



**SOUTH DAKOTA
DIVISION OF BANKING**

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TO: CHIEF EXECUTIVE OFFICER
ALL STATE CHARTERED BANKS

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RE: LOAN PARTICIPATION GUIDANCE

The transfer of financial assets occurs routinely in banking. The most common example is the sale of loans in whole or in part under participation agreements. These assets are sold for a variety of reasons, but most often as credit line management driven by a bank's legal lending limit.

Various risk management practices apply at both the selling and acquiring institutions. The Division is issuing the attached *Loan Participation Guidance* to discuss the risks and the management practices that banks are expected to employ.

Highlights:

- Loan policy considerations
- Loan administration, underwriting, and risk management considerations
- Accounting considerations
- Legal lending limit and contract considerations

Any questions regarding this *Guidance* may be directed to your institution's Contact Examiner at the Division of Banking (605-773-3421).

Enclosure

LOAN PARTICIPATION GUIDANCE
SOUTH DAKOTA DIVISION OF BANKING

Many banks transfer portions of loans and other financial receivables. Selling institutions utilize loan participations when extensions of credit to a single borrower would otherwise exceed the bank's legal lending limit, to diversify risk, and manage liquidity. Purchasing institutions use loan participations to diversify loan portfolios and compensate for low local loan demand. This *Guidance* is intended for both parties to the transaction.

A bank's loan policy should provide for sales and purchases of loan participations. The basis for effective risk management processes is the development of loan policy provisions specific to the type of lending in which the bank engages. These provisions should clearly address the risk in participation loans and the degree of risk the bank is willing to accept. The participation transaction should comply with all areas of the policy, but more specifically:

- General fields of lending in which the bank will engage and the kinds or types of loans within each general field;
- Lending authority specifically for entering into participation agreements;
- Responsibility of the board of directors in reviewing, ratifying, or approving loans;
- Guidelines for rates of interest and the terms of repayment;
- Limitations on the amount advanced in relation to the value of the collateral and the documentation required by the bank for each type of secured loan;
- Guidelines for obtaining and reviewing real estate appraisals as well as for ordering reappraisals, when needed;
- Maintenance and review of complete and current credit files on each borrower;
- Appropriate and adequate collection procedures including, but not limited to, actions to be taken against borrowers who fail to make timely payments;
- Description of the bank's normal trade area and circumstances under which the bank may extend credit outside of that area;
- Guidelines, which at a minimum, address the goals for portfolio mix and risk diversification and cover the bank's plans for monitoring and taking appropriate corrective action, if deemed necessary, on any concentrations that may exist;
- Guidelines addressing the bank's loan review and grading system ("Watch list");
- Guidelines addressing the bank's review of the Allowance for Loan and Lease Losses (ALLL); and
- Guidelines for adequate safeguards to minimize potential environmental liability.

Participation loans purchased should meet the same underwriting criteria as a loan originated by the purchasing bank. The absence of proper credit analysis on purchased credits may affect loan quality and pose undue risk to the acquiring institution. The participating bank should have the same documentation standards for purchased loans as originated loans. The initial decision to purchase the credit must be supported by relevant information and details on collateral values, lien status, loan agreements, and participation agreements before a commitment is made to purchase.

Ongoing credit review requires updated financial information on the parties to the loan as well as collateral analysis. The purchasing institution's ALLL methodology must include purchased loans as well as originated loans. When appropriate, impairment testing should be performed on purchased credits. Examiners will expect the bank's methodology to consider all purchased loans quarterly in its determination of an appropriate Allowance. ALLL methodologies should consider any risk associated with purchased loans that may differ from the bank's traditional loan portfolio.

While an originating bank may assign its own credit risk rating, the purchasing bank must independently validate the loan rating, as well as ensure adequate documentation, financial analysis, and compliance with laws, regulations, and loan policy and procedure. Loan review procedures must set forth time frames for reviewing credits that are consistent with the risk in the credits and must include procedures for adjusting loan ratings on a timely basis when credit conditions change.

In order to effectively transfer a loan, satisfy lending limits, and reduce risk on the balance sheet of the selling institution, FAS 140 provides that recording the transfer of an asset as a sale must meet the conditions for surrender of control. The bank should have legal counsel and an accountant review the contracts to assure that a transaction qualifies as a sale. Examiners will review participation agreements and outside opinions obtained by each institution. If the transaction does not comply with the established criteria, the loan participation would be accounted for as secured borrowings. A loan participation accounted for as a secured borrowing is not removed from the books of the selling institution, and the participation portion of the loan is reported as both Loans and Other Borrowed Money in the Report of Condition.

To qualify as a sale, three criteria must be satisfied to demonstrate that control has been transferred to the purchaser:

1. The purchaser's interest in the loan must be *isolated* from the seller, meaning that the purchaser's interest in the loan is presumptively beyond the reach of the seller and its creditors, even in bankruptcy or other receivership;
2. Each purchaser has the right to pledge or exchange its interest in the loan, and there are *no conditions* that both constrain the purchaser from taking advantage of that right and provide more than a trivial benefit to the seller; and
3. The agreement does not both *entitle and obligate* the seller to repurchase or redeem the purchaser's interest in the loan prior to the loan's maturity, and it does not provide the seller with the *ability* to unilaterally cause the purchaser *to return* its interest in the loan to the seller (other than through a cleanup call).

When a bank sells a participation to manage legal lending limit considerations, the failure to meet sales criteria in FAS 140 will likely cause the total credit to exceed the limit for lending to a single borrower. Likewise, sale of several non-qualifying participations to one bank needing to be reported as "Other Borrowed Money" may result in the purchasing bank having an excessive loan to another financial institution.

In some loan participations, the agreement provides for the allocation of loan payments on some basis other than in proportion to ownership interest. For example, principal payments

may be applied first to the acquiring bank's ownership interest and all remaining payments to the selling bank's ownership interest (LIFO). In these instances, the participation agreement must also specify that in the case of loan default, participants will share in all subsequent payments and collections in proportion to their respective ownership interest at the time of default. Without such a provision, the banks would not have a pro-rata sharing of credit risk. Provided the sales criteria contained in FAS 140 are met, loan participations sold in which the participation agreements provide for the allocation of loan payments, absent default, on some basis other than proportional ownership interests, may be treated as sold and removed from the balance sheet for financial reporting purposes. However, if the participation agreements do not also contain a provision requiring that all payments and collections received subsequent to default be allocated based on ownership interests in the loan as of the date of default, those participations will be treated as loans sold with recourse for risk-based capital purposes regardless of the financial reporting treatment. Banks must report those loans on Schedule RC-R of the Report of Condition according to instructions for that schedule.

A participation loan can present unique problems if the borrower defaults, the lead bank becomes insolvent, or a party to the participation arrangement does not perform as expected. These contingencies should be considered in a written participation agreement. The agreement should clearly state the limitations the selling and buying banks impose on each other and the rights all parties retain. In addition to the general terms of the participation transaction, participation agreements should specifically include the following considerations:

1. The obligation of the lead bank to furnish timely credit information and to provide notification of material changes in the borrower's status;
2. 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;
3. The specific rights and remedies available to the lead and participating banks if the parties cannot agree on the handling of a defaulted loan;
4. Resolution procedures when the lead and participating banks cannot agree on the handling of a defaulted loan;
5. Resolution of any potential conflicts between the lead bank and participants in the event that more than one loan to the borrower defaults; and
6. 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.

Additional information regarding participation loans may be found in the following resources:

- FDIC Risk Management Manual of Examination Policies
<http://www.fdic.gov/regulations/safety/manual/index.html>
- Reports of Condition and Income Instructions
http://www.fdic.gov/regulations/resources/call/crinst/callinst2007_march.html
Glossary Entries for Sales of Assets for Risk-Based Capital Purposes and Transfers of Financial Assets