

# LOAN PARTICIPATIONS - ACCOUNTING AND REGULATORY ISSUES

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# Agenda – Issues to be covered

- What are participation loans?
- Participation loans vs. loans sold
- Participation loan policy
- Accounting and allowance for loan losses issues
- Regulatory issues – what are NCUA examiners looking for?
- Internal audit of participation loans

# What are participation loans?

- Participation loans are loans made by multiple lenders to a single borrower. Several credit unions, for example, might chip in to fund one extremely large loan, with one the “lead credit union.” This lending institution then recruits other credit unions to participate and share the risks and profits. The lead credit union typically originates the loan, takes responsibility for the loan servicing of the participation loan, organizes and manages the participation, and deals directly with the borrower.

## What are participation loans? (continued)

- Loan participations can, and often do, take the form of a loan pool underwritten by one credit union, which later sells a portion of the loan pool to other credit unions.

# Participation interest vs. secured borrowing

- A participating interest requires:
  - Proportionate ownership interest in an entire financial asset;
  - All cash flows (excluding fees for servicing or other services that are arms length) to be divided among participants in proportion to share of ownership;
  - Rights of each participating interest holder have the same priority (i.e. there can be no recourse and no participating interest holder is subordinated to another);
  - No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to do so.

# Participation interest vs. secured borrowing (continued)

- If a transfer of a portion of a financial asset does not meet the definition of a participating interest, the transaction must be accounted for as a secured borrowing.
- All credit unions are encouraged to review their participation agreements to determine if they conform to the new definition of a participating interest.

# Loan Participations - Pros and cons

## Pros

- Provide a source for selling loans
- Stay under loan caps
- Geographic and loan type diversification
- Average loan yield much higher than average investment yield

## Cons

- Increased complexity
- Greater risk, if large participation loan go bad
- Greater regulatory scrutiny
- No control over loan underwriting

# Board of Directors actions

- Approve a loan participation policy
- Approve by-laws changes if applicable
- Ensure independent analysis of every participation loan pool purchased
- Develop an annual plan
- Ensure management is monitoring and monthly reporting to the Board key ratios
  - Delinquency
  - Loan growth
  - Charge-offs



# Participation loan policy

- Written policy required by NCUA
- Risk assessment
- Strategic planning
- Due diligence
- Risk measurement
- Monitoring
- Control

# Participation loan policy (continued)

- Risk assessment
  - Credit risk assessment
  - Interest rate risk assessment
  - Liquidity risk assessment
  - Transaction risk assessment
  - Compliance risk assessment

# Participation loan policy( continued)

- Strategic planning
  - Strategic risk assessment
  - Reputation risk assessment

# Participation loan policy (continued)

- Due diligence
  - Conflicting interests
  - Financial condition
  - Loan product experience
  - Significant staffing changes
  - Loss of control
  - Contract and legal review
  - Loan underwriting

## Participation loan policy (continued)

- Risk measurement, monitoring and control
  - Post closing review
  - Monitor financial health of originating credit union
  - Annual review of loan pool status

# Accounting and allowance for loan loss issues



- Accounting issues
  - Is the accounting treatment supported by agreement or legal opinion?
  - Is there a uniform policy for accounting for collected points and fees?
  - Separate sub-ledgers maintained for participation loans or loan pools?
  - Is interest calculated using contractual terms?
  - Are delinquency reports segregated by individual participants?
  - Are timely reports received from selling credit union?

# Accounting and allowance for loan loss issues (continued)

- Allowance for loan loss issues
  - Are loan participation identified and addressed in the ALLL methodology?
  - Are participation loan charge-offs and recoveries tracked separately and by loan pool?

# Regulatory issues – What are NCUA Examiners looking for?

- Same due diligence as if CU originated the loan itself:
  - Comfort with originator or lead lender
  - Separate and independent risk assessment and credit decision
  - Risk rate the credit
  - Meet CU's lending requirements
  - Pre-closing review of documentation



# Keys to success

- Each participant perform independent financial analysis
- Each participant has reviewed loan documents
- Participations should be non recourse to the lead lender
- Document who makes the decision for a work out, lead or majority
- Use a qualified attorney

# Regulatory issues – What are NCUA Examiners looking for?

(continued)

- Regular monitoring of the credit:
  - Collection of financial information
  - Analyze the financial information
  - Maintain loan administration and review
  - Appropriate and proactive risk grade the credit

# Internal audit of participation loans

- Review policy
- Select sample of new participation loans
- Review and evaluate due diligence
- Review payment history, delinquency and charge offs
- Examine the adequacy of allowance for loan losses
- Report findings and make recommendations

# QUESTIONS

