

**Clarification on the Responsibilities of the Board of Directors February 26, 2021:** As described in SR letter 21-4 / CA letter 21-2, “Inactive or Revised SR Letters Related to Federal Reserve Expectations for Boards of Directors,” this SR letter was revised as of February 26, 2021 to better reflect the Federal Reserve’s guidance for boards of directors in SR letter 21-3 / CA letter 21-1, “Supervisory Guidance on Board of Directors’ Effectiveness,” and SR letter 16-11, “Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$100 Billion.” No other material changes were made to this letter.

## **Attachment A**

### **Disposal of Problem Assets through Exchanges**

#### **Background**

Deterioration in asset quality arising from weak economic conditions over the past several years has led to an increase in the levels of nonperforming assets and other real estate owned (OREO) (collectively, problem assets). In the recent past, examiners have encountered situations where institutions, especially smaller institutions, were considering or structuring transactions to reduce the volume of problem assets.

In some instances, referred to in this guidance as “asset exchanges,” third parties or marketing agents have offered to purchase problem assets from institutions and replace them with performing assets, which would help institutions diversify their loan portfolios. Institutions perceived that asset exchange transactions offered the potential to increase interest income, reduce the level of real estate concentrations, enhance liquidity, and reduce the stress on capital. Nevertheless, these transactions may pose significant risks. In some of these transactions, sellers have exchanged problem assets for purportedly performing assets (acquired assets) that were recorded at values in excess of fair value.

Attachment B of this guidance offers a detailed example of such an asset exchange transaction. The risks involved in these activities, the risk management considerations for institutions, and the supervisory considerations for examiners when faced with these transactions are outlined below.

#### **Risk management considerations**

Asset exchanges may expose institutions to significant risks, which management should assess before entering into such transactions. Management should focus not only on the immediate or short-term benefits of a transaction, but should determine its long-term effect on the institution’s balance sheet and loss exposure. Management should also determine how these risks align with the institution’s overall risk management strategy.

In undertaking due diligence on these types of transactions, management should assess the risks and provide evidence of its analysis, taking into account:

- The reported benefits to the institution from the transfer. This assessment should address whether the transaction would actually enable the institution to transfer significant risk associated with the problem assets.
- The economic costs and benefits of the transaction. This should include the economic benefits accruing to the marketing agent; the marketing agent's responsibilities and liabilities; and the loss position, including recourse, of each participant if either the ceded assets or acquired assets do not perform as anticipated.
- The servicing responsibilities attached to the acquired assets. If the institution assumes servicing responsibilities for the acquired assets, the institution should evaluate and show evidence that it has the capacity and infrastructure in place, as well as appropriate risk controls, to service the acquired assets.
- The transaction's compliance with the firm's risk tolerance and risk mitigation policies, including the overall strategy for managing or reducing problem assets.
- The appropriate accounting treatment in accordance with U.S. generally accepted accounting principles (GAAP). Specific issues with regard to the appropriate accounting treatment include, but are not limited to, the following:
  - When specific loans are identified for inclusion in exchange transactions and the institution decides to sell the loans, they should be transferred to a "held-for-sale" account at the lower of cost or fair value with losses recognized through earnings. Any reduction in value should be reflected as a write-down of the recorded investment resulting in a new cost basis. The sale of these loans should occur at an appropriate fair value.
  - Newly acquired assets should be recorded at an appropriate fair value.
- A review of the marketing agent. This should include, but not be limited to, an assessment of the agent's financial strength, including its ability to provide credit enhancement if it is required in the transaction.
- The relationship between the marketing agent and any entity providing services for the transaction, with particular attention paid to possible cross-ownership or other related-party relationships.
- An independent valuation by a reputable and experienced third-party valuation expert of the assets being acquired. The party that performs the valuation should be independent of the marketing agent and the institution selling the performing assets. The use of outside resources does not relieve management of its responsibility to ensure that fair value estimates are measured in accordance with GAAP.<sup>1</sup> Management should sufficiently understand the bases for the measurement and valuation techniques used by outside

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<sup>1</sup> Fair value measurements are determined based on assumptions that market participants would use in valuing the assets. This should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows.

parties to determine the appropriateness of these techniques, the underlying inputs and assumptions, and the resulting fair value measurements.<sup>2</sup>

- The acquiring institution's experience, skills, personnel, and risk management capabilities to manage the newly acquired assets, especially if the assets are in business segments or geographical areas that are different from the institution's own.

### **Supervisory responsibilities**

While it is not necessary to scope a specific review of these transactions into routine examination and inspection activities, particularly where there is no evidence that a bank has engaged in such transactions, Reserve Banks nevertheless should be aware of indications of possible asset exchange transactions as part of their routine monitoring of financial institutions between examinations. Examiners should hold ongoing discussions with an institution's management as part of the supervision process if examiners become aware that the institution is considering these types of transactions. Monitoring activities should focus on financial statement changes commonly associated with asset exchanges, internal risk management reports, and other documents received on a routine basis. Indicators that asset exchanges might have taken place include:

- Asset sales at (or very near) book values, with either no loss recognized, or a gain on recovery of a prior write-down recognized. It is unusual for a third party to buy problem assets at higher than the selling institution's book value at the time of the sale.
- Board or management discussion of strategies designed to achieve material reductions in problem assets.
- Material loan sales and purchases involving the same counterparty, on or around the same date.
- Significant reductions in the institution's nonperforming loan totals without attendant losses. The motivation for asset exchanges is to reduce problem assets, but this may be difficult to do in the current economic environment without realizing significant losses.
- Purchase of a large portfolio of loans that are outside the institution's traditional markets and/or are inconsistent with the institution's business strategies or lending and investment policies.
- Purchase at (or near) par of a large portfolio of loans that, while currently performing, have high-risk characteristics (e.g., are outside generally accepted underwriting standards for this type of credit) that indicate they may not continue to perform in accordance with their contractual terms.
- Large net loan or asset growth during a short period. Because asset exchanges nearly always involve an institution purchasing more assets than it is selling, it is common for the balance sheet to grow rapidly as a result of the asset exchange transaction.

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<sup>2</sup> Examples of significant inputs and assumptions include, but are not limited to, default probabilities, current loan-to-value ratios, loss severities, and prepayment speeds.

## **Supervisory actions**

If examiners observe an institution engaging in asset exchanges, they should determine whether the appropriate risk management measures have been considered and management has used appropriate valuations in accordance with GAAP. Important findings should be noted in the examination/inspection report and, as appropriate, plans for remedial action discussed with management. Given the concern regarding both safety-and-soundness issues as well as the appropriate valuation practices, Reserve Banks should contact the appropriate Board staff analyst to discuss the asset exchange transaction.