Industry Call-in on Loan Participations April 4, 2013

Good afternoon. I am John Vogel - Regional Director for the FDIC's NY Region and I would like to welcome everyone and thank you for joining us for our quarterly calls with the industry on regulatory hot topics. Today our Regulatory Conference Call is entitled "Regulatory Expectations for Loan Participations", in which we discuss proper accounting for participations, regulatory expectations for credit risk management practices, and risks associated with such investments. We hope this call will provide helpful information to assist your institution with developing effective procedures governing both originating and purchasing loan participations. We very much appreciate your participation in today's call.

Your confirmation email included a link to the power point slides for the various topics being covered. The PowerPoint slides should aid you in following today's presentation and can be used for future reference. If you have any questions relating to this presentation, you can contact the presenters or email us at Nycalls@fdic.gov. There will be a question and answer session at the end of the presentation – the operator will provide procedures for calling in a question. Please note that you may also send email questions at any time during the presentation to NYCalls@fdic.gov. For any questions that are specific to a particular borrower or present a unique set of circumstances for a particular bank, please email those questions to the NYcalls mailbox. A written transcript and Q&A document will be posted to the same weblink you used to register for today's call.

With me today are two presenters with considerable knowledge pertaining to our subject matter: Senior Examiner Larry Reynolds and Regional Accountant George Herger. It is now my pleasure to turn the program over to Larry, who will begin the presentation.

Thank you Regional Director Vogel. By way of introduction, the second slide gives a recap of what we will be covering during this presentation on loan participations. I will provide an overview, followed by perspectives from the buying and selling side, as well as examiner expectations when we encounter participations during an exam. Then regional accountant George Herger will discuss the accounting considerations. At the end of the presentation, we will try to answer any questions they you may have. You can e-mail them during the presentation to **NYCalls@FDIC.gov**, and we will be taking call-in questions as well. By way of disclaimer, any examples used in the presentation are for illustrative purposes only, and do not constitute either an endorsement or criticism of any product, service, geographic region, or market segment mentioned.

To make sure we are all on the same page, the third slide provides a definition of loan participations; basically where the originating lender sells a portion of a loan to one or more other institutions. That originator, or lead bank, retains a portion of the loan, remains the lender and lien holder of record, services the loan, and is generally the sole point of contact with the borrower. Moving on to slide four -

On March 1, 2013, the American Banker ran an article by Andy Peter on small banks and loan participations. In that article, he mentioned not only loan participations but also syndications and assignments. This brought to my mind the question - "What's the difference?" The difference is that the plain vanilla participations we typically encounter involve separate contractual relationships between the borrower and lead bank and between the lead bank and the buying bank. The borrower need not even be aware that a portion of their loan no longer resides with their lender. A syndication on the other hand involves a single contract among the borrower and all of the participating lenders, with one (or more) of them taking the lead from a servicing stand point. In contrast, an assignment is not really a participation, but an outright sale by the original lender to another institution, transferring the debt and lien legally to them, though they may or may not continue to service the loan. While many banks are selling-on residential mortgages to Fannie or Freddie, many are also purchasing loan assignments from various loan origination sources, which was the thrust of the American Banker article. And there is nothing inherently wrong with purchasing loans, either by participation, syndication, or assignment, so long as appropriate risk management practices are followed.

So, why do banks get involved in participations? Slide five provides a quick overview of the rationale, pitfalls, and examination emphasis of loan participations. Buying banks get loans they might not otherwise be able to access. Selling banks can reduce their concentration risk while still servicing larger customers. But the things that can make participations desirable can also present difficulties. If problems arise with either the borrower or the lead bank, and the contract between the lead and participating banks is not thoughtfully constructed, and strictly adhered to, things can get very problematic. This leads to examiner concerns with participations. Not only are we interested in, obviously, the credit quality of the borrower, but also with the quality of service between the lead and buying bank.

Moving to slide six, let's look at loan participations from the perspective of the two banks involved. The lead bank can provide a customer with a larger loan than they might otherwise be able to book, thus keeping that customer and relationship. At the same time this can free up funds, via the sale, to service other customers and increase overall diversification. Or perhaps it's not the individual customer that represents the concentration risk, but rather a market segment (floor plan lines, hotels, mid-town office buildings) that needs to be reduced. The buying bank may get the opportunity to bulk up its loan portfolio in a time or place of low demand. Or perhaps it will give them entrée into markets they don't have direct access to, like floor plan lines, hotels, or mid-town office buildings. They can build up their loan base without investing as much in servicing infrastructure, or they can reduce their geographic concentration.

Now that we have established that participations can be a win-win proposition, on slide seven are some of the roles and responsibilities of the lead or selling bank. The originating bank may decide to sell some of a loan even before it is made, or come to that conclusion later. Either way it draws up a contract representing either the participation or the sale and assignment. And as with any legal document, it needs to be clear about the rights and responsibilities of both parties. We will cover more about the contents of a participation agreement a little later. If the sale is a participation or syndication rather than an assignment, the lead bank will be responsible for collecting and passing on loan payments, as well as periodic financial information and any ongoing dialogue with the borrower.

The buyer of course has their roles and responsibilities, as highlighted on slide eight. Most importantly, does the loan pass muster. A strong internal credit analysis is just as critical for participations as it is for a direct loan. The buying bank cannot rely on the credit analysis of the lead. As Ronald Reagan famously said – "Trust, but verify." This, I might add, is the mantra of all good examiners. The seller may pass on its own credit analysis, or it might not. Either way, the buying bank has to underwrite the credit itself. Examiners expect to see **exactly** the same depth and breadth of analysis, regardless of the origin of the loan. And, in addition to an analysis of the credit and the collateral, the buying bank needs to also perform reasonable due diligence on the seller. When buying a loan, you are not only agreeing to the terms of the loan, but also to the terms of the participation contract, syndication, or assignment. Typically, an assignment cedes all rights and responsibilities to the buyer. But not always. A loan seller may retain a slice of the servicing obligation in order to protect their reputation with the buyer, or the borrower, or both.

As I said earlier, participations can be a win-win situation. On slide nine are some of the things that can go wrong. First and foremost is not fulfilling your roles and responsibilities, either as the buyer or the seller. Regardless of which side of the transaction you are on, there needs to be a well-documented credit analysis. My favorite advice to bankers – "If it's not written down, I can't give you credit for it." I believe you when you say you did a thorough loan review. But if you can't show it to me, as an examiner, I can't give it full weight and consideration. And I can cite at least one case where the buying bank did a better credit analysis than the selling bank. But please, don't ask the seller what the examiners rated the loan. We all know that exam results are strictly confidential, right down to the rating on any one loan.

The next most common issue has to do with the participation agreement itself. The selling bank places itself at risk if it fails to adequately perform its duties in servicing the loan. And not just the collecting and passing on of payments. As the lead, you are responsible for timely collection of financial statements, and other servicing obligations. Failure to perform these duties can harm not only your reputation, but your bottom line as well.

One of the benefits of participations is the opportunity for geographic or product diversity. But it is a potential hazard as well. Investing in Florida, Nevada, and SoCal loans was a good idea. Until it wasn't. If you are going to diversify out of area, you need to do, and document, some due diligence for that location as well.

If the loan you bought is a new type of loan or to an unfamiliar industry, you need to demonstrate that you have studied the risks and rewards for that product or business segment. Hotel/motel loans are all well and good, but if your loan policy covers only residential and auto loans, the exam crew will notice and find fault with those policy weaknesses.

So, at the risk of preaching to the choir, slide ten recaps the age-old and ageless C's and P's of credit analysis. But first and foremost – it has to be <u>your</u> credit analysis. Theirs might be prettier, but the loan is on <u>your</u> books.

This brings us to slide eleven, and what examiners do. Which is not really all that complicated. We want to know, and see, that you did all the things you are supposed to, to stay safe and sound. We explicitly ask for a list of loans bought and sold. And, even if you sold enough of it to put it below the sampling threshold, we care, because failure to service properly puts the bank at risk. So we will look at both the credit quality side and servicing side.

<u>Next slide</u> (12). Specifically, does the buying bank have copies of all the relevant records. Too often we have seen credit analyses of purchased loans that do not accurately reflect the note terms and collateral.
Examiners expect, and Boards need to require, that **all** of the loans in the portfolio are addressed in, and conform to, the lending policy. Is your policy silent on office tower loans, but your book of participations is full of them. That does not conform to policy.
Is your standard for debt service one point three X, but since the lead Bank of Anywhere only requires one point one X, that's OK. That will be seen as a policy violation.
Is that purchased loan out of sight, out of mind? "It's OK, Bank of Anywhere will let us know if anything bad is happening" is <u>not</u> the kind of monitoring we have in mind.

"We don't have financials on that loan, because the lead bank hasn't sent them" is <u>not</u> music to our ears. If, as the buyer, you have concerns about the credit, have you tried to resolve them with the lead? We may very well "pass" the loan, and find serious fault with your participations, not from a credit quality stand point, but for the servicing. And it plays both ways. Failure to get what you are due from the lead looks bad. Failure to service, as the lead, places you at risk as well. Next <u>slide (#13).</u>

As always, we are interested in the internal credit assessment. As the lead bank, you have obligations not only to your customer and your institution, but also to the downstream participants. Are you fulfilling all the servicing requirements? Have you communicated all relevant information to the buyers? And in addition to all the credit issues, and servicing requirements, we are concerned with whether the transaction counts as sale to a third party, or does it represent a secured borrowing? Which touches on the proper accounting treatment, which we will get to soon.

This brings me to the final segment of my portion of the presentation. Slides fourteen and fifteen cover some, but by no means all, of the things needed in a well-constructed participation agreement, whether of the traditional form, or a syndication. If, in the case of an assignment, some servicing obligations remain with the originator, those need to be clearly laid out as well. I won’t read all of the points, but suffice it to say the devil is in the details when things start to slide sideways. And without reading the particular bullet points on the slides, it is important to emphasize that the participation agreement needs to cover not only the normal and expected servicing functions, but cover abnormal possibilities. If you haven’t gotten tired of hearing about contingency planning, you haven’t had an exam lately.

Before we move on to the accounting portion, I want to recap the most important concepts covered so far. Each participation buyer is expected to do their own credit analysis and collateral review, just as if it was a direct loan. If the participation is structured as a true sale, and the borrower can’t perform at any point, the seller is under no obligation to make the buyer whole. You can’t give the screaming baby back to mom or dad just because you no longer like the way it smells. In addition to borrower analysis, the buying bank should perform a due diligence review of the seller, in order to assure that they can perform the duties required, and they also need to preform due diligence regarding any “new” features that the participation may represent. Such as a new geographic region, new market segment (for example manufacturing or hospitality) or a new loan product, like indirect auto paper. You own it; we expect you to understand it, front to back.

At this point, I will turn the microphone over to George Herger, New York Regional Accountant, who will cover the accounting ramifications of selling and buying participations.

SLIDE 16
I am pleased to able to meet with you today and provide FDIC regulatory guidance on accounting for loan participations.
As a matter of policy, the FDIC disclaims responsibility for any private publications or statements of its employees. The information provided is believed to be correct, but does not necessarily reflect the policies or views of the FDIC. Specific policy positions of the FDIC are arrived at after extensive deliberations.

SLIDE 17

Since 2010, recognition and measurement accounting guidance for transfers and servicing of financial assets have been modified.

Accounting Standards Codification Topic 860 “Transfer and Servicing” (formerly FAS 166 “Accounting for Transfers of Financial Assets”) altered the financial components approach contained in FAS 140, “Accounting Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.

SLIDE 18

The guidance establishes conditions or limits for derecognition of financial assets in a transfer of a portion of an entire financial asset.

Before considering whether the conditions to be accounted for as a sale have been met, the transfer of a portion of an entire financial asset must first meet the definition of a participating interest.

The transferred portions of financial assets’ characteristics must be the same as the characteristics of the original, entire financial asset.

SLIDE 19

Participating Interests –

A participating interest in an entire financial asset, as defined by ASC Topic 860, has all four of the following characteristics:

(1) From the date of the transfer, it represents a proportionate (pro rata) ownership interest in an entire financial asset;

(2) From the date of the transfer, all cash flows received from the entire financial asset, except any cash flows allocated as compensation for servicing or other services performed (which must not be subordinated and must not significantly exceed an amount that would fairly compensate a substitute service provider should one be required), must be divided proportionately among the participating interest holders in an amount equal to their share of ownership;

(3) The rights of each participating interest holder (including the lead lender) must have the same priority, no interest is subordinated to another interest, and no participating interest holder has recourse to the lead lender or another participating interest holder other than standard representations and warranties and ongoing contractual servicing and administration obligations; and

(4) No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to do so.

SLIDE 20

If the transfer of a portion of an entire financial asset fails any of the requirements for a participating interest both the lender transferring the participation and the party acquiring must account for the transaction as a secured borrowing.

SLIDE 21

If the transfer of a portion of an entire financial asset meets all the requirements for a participating interest, the transfer must evaluate whether the transfer meets all the conditions for derecognition/sale.

Isolated from the transferor.

Transferee has the right to pledge or exchange the assets received.

Transferor does not retain effective control over transferred assets.

SLIDE 22

Conditions that do not constrain participating bank’s right to pledge or exchange participating interest:

Required to obtain lead bank permission to sell or pledge that is not unreasonably withheld.

Prohibit sale to lead bank competitor if other willing buyers exist.

Absence of an active/ liquid market.

SLIDE 23

The lead bank will be found to maintain effective control over a transferred participating interest if:

It has unilateral ability to require the participant to return the financial asset and that return provides more than a trivial benefit to the lead bank.

A “call” or other right conveys more than a trivial benefit when the price is fixed, determinable or otherwise advantageous, except where the price is far out of the money and likely will not be exercised.

Also, effective control exists where the lead bank is empowered to call the loan at any time and can enforce the call by stopping interest payments at the call date.

If the participation agreement constrains the participating institution from pledging or exchanging its participating interest, the originating lender presumptively receives more than a trivial benefit, has not relinquished control over the participating interest, and should account for the transfer of the participating interest as a secured borrowing.

SLIDE 24

Accounting for a Transfer of a Participating Interest That Qualifies as a Sale – Upon the completion of a transfer of a participating interest that satisfies all three of the conditions to be accounted for as a sale, the participating institution(s) (the transferee(s)) shall recognize the participating interest(s) obtained, other assets obtained, and any liabilities incurred and initially measure them at fair value. The originating lender (the transferor) must:

(1) Allocate the previous carrying amount of the entire financial asset between the participating interest(s) sold and the participating interest that it continues to hold based on their relative fair values at the date of the transfer.

(2) Derecognize the participating interest(s) sold.
(3) Recognize and initially measure at fair value servicing assets, servicing liabilities, and any other assets obtained and liabilities incurred in the sale.
(4) Recognize in earnings any gain or loss on the sale.
(5) Report any participating interest(s) that continue to be held by the originating lender as the difference between the previous carrying amount of the entire financial asset and the amount derecognized.

SLIDE 25
Under ASC Topic 860, so-called "last-in, first-out" (LIFO) participations in which all principal cash flows collected on the loan are paid first to the party acquiring the participation do not meet the definition of a participating interest. Similarly, so-called "first-in, first-out" (FIFO) participations in which all principal cash flows collected on the loan are paid first to the lead lender do not meet the definition of a participating interest. As a result, neither LIFO nor FIFO participations transferred on or after the beginning of a bank's first annual reporting period that begins after November 15, 2009 (i.e., January 1, 2010, for a bank with a calendar year fiscal year) will not qualify for sale accounting and instead must be reported as secured borrowings.

SLIDE 26
Multiple Loan Advances:
If a loan 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

SLIDE 27
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
(ASC 860-10-55-17H)

SLIDE 28
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

SLIDE 29

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

We will now look at four examples covering accounting concepts for loan participations.

SLIDE 30

Example 1 shows the pre/post FAS 140 accounting treatments for loan participations.

Before ASC 860/FAS 166, 2010, LIFO arrangement could be derecognizes, if they met the criteria for sale treatment.

After, 2010, it is not so.

7/1/09, Bank A originates a $500,000 loan and 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

SLIDE 31

Example 2 covers multiple loan advances which may not meet the criteria for participating interests and both portions could be reported as secured borrowings. Must be combined into an aggregate loan and all parties' portions have the same characteristics that is pro-rata/proportionate cash flows, etc.

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

The loan advance is transferred in its entirety, it is a separate unit of account and retains its identity and does not become part of the larger loan balance

SLIDE 32 and 33

Example 3 depicts the concept for analyzing all agreements/arrangements. The two loans are to be analyzed as an entire financial asset. In the example, the cash flows are not pro rata/proportionate and therefore the two loans do not meet the requirements for a participating interest. The $80,000 loan would be reported as a secured borrowing.

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

In evaluating a transfer, ASC 860 requires consideration of all arrangements or agreements made contemporaneously with, or in contemplation of, the transfer

ASC 860-10-40-4C

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

SLIDE 34 & 35

Example 4 covers the extension of a LIFO participation pre ASC 860/FAS 166 which was accorded derecognition. Assuming the extension is not considered a new loan, no transfer has occurred and the accounting treatment would continue. If deemed a new loan, the transfer would be not meet the definition of a participating interest and should be reported as a secured borrowing.

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 a treated as a new loan or a continuation of the old loan

"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

SLIDE 36
Call Reporting by lead lender for participations that are secured borrowings: the entire loan is still on the books

Here is the assets side.

Report the entire loan, as the bank's loan asset
Report interest income on all portions in Schedule RI, item 1.a
For risk-weighted assets, entire loan is included in Schedule RC-R
Include in the analysis for determining allowance for loan and lease losses

SLIDE 37
Call Reporting by lead lender for participations that are secured borrowings

Here is the liabilities part.

Report transferred participation as a secured borrowing (liability)
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

SLIDE 38
Reporting in Call Report by participating bank for participations that are secured borrowings

Normally report acquired participation in “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

In summary,

There limits and conditions for sale treatment and derecognition.

The concept of a “participating interest” is the first test: must be the same characteristics, same pro rata/proportionate ownership interest, pro rata cash flows, same rights, and all parties must agree to a pledge or exchange.

If the transaction fails any participating interest test, it is a recognized as a secured borrowing.

Then, evaluate whether a sale has occurred: isolation from the transferor; can pledge or exchange; and no effective control remains with transferor.

If a sale – derecognize sold portions; recognize any gain/loss.

Generally, recent LIFO/FIFO arrangement will not meet the test for participating interests.

Multiple advances must become part of the larger loan and all parties meet participating interest test.

Sales of portions of guaranteed loans at par with large interest spreads will not meet the participating interest test because the resultant interest-only strip means all cash flows are not pro rata/proportionate.

This concludes our formal presentation. We will use the remaining time to answer your questions.

QUESTIONS