Considerations for Reviewing Participation Credits
Developed by the CSBS State Examiner Review Team (SERT)
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Overview:

A participation credit is a multi-lender financing arrangement where a lead lender sells a portion of a credit to one or more participant lenders. The lead lender generally continues to manage the credit on behalf of the participant lenders.

Participation credits are often commercial real estate or land development credits. The purchase of a large amount of these credits can cause an unintended concentration in a particular type of credit or market area. Examiners should ensure participant bank management is aware of concentration risks and is monitoring them appropriately.

Some lead institutions retain none of the original credit (i.e. 100% is participated to other banks). These types of participation credits may bear more risk. If the lead bank has no principal investment, they may have less incentive to diligently service the credit.

Underwriting and Analysis

It is the responsibility of the participant bank to ensure they have access to all source documents. It is the examiner’s job to ensure the bank has obtained and reviewed the documents.

As a general rule, participant banks should apply the same standards of underwriting, documentation, and reporting that would be used if the participant bank were originating the credit. Therefore, examination procedures for reviewing participation credits are similar to those of traditionally-originated credits. Participation credits do, however, have characteristics that warrant additional examiner attention.

Many lead banks provide participant banks with online access to credit documents. Examiners should ensure the participant bank has access to all documents needed to adequately underwrite a credit. The participant bank need not maintain a traditional file as long as the relevant information is available elsewhere. However, reliance on the lead bank’s credit analyses is not sufficient. Participant banks are required to perform their own appropriate due diligence. If documents are available electronically, the participant bank should document its review of the online documentation.
The Participation Agreement

The participation agreement is the document that sets forth the rights and responsibilities of both the lead bank and the participant(s). Since the participant bank does not have a signed promissory note, the participation agreement gives the participant bank, among others, the right to receive payment. The agreement should, at a minimum, specify:

- **The payment arrangement**, (e.g. pro rata, last-in first out (LIFO), or first-in first-out (FIFO)). The most commonly used arrangement is a pro-rata agreement, whereby the loan payments received from the borrower are distributed based on the respective ownership interest of the lead and participant banks. Even if a loan is structured on a payment structure such as LIFO or FIFO, payment terms often revert to pro-rata if a default on the underlying obligation has occurred.

- **The communication duties of the lead bank**. The agreement should specify the rights of the participant bank(s) to be notified of changes in the borrower’s status and to receive up-to-date financial documentation. Participant banks normally do not have direct contact with the borrower. Therefore, those banks are reliant upon the lead bank to provide the necessary credit documentation.

- **The process for modifying the loan**. The agreement should specify that the lead bank receive approval from a majority of the participants prior to modifying the loan.

- **The actions to be taken in the event of a default**. The agreement should specify how resolution costs will be allocated between the participant(s) and the lead bank.

- **The process by which conflicts will be resolved between the lead lender and participant(s)**. The agreement should specify provisions for terminating the agency agreement should conflicts be irreconcilable.
The Loan Policy

The participant bank’s loan policy should establish procedures, as well as limitations, for monitoring and administering participation credits. Often, participation credits are covered in a separate section of the loan policy because of their unique characteristics. The participation section of the loan policy should, at a minimum, set forth:

- **The maximum extent** to which the institution will be exposed to participation credits. Depending upon the extent of utilization, limits may be appropriate for the following:
  - Per credit,
  - Per originating bank,
  - Per a segmented loan type or market area, or
  - Aggregate volume.

Limitations are often expressed as a percentage of capital or total assets. Though the participant bank’s legal lending limit also applies to participation credits, management should consider a lower lending limit due to the added risks these credits can present. For example, a policy may limit the aggregate amount of participation credits at 100% of Tier 1 capital, but also limit each participation credit to 10% of Tier 1 capital.

- **The approval process for approving participation purchases.** The policy should clearly state which channels of approval a participation credit must go through prior to funding. The policy should apply the same standards of approval to participation credits as it does to non-purchased credits. If particular loan officers have been authorized to purchase such credits, their lending limits/purchase authority should be well-defined. Often, only senior lenders are authorized to purchase participation credits.

- **A list of approved lead banks, supported by the due diligence performed on each.** As a best practice, institutions should perform reasonable due diligence on each lead bank prior to purchasing credits from that institution. Documentation of this review should be maintained and could include an assessment of the lead institution’s management capabilities, liquidity, loss history, and growth rates.

- **Potential restrictions on the type of credit purchased.** Certain types of credit may be outside the expertise and comfort of lending staff, and therefore should be prohibited by the loan policy.

- **Documentation requirements** depending on the type of credit.

- **Required pre-purchase analysis** to be presented to committee or senior management. A pre-purchase analysis should be a requirement of the loan policy. The analysis should present, at a minimum, note purpose, related borrowers, collateral adequacy, repayment capacity, and borrower financial condition.

- **The type of ongoing monitoring** required throughout the life of the credit. Examples of ongoing monitoring are: copies of draw requests and site progress inspections (if development/construction), yearly tax returns and periodic financial information from borrowers and guarantors, and tenancy information or rent rolls (if applicable).
Allowance for Loan and Lease Losses (ALLL)

Because banks may experience a relatively high level of loss from participation credits, it may be appropriate to give additional attention to these credits when evaluating the adequacy of the ALLL. If a participation credit is impaired, the credit should be evaluated in the same manner as other impaired loans to determine if a collateral or discounted cash flow shortfall exists. This analysis should comply with Statement of Financial Accounting Standards (FAS) 114, Accounting by Creditors for Impairment of a Loan.

For those participation credits that are not impaired, management will need to comply with the FAS 5, Accounting for Contingencies, requirement that the unimpaired portion of the loan portfolio be segmented according to various risk characteristics. This segmentation will vary depending upon the underlying volume and characteristics of the bank’s purchased loans. Given that participation credits are often in different market areas and written with different underwriting criteria, these credits may need to be segregated and assigned loss rate percentages that vary from the bank’s internally-originated loans. Though historical loss remains a relevant determinant, management should also sufficiently incorporate other environmental or qualitative risk factors.

Real Estate Appraisals

Although the originating bank generally engages an appraisal firm to provide an acceptable appraisal for real estate-related transactions, this does not eliminate a participant bank’s responsibility under Part 323 of the FDIC’s Rules and Regulations and the Federal Reserve Bank’s Regulation Y.

The participant bank should perform (and document) a thorough appraisal review for compliance with the applicable appraisal regulations. This review, to be done prior to funding, may consider:

- An assessment of the data used in each valuation method—and whether or not such data is realistic,
- The timeliness of the appraisal,
- Whether comparables used are reasonable and representative of the proposed project, or
- The appraiser’s competency in assigning values to this type of project.

If the appraisal fails to meet the regulatory requirements, the participant bank should address this issue with the originating bank prior to funding the purchase.

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1 A loan is impaired when, based on current information and events, it is probable a creditor will be unable to collect all amounts due (interest as well as principal) according to the contractual terms of the loan agreement.

2 Accounting Standards Codification (ASC) Topic 310.

3 ASC Topic 450
**Accounting/Legal Issues**

FAS 166, *Accounting for Transfers of Financial Assets*, amended FAS 140 and is effective for reporting periods after January 1, 2010. FAS 166 permits only an entire financial asset, a group of entire assets, or a “participating interest” in an individual financial asset to qualify for sale accounting. The characteristics of a “participating interest” are:

- Cash flows received must be allocated in proportion to interests in asset,
- No recourse, other than standard reps and warranties,
- No subordination, or
- No right to pledge or exchange the entire asset.

A loan participation sold on a FIFO (First-in First Out) or LIFO (Last-in First-out) basis will not qualify as a “participating interest.” This raises several issues for the selling bank:

- Financial Reports (i.e. Call Report) – the participation should remain on the originating bank’s books as a loan and the amount ‘sold’ should be reported as a borrowing.
- Allowance for Loan and Lease Losses (ALLL) – if the risk has not been transferred, the participation should be considered in the bank’s ALLL analysis
- Legal Lending Limit –
  - Participations which do not qualify for sale treatment under FAS 166, may need to be included in the borrower’s total loans for legal lending limit purposes.

NOTE: This is subject to each State’s legal lending limit statutes. Some states may determine that a ‘pro-rata on default’ clause precludes from including for LLL calculation. Please follow your department ruling.

FIFO and LIFO participations made prior to January 1, 2010, will be grandfathered and qualify for sale accounting treatment, provided there have been no extensions or modifications of terms after the effective date.

*In the event the FDIC assumes assets of an institution as receiver, the existing terms of a participation loan will be permanently grandfathered if that participation was either sold, or in process, on or before September 30, 2010.*

**Interest Reserves**

Many real estate development credits include an interest reserve, which is used to pay accrued interest while the construction project is in process. These reserves are typically built into the line of credit if the project is still in its development stage. On occasion, the lead bank may set up a separate promissory note, particularly if the original line of credit has been fully advanced.

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4 ASC Topic 860
5 Detailed instructions are included in the December 2009 Supplemental Call Report Instructions.
In either case, the participant bank needs to be informed as to the source of any interest payments on a development project loan. Because interest reserves will keep the development note current, participant banks may be unaware of repayment difficulties by the borrower until the interest reserve has been fully exhausted. By this point, corrective action may be ineffective. If the interest reserve becomes fully advanced before the project is completed and the lead bank is drawing on another note to make payments on the participation loan, this is an indication that the borrower lacks liquidity and/or the project is experiencing issues that could ultimately lead to default.

Examiners should ensure the participant bank’s cash flow analysis incorporates the additional debt-service requirements of a fully advanced interest reserve. Examiners should also ensure that participant bank management fully understands the risk associated with development-type participation credits and maintains current documentation of site/progress inspections performed by the lead bank.

**Impact of a Lead Bank’s Failure**

Loan participants may suffer a loss in situations where the lead bank fails and the loan customer’s deposits (including pledged deposits) are offset against their outstanding loan(s). Instead of participating pro-rata in the setoff amount, the participating bank will be issued a Receiver’s Certificate in the amount of the setoff from the Federal Deposit Insurance Corporation (FDIC) as receiver of the lead bank.

When a bank fails, the FDIC will either sell the borrower’s loan at closing or retain it in the receivership estate. In either case, the borrower is still obligated to pay the debt. If the borrower has deposits in the failed bank, the borrower has the right to set off any of his/her deposits against any indebtedness owed to the failed bank, or the FDIC, as receiver, may initiate such action, particularly if a borrower’s loan is in default.

A string of court cases in the 1980’s have established that such an offset is not a payment; it is a bookkeeping transaction or “a mere shifting of credits.” Only the balance of a loan after a setoff is deducted is considered part of the assets of a failed bank. Because the setoff does not augment the receivership estate, there are no proceeds to be passed on to the loan participant. As a result, a loan participant may suffer a loss if the borrower or receiver exercises a right of set off against the failed lead bank. Demand deposits and certificates of deposit pledged as collateral on a loan will also be considered a setoff when applied to the loan balance in a failed bank situation. The loan participant is therefore left with a general unsecured claim against the receivership for the amount of the setoff. After the setoff, the loan participant continues to receive its pro-rata share of any payments made by the borrower or any proceeds of foreclosed loan collateral.

For this reason, management is reminded of the importance of monitoring participation interests, reducing concentrations of purchased loans, and performing appropriate due diligence of the originating institution. In those situations where the lead bank is a high-risk institution, participating banks should consider requesting borrower deposit information to determine the extent of any uninsured deposits and potential setoffs.

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7 Courtesy of Texas Department of Banking Regulatory Guidance – 3009, dated August 5, 2009.