POLICY STATEMENT
TRANSACTIONS INVOLVING NONCASH CONSIDERATIONS

PURPOSE: To provide policy guidance with respect to the sale of Covered Assets in which consideration other than cash is received.

INTRODUCTION: Since all-cash transactions minimize future financial exposure to the FSLIC Resolution Fund (FRF), cash transactions are preferred over seller financing transactions. Nevertheless, due to the depressed nature of the real estate market in many sectors of the country and competition for third-party financing resulting from large foreclosed real estate portfolios, seller financing is sometimes necessary to achieve maximum values on the disposition of many Covered Assets. Additionally, factors such as the reduction in the universe of lenders for most commercial type properties as a result of the capital requirements of FIRREA and the poor quality of certain properties have contributed to the need for Acquiring Associations to consider and evaluate purchase offers that include seller financing. Accordingly, most Assistance Agreements require the Acquiring Association to offer financing in connection with the marketing of Covered Assets to assure that Covered Assets are liquidated in a manner that maximizes the values of the assets while minimizing losses to the FRF.

In many instances the consideration received upon the sale of a Covered Asset will include a note from the purchaser in addition to cash. In some instances, other forms of noncash consideration may be received. Under most Assistance Agreements, such notes or other noncash consideration can themselves be treated as Covered Assets.

In cases in which a note or other noncash consideration is received upon the disposition of a Covered Asset and, such consideration itself becomes a Covered Asset, three separate questions arise under the typical Assistance Agreement:

1. Does such a transaction qualify as a sale within the meaning of the Liquidation provision of the Assistance Agreement so as to give rise to a "Covered Asset Loss" or "Covered Asset Recovery" and a potential "Gain Share Payment" or "Loss Sharing"?

2. If the transaction does constitute a Liquidation, at what value is the noncash consideration to be taken into account in determining whether the transaction should be consummated, and in calculating the Covered Asset Loss or Covered Asset Recovery?

3. If the noncash consideration is itself to be a Covered Asset, what effect does that have on the payment of Gain Share or Loss Sharing?

Many Assistance Agreements have similar provisions dealing with Covered Asset Losses, Covered Asset Recoveries, Gain Sharing and Loss Sharing. This policy assumes that they are all consistent with the description below. However, each Agreement must be reviewed to determine that the analysis reflected herein is applicable to the particular Agreement.

<u>POLICY</u>:

1. <u>CHARACTERIZATION AS A LIQUIDATION OF A TRANSACTION IN WHICH NONCASH CONSIDERATION IS RECEIVED</u>

Under most Assistance Agreements, an Acquiring Association can debit the Special Reserve Account for a Covered Asset Loss if such loss results from a Liquidation of a Covered Asset. A Liquidation of a Covered Asset is normally defined to be a sale of the asset; thus, in order to constitute a Liquidation, a Covered Asset must be sold. The requirement of a sale was intended to require a disposition of a Covered Asset to a third party.

If the consideration received for the Covered Asset in the transaction is other than cash, and will itself become a Covered Asset under the provisions of the Assistance Agreement, the transaction may not constitute a sale, but merely an exchange of one Covered Asset for another. In order to constitute a sale, a significant cash payment must be received in addition to any noncash consideration. As a matter of policy, the FDIC will operate on the <u>general rule</u> that in order for a transaction involving a Covered Asset to be considered a sale and, therefore, a Liquidation within the meaning of the Assistance Agreement, at least 20% of the total consideration to be received for such Asset must be cash. <u>This is only a general rule and exceptions may be made on a case-by-case basis.</u> Exceptions should be isolated and infrequent transactions that are justified by facts peculiar to the particular situation.

2. <u>VALUATION OF NONCASH CONSIDERATION FOR DETERMINING APPROVAL OF TRANSACTIONS AND THE AMOUNT OF A COVERED ASSET LOSS OR COVERED ASSET RECOVERY.</u>

The FDIC considers the independent valuation (e.g., the appraisal) of the Covered Asset, or of the underlying collateral in the case of loans, to represent the Covered Asset's present <u>cash equivalent value</u>. Asset plans for the disposition of Covered Assets generally utilize appraised value in establishing an acceptable sales price and, therefore, such sales price, regardless of terms, should compare favorably to the appraised value. In any disposition of a Covered Asset, FDIC would expect that the total consideration to be received has a cash value at least equal to the minimum sales price. If the consideration to be received includes noncash consideration, such consideration must be valued on a cash equivalent basis to determine whether cash value equal to the minimum sales price has been received.

By far, the most common noncash consideration likely to be received upon the disposition of a Covered Asset is a Loan to Facilitate provided by the Acquiring Association. The cash value of such a Loan to Facilitate is equal to the present value of the cash flows to be generated by such Loan. In determining the present value of such cash flows, a market discount rate should be used. That rate should be determined by taking into account all relevant factors, including, but not limited to, prevailing interest rates, loan to value ratio, type of asset, market conditions, assumability and subordination. In some cases, a true market discount rate would be so high that a disposition cannot be effectuated. In such cases, the advisability of the transaction should be reconsidered. If it is nevertheless determined that the transaction should be consummated, judgment must be used to determine a fair discount rate. However, in no event should the discount rate be less than the FDIC's cost to carry the Covered Asset. In most cases, the cost to carry will be equal to the Guaranteed Yield Rate applicable at the time of the transaction as set forth in the Assistance Agreement.

In any event, if a Loan to Facilitate the sale of a Covered Asset is to be made by an Acquiring Association on sub-market terms, the stated sales price must exceed the minimum sales price set for the Covered Asset by an amount such that the cash equivalent of the Loan to Facilitate, when added to the cash to be received, will at least equal the minimum sales price.

To illustrate, assume the following facts:

• Book Value	$ 14,200,000
• Appraised Value	$ 11,500,000
• Minimum Sales Price	$ 11,000,000
• Terms of Sale:	
Gross Sales Price	$ 11,600,000
Cash Down Payment	$ 3,600,000
Face Amount of Loan to Facilitate	$ 8,000,000

. Terms of Loan:

Term	5 Years
Interest Rate	10% Fixed
Payment Date	Interest only due monthly; principal ballon payment at end of 5 years
Guarantor	None; non-recourse loan

. Assumed "Market" Interest Rate	11.5%
. NPV of Interest Payments @ 11.5%	$ 3,031,337
. NPV of Principal Payment @ 11.5%	4,642,112
. NPV of Loan	7,673,449
. NPV of Cash Down Payment	3,600,000
. Gross Proceeds from Sale	$ 11,273,449

Since the net present value of the cash flows of $11,273,000 exceeds the minimum sales price of $11,000,000, this transaction would come within the guidelines outlined above and would be considered favorably by the FDIC.

Conversely, if the asset was offered for sale at the appraised value of $11,500,000, the transaction would not be within the guidelines and would require additional justification.

This discounted cash flow analysis is applicable to whatever type of loan that is made. Payments under the loan should be scheduled by payment date and then discounted back at the market discount rate.

Transactions meeting these guidelines will <u>NOT</u> receive automatic approval. Each case will be decided upon its own merits. Nevertheless, for those transactions that do fall within the guidelines, the Acquiring Association can be confident that the transaction will not be rejected solely on the grounds that terms of the Loan to Facilitate are not satisfactory to the FDIC. Similarly, those transactions that fail to meet the guidelines will not be automatically rejected, but it is incumbent upon the Acquiring Association to justify the deviation.

For those approved transactions that qualify as Liquidations under the above guidelines, the same discounted present value will be used to determine the amount of Covered Asset Loss or Covered Asset Recovery realized upon the disposition of a particular Covered Asset. Under most, if not all Assistance Agreements, a Covered Asset Loss or Covered Asset Recovery is measured by the proceeds received upon Liquidation of the Asset. The term "proceeds" is not further defined, but can only mean cash equivalent value. Accordingly, for such purposes, the gross proceeds received will be equal to the sum of the cash received, plus the discounted present value of any other noncash consideration received. Under the illustration above, the Covered Asset Loss would equal $2,926,551.

If a Loan to Facilitate itself becomes a Covered Asset, its Book Value will be equal to the discounted present value of its cash flows, not its face amount, and its actual yield rate will be equal to the discount rate utilized in determining that value, not its coupon rate.

3. EFFECT OF TREATMENT OF NONCASH CONSIDERATION ON THE PAYMENT OF GAIN SHARE.

As an incentive for the Acquiring Association to maximize the value received upon the disposition of Covered Assets, and thereby minimize cost to the FDIC, many of the Assistance Agreements negotiated in 1988 contain provisions for Gain Sharing. These provisions permit the Acquiring Association to debit the Special Reserve Account for a percentage share of that portion of the net proceeds from the sale of a Covered Asset which exceeds a certain bench mark amount. This payment is independent of any debit for a Covered Asset Loss realized upon the sale.

Gain Share will also be calculated using the discounted cash flow principles set forth herein. To illustrate, assume in the above illustration that the Acquiring Association is entitled to 10% of that portion of the net proceeds received from disposition of the Covered Asset in excess of 75% of its Book Value. The Acquiring Association's Gain Share amount would be calculated as follows:

. Proceeds from sale (NPV)	$ 11,273,449
. Bench Mark Value (75% of $14,200,000)	10,650,000
. Excess Subject to Gain Share	$ 623,449
. Acquiring Association's Share (10%)	$ 62,345

The purpose of paying Gain Share is to provide an incentive to the Acquiring Association to maximize the value realized from a disposition of a Covered Asset and thereby minimize cost to the FDIC. Therfore, if the disposition involves a loan from the Acquiring Association that itself becomes a Covered Asset, the disposition only reduces FDIC's cost to the extent the terms of the loan are sufficient to cover the cost to carry the loan, and the loan is paid according to its terms. Thus, if the loan subsequently goes into default and a loss is suffered on its Liquidation, the Gain previously calculated was not, in fact, realized. Accordingly, any Gain Share paid must be subject to recapture to the extent that the full value of the new loan is not fully realized. This is especially true with respect to non-recourse loans where the lender must look solely to the security property for repayment of the debt.

To illustrate, assume that in the above example all interest is paid, but the principal of the loan is not paid at the end of year 5 when due. Assume further that negotiations result in the transfer of the asset to a new purchaser for cash of $4,400,000 which is received at the end of year 6, one year after the loan principal was due and payable. Assume the $4,400,000 had a discounted present value on the date when the loan principal was due of $4,000,000. Under this scenario, the Acquiring Association only received proceeds from the sale of the original Covered Asset as follows:

.	NPV of Interest Payments	$ 3,031,337
.	NPV of Down Payment	3,600,000
.	NPV of Final Cash	4,000,000
		$ 10,631,337

Since the $10,631,337 is less than the bench mark value of $10,650,000, no amount is subject to Gain Share and the Acquiring Association must credit back the $62,345 previously received. In contrast, if the net present value of the cash received had been $4,068,663, then the total net present value realized would have been $10,700,000 and a Gain Share of $5,000 [10% x ($10,700,000 - $10,650,000)] would have been earned. In this event, a net $57,345 should have been credited back.

Thus, in cases in which the proceeds received upon the disposition of a Covered Asset includes a loan made by the Acquiring Association that is itself a Covered Asset, although Gain Share may be paid at the time of the transaction, such payment is subject to repayment in the event the loan is not paid off according to its terms. Moreover, because it is highly likely that if such a loan becomes delinquent, it will not result in the Acquiring Association receiving the cash equivalent value assumed, any Gain Share paid should be credited back in full <u>immediately</u> upon default as that term is defined in the loan documents.

With respect to those Assistance Agreements that contain provisions for Loss Sharing, the Gain Sharing principles discussed above would apply.