Loan Participations

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The 2007-2010 period illustrated that lenders must use greater care when selling or purchasing participating interests in loans, if they are to achieve their business goals.

Originators and sellers of loans may desire to reduce their exposure to a single borrower, industry or geography, or they may, on occasion, find that the transaction may be structured to generate either sale or servicing fee income. Sale of participations also allows lenders to maintain relationships with business customers by satisfying their lending needs without exceeding legal lending limits. Buyers may view the purchase of participating interests from an originating lender to be a cost-effective means of increasing outstanding loans and compensating for low loan demand locally, as well as a method to manage borrower, industry and geographic risk. Presumably, both the originator/seller and the purchaser of the participating interest desire the transaction to be a "true sale" of the participating interest in the loan.

What follows is a short checklist of considerations which both loan sellers and purchasers should review, in order to achieve their business goals. While many of these points have long been understood, the "Great Recession" reemphasized their importance.

1. Underwrite it, yourself. If you are purchasing, remember that you are lending and must underwrite the loan. See item 4 below. This responsibility cannot be transferred to the originator by terms of a participation agreement.

2. Understand the degree to which you are either (a) diversifying/spreading your risk or (b) increasing your risk. During the Great Recession, lenders with portfolio concentrations in real estate discovered that attempts to geographically diversify their risk by purchasing participations in more real estate loans but in faraway places, were unsuccessful.

3. Revisit and improve the terms of participation agreements. Many "form" agreements were simply wrong with respect to accounting treatment or were inadequate to address inter-bank disagreements in bad credits. Review the guidance found at Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 860 "Transfer and Servicing" (which updated former FAS 166). Among other things, ASC 860 provides that methods of dividing distributions of loan payments among the participants and originator, other than pro rata, will no longer qualify as a "true sale" and must be reported as secured borrowings. Failure to get this right will have accounting, legal and regulatory implications, especially if the sale of the participating interests was part of legal lending limit compliance.

4. Review the FDIC guidance. In November, 2015, the FDIC issued a "Financial Institution Letter on Effect of Risk Management Practices for Purchase Loans and Purchase Loan Participations" (FIL-49-2015; November

6, 2015), https://www.fdic.gov/news/news/financial/2015/fil15049.html. Ignoring the Financial Institutions Letter is likely to garner further attention from the FDIC. Among the other comments contained in the Financial Institutions Letter is the following:

"Financial institutions that purchase loans for participation should perform the same degree of independent credit and collateral analysis as if they were the originator. To do so, it is necessary for the institution to ensure that it has the requisite knowledge and expertise specific to the type of loans or participations purchased in that it obtains all appropriate information from the seller to make an independent determination. The institution should perform a sufficient level of analysis to determine whether the loans or participations purchased are consistent with the Board's risk appetite and comply with loan policy guidelines prior to committing funds, and on an ongoing basis. This assessment and determination should not be contracted out to a third party."

5. Address key terms of the originator/participant relationship, during negotiations and in an agreement:
(a) specific methods of decision-making, consultation and consent, and dispute resolution;
(b) disclosures of information and control of documents;
(c) standards for administration of loan and liability among lenders; and
(d) address disbursements and costs.

6. Assume the borrower will default when addressing the terms in item 5 above.

7. Consider the possibility that the loan originator or a participant financial institution may breach, default, or be placed in receivership, and the originator and loan servicer may be a substituted party - even a non-bank. Many of the participation difficulties we have seen in the last 8 years arose out of the belief of participants that the loan originator/servicer had some sort of motivation to act in ways that were detrimental to the participants. Agreements that create sufficient transparency and consultative decision-making are helpful in avoiding these situations and the resulting litigation.

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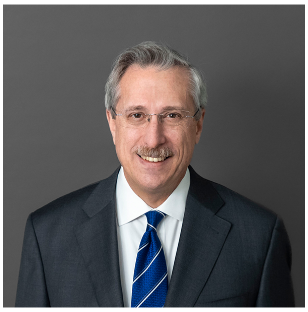

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