Current Issues in Loan Participation

Related Industries

Financial Institutions

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Recent regulatory actions impacting buyers and sellers of loan participation interests should prompt institutions to review their policies and procedures for such activities, and take whatever actions may be appropriate in light of their particular situation. While not raising new issues relating to the proper purchase, sale and accounting for participation interests, the regulatory actions serve to remind institutions that use of loan participations requires careful consideration and should not be engaged in lightly without understanding the potential impact on buying and selling institutions.

Buyer Beware

Purchasers of participations should be aware that the FDIC on September 12, 2012, issued FIL-38-2012 providing guidance on "Effective Credit Risk Management Practices for Purchased Loan Participations." While the FDIC recognizes the importance of loan participations to growth and earnings goals, risk diversification and effective use of excess capital, it cautions against excessive dependence or reliance on originating or lead institutions without adequate independent due diligence and underwriting by the purchaser of the participation.

In the advisory, the FDIC covers a number of items related to the importance of effective loan participation management over the life of the loan. These items include establishing and following loan policy guidelines for participations, careful crafting ofparticipation agreements, conducting independent credit and collateral analysis, and carrying out due diligence and monitoring participations, especially in unfamiliar and out-of-market situations.

Seller Beware

In recent examinations of sellers of participation interests, regulators have identified issues arising from the existence of "optionality" provisions in participation agreements that provide the originating

lender with the option of repurchasing the participated portion of the loan upon a borrower default. Such "optionality" provisions have been determined to cause the interest sold by the originating lender to be classified as a "secured borrowing" rather than constituting a "true sale" of the participation interest under applicable accounting guidance.

In circumstances where the interests may be inappropriately categorized in call reports and other financial filings, regulatory agencies and accountants may, depending on materiality, also require participation originators to file restated call reports to reflect the change in classification if appropriate. Call report restatements can, in turn, lead to a determination that the financial statements included in filings made by publicly traded financial institutions and financial holding companies with the Securities and Exchange Commission and/or state securities regulators, or in registration statements made available to potential investors in connection with pending offerings, must be restated and the related securities filings amended.

Reclassifying the participation interest as a "secured borrowing" by the originating lender may also result in "loan to one borrower" (LTOB) issues as well as, in some instances, Reg O issues depending on the nature of the credit, the impact of aggregation rules, and nature of the borrower. Regulatory capital ratios and ALLL issues may also be impacted. The Ohio Division of Financial Institutions (ODFI) has issued guidance for Ohio-chartered institutions clarifying that LTOB issues for Ohio banks remain governed by Ohio law and ODFI Rule 1301:1-3-01(A)(10)(b)(vi)(a) and analysis of whether credit risk has been effectively transferred to the acquiring institution for purposes of LTOB restrictions.

Covered individuals employed at institutions participating in federal programs and initiatives such as SPLF and TARP may also be impacted by restated financial results that, in turn, impact compensation previously earned and received (i.e. through a mandatory "clawback"). In addition, originating institutions with participation interests that are held by the FDIC as receiver for a failed institution may, due to the failed institution's circumstances, be forced to accept significantly reduced loan settlement payments as a result of the failure of the FDIC to recognize the "optionality" provision.

Originating institutions should consult with legal, accounting and credit professionals to evaluate whether it may be appropriate or feasible to amend existing participation agreements, as well as future participation agreements, to eliminate "optionality" provisions that afford a repurchase option for the originator. However, even if amendments are adopted with regard to outstanding participations, agencies may still require reclassification and restatement with respect to the related participations by the originating institution.

Summary

Loan participations have been (and remain) a viable method of allocating credit risk and continue to be a viable source of income and credit management for lending institutions. However, careful attention should be given to structuring and reporting participations as well as to securing an independent credit analysis and credit risk assessment before purchasing, and in ongoing management of, participation relationships.