



FDIC New York Region Regulatory Teleconference: Loan Participations

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LOAN PARTICIPATIONS

- Overview and Definitions
- Bank and Examination Perspectives
- Accounting Considerations

Questions may be e-mailed to: NYCalls@FDIC.gov

LOAN PARTICIPATIONS

Overview

Definition of Loan Participation

An arrangement under which a lender originates a loan to a borrower and then sells a portion of that loan to one or more other banks.

The lead (originating) bank retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants.

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Overview

Types or Levels of participation

Participation —

- Separate and distinct contracts between the borrower and the lead bank, and between the lead and buying banks.

Syndication —

- A single contract among the borrower, the lead lender, and all the syndicate members.

Assignment —

- Outright transfer of all rights and obligations of the seller to the buyer.

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Bank Perspective

Rationale for involvement —

- Participating banks are able to compensate for low loan demand or invest in large loans without servicing burdens and origination costs. Selling banks can accommodate a larger credit while mitigating some of the risk.

Pitfalls —

- If not appropriately structured and documented, a participation loan can present unwarranted risks to both the seller and purchaser of the loan.

Examination emphasis —

- Examiners routinely determine the nature and adequacy of the participation arrangement as well as analyze the credit quality of the loan.

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Bank Perspective

Benefits for the:

Lead bank —

- Helps to satisfy lending needs of its business customers without exceeding its lending limits
- Enables greater risk diversification
- Enhances liquidity

Participating bank —

- Helps supplement the loan portfolio when local loan demand is low
- May invest in large loans without servicing burdens and origination costs
- May provide diversification (geographic, business sector, product type)

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Bank Perspective

Roles and Responsibilities

Of the Lead/Selling Bank—

- Originates the credit and opts to sell some or all
 - Holds loan documentation in its own name (a participation)
 - Or legally transfers the note and lien to the buyer (an assignment)
- Draws up participation (or sale) agreement
- Services the loan
 - Disburses payments to participating banks
 - Throughout life of loan, passes along borrower's credit and financial information to participating banks

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Bank Perspective

Roles and Responsibilities

For the Purchasing Bank —

- Determine if loan participation fits the bank's loan criteria
 - Conduct an independent credit analysis of borrower
 - Analyzes the value and lien status of the collateral
- Maintain full credit information on the borrower during the term of the loan
 - Including its own assessment of credit quality
- Agree to terms of participation contract
- Receive documentation assigning an interest in the loan and related collateral, either in
 - participation contract or
 - legal transfer of title (a sale and assignment)

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Bank Perspective

Roles and Responsibilities

Potential Pitfalls —

- Failure to properly underwrite and retain documentary evidence
- Failure to adhere to the terms of the participation contract
 - Not obtaining and forwarding operating statements
 - Not forwarding appropriate payments or payment information
- Out of area exposure
- Out of policy
 - New line of business; new loan product

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Bank Perspective

Roles and Responsibilities

Proper and documented credit analysis—

The Five “P”s

- People
- Purpose
- Payment
- Protection
- Perspective

The Five “C”s

- Character
- Capacity
- Capital
- Collateral
- Conditions

Not theirs. Yours.

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Examination Perspective

Examination Review of a Loan Participation

For any and all banks —

- Identify the loan as a participation
 - Determine whether bank is the lead or participating bank

- Review the credit quality and assign a classification

- Review participation agreement
 - Determine whether roles and responsibilities as seller or as buyer are being properly fulfilled.

LOAN PARTICIPATIONS

Examination Perspective

Examination Review of a Loan Participation

At the Purchasing Bank —

- Does the bank have copies of all relevant documents to properly support the lending decision?
- Does the loan participation conform with the loan policy?
(If its not in your policy, examiners consider it an unmanaged risk.)
- Has the bank continued to monitor loan performance?
- Is the bank monitoring conformance to the participation agreement?
 - Are there oversight weaknesses that require management's attention?

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Examination Perspective

Examination Review of a Loan Participation

For the selling bank —

- What is the internal assessment of credit quality?
- Have facts and concerns relative to the loan been communicated to the participating bank(s)
- Are there servicing weaknesses requiring management's attention?
 - Failure to fulfill servicing obligations place the selling bank at risk.
- Does participation qualify as a sale, or must it be accounted for as a secured borrowing?
(more on proper accounting treatment later)

LOAN PARTICIPATIONS

Examination Perspective

Participation Agreements need to address:

- The obligation of the lead bank to furnish timely credit information and to provide notification of material changes in the borrower's status;
- Requirements that the lead bank consult with participants prior to modifying any loan, guaranty, or security agreements and before taking any action on defaulted loans;
- The specific rights and remedies available to the lead and participating banks upon default of the borrower;

LOAN PARTICIPATIONS

Examination Perspective

Participation Agreements considerations (continued):

- Resolution procedures when the lead and participating banks cannot agree on the handling of a defaulted loan;
- Resolution of any potential conflicts between the lead bank and participants in the event that more than one loan to the borrower defaults; and
- Provisions for terminating the agency relationship between the lead and participating banks upon such events as insolvency, breach of duty, negligence, or misappropriation by one of the parties.

Accounting Update

Loan Participation Accounting

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Accounting Update

- ASC Topic 860 (formerly FASB 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140*), *Transfers and Servicing* (ASC 860)
 - Effective as of beginning of an entity's first annual reporting period that begins after 11/15/09
 - 1/1/10 for calendar year banks
 - Recognition and measurement provisions must be applied to transfers on or after the effective date

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Accounting Update

- ASC 860/FAS 166 modified the financial components approach in FAS 140
 - Limits the circumstances in which a portion of a financial asset is eligible for derecognition
 - Transfers of portions of financial assets are eligible for derecognition only if the transferred portions mirror the characteristics of the original financial asset
 - Introduces concept of a “participating interest” for transfers of portions of an entire financial asset

LOAN PARTICIPATIONS

Accounting Update

- A participating interest has all of the following characteristics
 - Represents a proportionate (pro rata) ownership interest in an entire financial asset
 - All cash flows received from entire asset (except any allocated as compensation for services performed provided certain conditions are met) must be divided among participating interest holders in proportion to their shares of ownership
 - No interest is subordinated to another interest and no participating interest holder has recourse to another
 - No party has right to pledge or exchange entire asset unless all participating interest holders agree

LOAN PARTICIPATIONS

Accounting Update

- Compensation for services performed
 - Must not be subordinated
 - Must not significantly exceed amount that would fairly compensate a substitute service provider should one be required

- If transfer of a portion of an entire financial asset does not meet definition of a participating interest
 - Both lead lender transferring the participation and the party acquiring the participation must account for the transaction as a secured borrowing with a pledge of collateral

LOAN PARTICIPATIONS

Accounting Update

- If transfer of a portion of an entire financial asset meets the definition of a participating interest
 - Transferor (normally lead lender) must evaluate whether the transfer meets all of the conditions for derecognition in ASC 860
 - Isolation of transferred assets from the transferor
 - Transferee has right to pledge or exchange the assets received
 - Transferor does not maintain effective control over the transferred assets
 - If all conditions are met, account for transfer as a sale

LOAN PARTICIPATIONS

Accounting Update

- Conditions that do not constrain transferee's (participating bank's) right to pledge or exchange participating interest received
 - Requirement to obtain transferor's (lead bank's) permission to sell or pledge that is not to be unreasonably withheld
 - Prohibition on sale to transferor's competitor if other potential willing buyers exist
 - Illiquidity, e.g., absence of an active market

LOAN PARTICIPATIONS

Accounting Update

- Transferor (lead bank) maintains effective control over transferred participating interest
 - When transferor has unilateral ability to cause holder to return specific financial asset and that ability provides more than a trivial benefit to the transferor
 - A call or other right conveys more than a trivial benefit if the price to be paid is fixed, determinable, or otherwise potentially advantageous, unless price is so far out of money that option will not be exercised
 - When transferor reserves right to call at any time and can enforce call by cutting off flow of interest to holder at the call date

LOAN PARTICIPATIONS

Accounting Update

- Transferor's accounting for a transfer of a participating interest that qualifies as a sale
 - Allocate previous carrying amount of entire financial asset between participating interests sold and retained on basis of relative fair values at transfer date
 - Derecognize participating interests sold
 - Recognize and initially measure at fair value servicing assets/liabilities and any other assets obtained or liabilities incurred
 - Recognize gain or loss on sale in earnings
 - Report any retained participating interest at difference between previous carrying amount of entire asset and amount derecognized

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Accounting Update

- “Last-in, first out” (LIFO) and “first-in, first out” (FIFO) participations
 - Do not meet definition of participating interest because all principal cash flows collected on the loan are paid first to one of the parties, not proportionately
 - Transfers on or after effective date of FAS 166 (1/1/10 for calendar year banks) do not qualify as sales, must be reported as secured borrowings
 - Transfers before effective date of ASC 860 not affected
 - If transfer qualified as a sale, it continues to be reported as a sale

LOAN PARTICIPATIONS

Accounting Update

- Participations in lines of credit and loans with multiple advances (e.g., construction loans)
 - If an advance is transferred in its entirety, it would be a separate unit of account if it retains its identity and does not become part of a larger loan balance
 - If an advance is transferred in its entirety, but loses its identity and becomes part of a larger loan balance, transfer would be eligible for sale accounting only if
 - Transferor does not retain any interest in the larger balance or
 - Transferor's interest in larger balance meets definition of a participating interest

LOAN PARTICIPATIONS

Accounting Update

- Participations in lines of credit and loans with multiple advances (e.g., construction loans)
 - If only a portion of advance that has lost its identity is transferred, portion of entire loan transferred and other portion of entire loan must meet definition of a participating interest in order to evaluate whether transfer qualifies for sale accounting
 - See FAS 140, paragraph 26C(c), as amended by FAS 166 (ASC 860-10-55-17H)

LOAN PARTICIPATIONS

Accounting Update

- Participations in lines of credit and loans with multiple advances (e.g., construction loans)
 - Accounting under ASC 860 is based on the date that a participation is transferred, not the date of loan agreement or participation agreement
 - For a calendar year bank, even if loan agreement or participation agreement was entered into before 2010, when all or a portion of an advance that has lost its identity is transferred in 2010 or thereafter, portion of entire loan transferred and other portion of entire loan must meet definition of a participating interest in order to evaluate whether transfer qualifies for sale accounting

LOAN PARTICIPATIONS

Accounting Update

- Transfers of guaranteed portions of SBA loans
 - If guaranteed portion is transferred at par and “seller” agrees to pass interest through to “purchaser” at less than contractual interest rate and spread between contractual rate and pass-through interest rate significantly exceeds amount that would fairly compensate a substitute servicer, excess spread is an interest-only strip
 - Existence of interest-only strip results in disproportionate sharing of cash flows, so guaranteed and unguaranteed portions do not meet the definition of a participating interest
 - Transfer of guaranteed portion must be accounted for as a secured borrowing

LOAN PARTICIPATIONS

Accounting Update

Example 1

- On 7/1/09, Bank A originates a \$500,000 loan and also enters into a LIFO participation agreement with Bank B for 25% of the loan balance, which it transfers to Bank B in a transaction that qualifies as a sale under FAS 140
- On 3/1/10, Bank A transfers a 20% interest in its share of the loan to Bank C
 - This transfer does not affect the accounting for the LIFO participation transferred to Bank B on 7/1/09 because the transfer to Bank B predated the effective date of ASC 860/FAS 166
 - The transfer to Bank C cannot be accounted for as a sale because Bank A's interests in the entire financial asset (the \$500,000 loan) held initially and subsequently do not meet the definition of a participating interest

LOAN PARTICIPATIONS

Accounting Update

Example 2

- As of 12/31/09, Bank D has an outstanding construction loan commitment for \$500,000 under which \$400,000 has been advanced. Because Bank D's legal lending limit is \$400,000, it entered into a LIFO loan participation agreement with Bank E when commitment was originated in 2009. Bank E will fund the final \$100,000 in advances.
- On 2/1/10, borrower requests a \$50,000 advance, which in effect Bank E fully funds
 - The transfer of the \$50,000 advance would mean that neither Bank D's nor Bank E's interest in the construction loan meets the definition of a participating interest
 - The transfer of the \$50,000 participation should be reported as a secured borrowing

LOAN PARTICIPATIONS

Accounting Update

Example 3

- On 2/15/10, Bank F has a legal lending limit of \$100,000 and enters into two loan agreements with a borrower
- The first agreement is for \$80,000 and requires quarterly principal payments of \$20,000 beginning in three months, which it transfers to Bank G
- The second agreement is for \$100,000 and also requires quarterly principal payments of \$20,000, but the first payment is due in 15 months, which Bank F retains
- Both loans have 4% interest rate payable quarterly

LOAN PARTICIPATIONS

Accounting Update

Example 3 (cont'd)

- In evaluating a transfer, ASC 860 requires consideration of all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer
 - Considering the two loans together as an entire financial asset, cash flows received are not divided proportionately and therefore the two loans do not meet the definition of a participating interest
 - The transfer of the \$80,000 loan should be reported as a secured borrowing

LOAN PARTICIPATIONS

Accounting Update

Example 4

- On 1/15/08, Bank H originates a \$1,000,000 loan and also enters into a LIFO participation agreement with Bank J for 20% of the loan balance, which it transfers to Bank J in a transaction that qualifies as a sale under FAS 140
- The loan matures on 1/15/10 and Banks H and J agree to extend the loan and make other changes to the loan agreement
- How do the extension and the other changes affect the accounting for the participation transferred to Bank J?
 - Depends on whether the extended loan is treated as a new loan or a continuation of the old loan

LOAN PARTICIPATIONS

Accounting Update

Example 4 (cont'd)

- “If the terms of the new loan resulting from a loan refinancing or restructuring other than a troubled debt restructuring are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan shall be accounted for as a new loan. This condition would be met if the new loan's effective yield is at least equal to the effective yield for such loans and modifications of the original debt instrument are more than minor.” (FAS 91, paragraph 12; ASC 310-20-35-9)
- If the extended loan is a new loan and the participation remains a LIFO participation, the participation would not meet the definition of a participating interest and it should be reported as a secured borrowing
- If the extended loan is a continuation of the old loan, there is no new transfer to evaluate

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Accounting Update

- Reporting in Call Report by lead lender for participations that are secured borrowings
 - Report transferred participation, as well as retained portion, i.e., entire loan, as a loan asset
 - Normally in Schedule RC, item 4.b, “Loans and leases, net of unearned income,” and in appropriate loan category in Schedule RC-C, part I, Loans and Leases
 - Include interest income on both portions in Schedule RI, item 1.a
 - Include in risk-weighted assets in Schedule RC-R
 - Include in loan and lease portfolio for purposes of determining allowance for loan and lease losses

LOAN PARTICIPATIONS

Accounting Update

- Reporting in Call Report by lead lender for participations that are secured borrowings
 - Report transferred participation as a secured borrowing (liability)
 - Schedule RC, item 16, “Other borrowed money”
 - Appropriate subitem(s) of Schedule RC-M, item 5.b, “Other borrowings”
 - Schedule RC-M, item 10.b, “Amount of ‘Other borrowings’ that are secured”
 - Schedule RC-C, part I, Memorandum item 14, “Pledged loans and leases”
 - Include interest expense in Schedule RI, item 2.c

LOAN PARTICIPATIONS

Accounting Update

- Reporting in Call Report by participating bank for participations that are secured borrowings
 - Normally report acquired participation in Schedule RC, item 4.b, “Loans and leases, net of unearned income”
 - Report in Schedule RC-C, part I, Loans and Leases, in the loan category appropriate to the underlying loan, not as a loan to the lead lender
 - Include in loan and lease portfolio for purposes of determining allowance for loan and lease losses
 - In Schedule RC-R, assign acquired participation to risk-weight category appropriate to underlying borrower or, if relevant, guarantor or nature of collateral

LOAN PARTICIPATIONS

**Overview, Bank and Exam Perspectives,
Accounting Considerations**

Questions?

Via voice



OR

NYCalls@FDIC.gov

Email





Industry Call-In

New York Region

April 4, 2013



Thank You for Participating.

LOAN PARTICIPATIONS

Resource Links:

- FIL 38-2012 Effective Credit Risk Management Practices for Purchased Loan Participations

<http://www.fdic.gov/news/news/financial/2012/fil12038.html#cont>

- FIL 44-2008 Guidance For Managing Third-Party Risk

<http://www.fdic.gov/news/news/financial/2008/fil08044a.pdf>

- Risk Management Manual of Examination Policies, Section 3.2, Loans

<http://www.fdic.gov/regulations/safety/manual/section3-2.html#syndicated>