Participation Q & A

Disclaimer: The specific facts and circumstances **of each loan participatio**n need to be closely evaluated. The controlling principle of the transfer of assets is that risks are either completely transferred/sold or partial risks and rewards that are retained are pro-rata/proportionate between all the participants.

LOSS SHARE PROTECTION

Question: What happens if the lead bank (in a participation) fails and another bank acquires the assets of that failed bank, and that acquiring bank has a loss sharing agreement with the FDIC? Does the lead bank then share the loss guarantee with participating banks?

Answer: No. The loss sharing agreement is between the FDIC and the acquiring bank, covering only their exposure to the borrower. The loss share does not attach to the loan itself. Therefore, there is no loss share protection for the other participants in the loan.

TRADE DOCUMENTATION

Question: What is the regulatory view of LSTA (Loan Sales and Trading Association) standard participation agreements in terms of how they would examine such documents? It's their standard documentation being utilized on some of the larger secondary market purchases that go through a participation.

Answer: Typically such documents have been thoroughly vetted by legal and industry specialists, and are generally considered adequate and acceptable. While we are not endorsing any particular set of documents, a standard set such as referenced would generally be accepted as adequate. As always, examiners would look to the institution's performance under those requirements.

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TRUE SALE TREATMENT

Question: If the bank has two lines of credit to the same borrowers that have the same collateral, such as general business assets, do the payments have to be applied on a pro rata basis amongst both loans or does each loan stand on its own as far as applying payments?

Answer: No, payments made on separate borrower notes do not need to be pooled and distributed pro-rata to participating banks, unless that is the form and substance of the contractual sale to the participating banks. While the loans may be combined for the purposes of accounting and reporting as a secured borrowing rather than as a true sale, this does not affect the handling and servicing of the individual notes.

Question: Is it fairly standard that the participation agreements address other loans originated by a lead bank that are not participated to the buying bank, stating that, in the event of default, the proceeds from collateral liquidation be applied first to the loan being participated and then to other loans not participated? Is that acceptable language for the transaction to be considered a true sale?

Answer: While this may not be a standard practice, it does appear to be a reasonable and prudent precaution, which may help to clarify whether a transaction constitutes a true sale or not. However, other facts and circumstances related to the sale need to be taken into account before reaching a final conclusion on the accounting and reporting treatment.

Question: If a loan sale that contains multiple notes originated contemporaneously has to be treated as a secured borrowing rather than as a participation, does this mean that the bank then violated its legal lending limit?

Answer: Yes. If the transaction fails the test to be treated as a true sale, then the exposure remains on the bank's books and would be considered a legal lending limit violation. In order to protect itself from such a violation, the originating bank should take all reasonable measures to assure that the transaction will qualify for true sale treatment.

Participation Q & A

Question: Have you come across loan participations where the lead bank does not have a main master note issued? The participating bank gets a note that is signed directly by the borrower and the lead bank has a note that is signed directly by the borrower, together totaling the amount of the loan that was requested. On the collateral documents, the lead bank is named as the administrative agent for the other banks.

Answer: This is an unusual structure that is not commonly seen. The transaction as presented appears to be structured in a manner to avoid the possibility of tainting the sale and not getting true sale treatment. Our largest concern in this case, aside from overall credit quality, is the standing of the various institutions involved regarding the collateral, in the event of liquidation, and the clarity with which this is addressed in the lien documentation.

Question: Regarding true sale treatment and servicing fees, if a loan has a rate of 6.5% and the current market rate for that loan is now 5%, can the loan be sold with a 1.5% servicing fee and be treated as a true sale?

Answer: No. The 1.5% would be too high to be a normal servicing fee. It is more than adequate compensation for a substitute servicer if one would be required. In this case you have an interest only strip and you would not be able to pass the participating interest test. Refer to Slide 29; which is analogous to the situation.

A loan can be sold at either a premium (or discount) to its face amount in order to adjust for differences between the note rate and the current market rate, and this does not interfere with its treatment as a true sale.

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CONFIDENTIALIY QUERY

Question: What are the confidentiality requirements for disclosing the borrower's information when soliciting participants for a loan sale or participation agreement? What documents or information would be sent that would violate confidentiality agreements or requirements? Additionally, what types of documents/facts should not be shared with participants?

Answer: Each transaction and participation agreement is different, with different terms and conditions. Insured institutions should consult with their outside legal counsel regarding disclosing confidential information consistent with its policies and procedures.

LITIGATION AMONG PARTICIPANTS

Question: When disputes arise as a result of a participation deteriorating in quality, what are the legal rights of the participants to recover monies from the lead agent in the event the loan was not serviced properly or the participation agreement was not followed accordingly? Additionally, has there been an increase in litigation trends over the current economic recession?

Answer: The rights of the participants to recover from the lead agent should be set forth in the participation agreement (which typically limits those rights except in limited circumstances). We cannot comment on trends in litigation among loan participants, except to say that many insured institutions that took part in defaulted participation loans are facing these issues. Typically the focus is on recovering a portion of the defaulted loan rather than litigating against the lead (absent breaches of the agreement), but again since we do not handle these types of situations we really cannot comment.