOSING PLANNING PROCESS

Once an institution is notified that it is undercapitalized or has unsafe practices, a series of events occurs (some concurrently), normally within a 90-day period. First, the managers of the institution undertake an effort to cure the problem(s) identified by the primary regulator. For example, institution management may attempt to cure the identified deficiency; seek additional capital; merge with another, more viable institution; self-liquidate; or market the institution to an outside buyer. Meanwhile, different groups within the FDIC and DRR move forward with individual, but coordinated, resolution efforts in anticipation that the institution will eventually fail and be placed into receivership status.

The resolution process involves valuing a failing institution, marketing it, soliciting and accepting bids for the sale of the institution, determining which bid is least costly to the insurance funds, and working with the acquiring institution(s) through the closing process. Alternatively, the process may involve ensuring the payment of insured deposits in the event there is no acquirer.

DRR's Franchise and Asset Marketing Branch begins monitoring a troubled institution after notification by the primary regulator of pending problems. Franchise and Asset Marketing seeks early access to the institution to identify and value assets, to seek out potential qualified buyers, and to prepare bid packages in an effort to sell the institution. The resolution process is facilitated by visitation reports, AVR/IP checklists, task flowcharts and timelines for work products, retention file checklists, and job aids that outline DRR resolution staff responsibilities, job roles, and tasks to be performed.

Further, DRR's Receivership Oversight staff is preparing to close the institution. One of DRR's pre-determined closing teams is designated for the problem bank. A Resolutions Coordinator and/or Receiver-in-Charge is identified as DRR's coordination focal point. This DRR official is responsible for preparing a Strategic Resolution Plan (SRP)[5] for each failing institution. To prepare for the actual closing effort in accordance with the guidelines in DRR's *Failed Financial Institution Closing Manual*, DRR planning meetings are held with all pertinent DRR staff. After an institution is closed, Asset Management manages the sale of the remaining institution assets.

[5] The SRP is a DRR inter-divisional coordination plan, which serves as the catalyst for communicating, planning, and reporting bank failure activities. Usually within 90 days after the institution's failure, the SRP will be replaced by a Receivership Business Plan.