

Strategic Loan Participations: The Good, the Bad and Maybe the Ugly

E. Andrew Keeney, Esq.

Kaufman & Canoles, P.C.

January 14, 2014





E. Andrew Keeney, Esq.

Kaufman & Canoles, P.C.

150 West Main Street, Suite 2100

Norfolk, VA 23510

(757) 624-3153

eakeeney@kaufcan.com

KAUFMAN & CANOLES
attorneys at law



Topics for Consideration

- Overview of Loan Participations
- Operational, Legal and Compliance Risks
- Tips to Avoid Risk, Abuses and Potential Liabilities of Loan Participations
- Some Contract Tips
- Best Practices

GROWTH!!!

- As of June 2011
 - 1,432 FICU's reported loan participation loans with total balances of \$12.8 billion
 - Since 2007 31% increase – up from \$9.7 billion

Credit Unions With \$100 Million or Greater in Participation Loans Outstanding

Charter #	Credit Union	State	Charter Type	Participation Loans Outstanding (\$000)	Assets (\$000)	Net Worth / Assets (%)	Total Loans & Leases (\$000)	Participation Loans / Total Loans (%)	Participation Loans / Net Worth (%)
23957	American Airlines	TX	Fed.	210,696	5,961,783	8.87	2,521,035	8.4%	39.8%
13242	Chartway	VA	Fed.	151,975	1,883,695	6.47	997,835	15.2%	124.8%
24694	America First	UT	Fed.	123,504	5,141,936	8.23	3,574,911	3.5%	29.2%
17429	Visions	NY	Fed.	110,890	2,665,935	12.76	1,428,887	7.8%	32.6%
15732	Western	CA	Fed.	107,706	1,649,520	9.61	898,354	12.0%	68.0%
15802	Hudson Valley	NY	Fed.	107,485	3,216,229	8.86	1,664,095	6.5%	37.7%
24212	SchoolsFirst	CA	Fed.	105,553	8,778,318	10.04	4,164,181	2.5%	12.0%
68579	Patelco	CA	State	351,075	3,594,551	10.20	1,900,260	18.5%	95.8%
66357	Delta Community	GA	State	287,357	4,099,297	10.74	2,478,721	11.6%	65.3%
67389	Atlanta Postal	GA	State	276,401	1,974,731	11.82	875,413	31.6%	118.4%
67390	Georgia's Own	GA	State	269,659	1,658,018	11.07	1,088,884	24.8%	146.9%
68428	Premier America	CA	State	170,669	1,324,487	8.84	777,259	22.0%	145.7%
62659	Advantis	OR	State	128,746	826,154	9.61	609,625	21.1%	162.2%
62715	Anheuser-Busch Empls.	MO	State	117,378	1,317,851	8.97	899,024	13.1%	99.3%
68429	Travis	CA	State	112,700	1,896,491	9.78	943,427	11.9%	60.7%
66584	California Coast	CA	State	104,270	1,635,082	9.53	977,442	10.7%	66.9%
68373	First Entertainment	CA	State	102,350	873,882	8.89	558,959	18.3%	131.8%

Source: RP Financial from SNL Financial and NCUA Call Report Data as of 9/30/2011

What is a Loan Participation?

- Defined by the regulations as a “loan where one or more eligible organizations participates pursuant to a written agreement with the originating lender.”
- Essentially a loan made by one or more credit unions to a single borrower.
- It is typically accomplished by an originating credit union selling a portion of a loan to a second credit union.

Benefits of Loan Participations to Selling Credit Union

- Increase liquidity
- Increase ability to serve members since participating lenders can extend loans for higher amounts
- Mechanism to manage interest rates
- Manage credit and geographic concentration risks

Benefits of Loan Participations to Buying Credit Union

- Diversified balance sheet
- Use of excess liquidity
- Increased revenue
- Generate loan growth
- Manage the balance sheets

Risks of Loan Participations to Selling Credit Union

- Regulatory compliance
- Full disclosure
- Credit administration

Risks of Loan Participations to Buying Credit Union

- Risk assessment
- Strategic planning
- Due diligence
- Contracts and legal review
- Underwriting credit risks
- Internal controls/fraud

NCUA Rules and Regulations

- Organizations eligible to participate in loan participations are:
 - federal or state-chartered credit unions
 - CUSOs
 - any federally-chartered or federally-insured financial institution
- Amount regulated by NCUA:
 - no amount specifically identified for a federal credit union
 - no federal credit union shall obtain an interest participation loan if some of that interest and other indebtedness exceeds 10% of the federal credit union's unimpaired capital or surplus

Other NCUA Limitations

A federal credit union originating lender must:

- originate loans *only to its members*
- retain an interest of at least 10% on the face amount of each loan (no reference to recourse or non-recourse)
- retain the original or copies of the loan documents
- require the credit committee or loan officer to use the same underwriting standards for participation loans as other loans underwritten and approved at the credit union

A written master participation agreement is mandatory

12

Other Limitations

A participating federal credit union that is not an originating lender shall:

- participate only in loans it is empowered to grant
- adopt a board-authorized participation policy setting forth loan underwriting standards prior to entering into a participation
- participate in participation loans only if made to its own members or members of another participating credit union
- retain original copies of participation agreement and a schedule of all covered loans; and
- obtain approval of Board of Directors or ALCO

Other Limitations

A risk assessment and due diligence shall be performed prior to entering into any third-party arrangement.

This is a mandatory requirement regardless of whether or not the other party is a credit union or a CUSO.

Regulatory Changes

- Effective Date: **September 23, 2013**
- Due Diligence Requirements
- Concentration Limits
- Loan Participation Policies
- Contract Requirements
- Borrower's Membership Requirements
- Grandfather of Certain Participations

15

Final Rule: Loan Participations; Eligible Obligations; Purchase of Assets and Assumptions of Liabilities

	PROPOSED RULE	FINAL RULE
Introduction, Scope, and Definitions, §701.22	Add introductory text to the rule to explain scope of §701.22.	<ul style="list-style-type: none"> • Additional modifications to introductory text to further clarify the rule's scope. • Conforming amendments to 2012 rule eliminating RegFlex.
	<p>Revise the definitions section to:</p> <ul style="list-style-type: none"> • Place definitions in alphabetical order; • Add a definition of <i>Associated Borrower</i>; • Revise the definitions for <i>Loan Participation</i> and <i>Originating Lender</i>. 	<ul style="list-style-type: none"> • Definition of <i>Associated Borrower</i> same as proposed. • Definition of <i>Loan Participation</i> same as proposed. • Definition of <i>Originating Lender</i> same as proposed, with minor modification for consistency with introductory text to §701.22. • Preamble language to address commenters' questions regarding other definitions.
	<p>Focus the rule on the purchase side only.</p> <p>Establish some consistency in the loan participations that a Federally Insured Credit Union (FICU) can buy, regardless of the eligible organizations involved.</p>	<p><i>Same as proposed.</i></p> <p><i>Same as proposed.</i></p>
Conditions for Loan Participation Purchase, §701.22	Revise the definition for <i>Loan Participation</i> to reflect the requirement for the originating lender's continued participation in the transaction throughout the life of the loan.	<i>Same as proposed.</i>
	Require a FICU, as a condition for purchase, to execute a written loan participation agreement with the originating lender.	<i>Same as proposed.</i>

Final Rule: Loan Participations; Eligible Obligations; Purchase of Assets and Assumptions of Liabilities

PROPOSED RULE		FINAL RULE
<p><i>Conditions for Loan Participation Purchase, §701.22 (continued)</i></p>	<p>Restrict a FICU, as a condition for purchase, to loan participations where the originating lender retains at least a 10 percent interest in the outstanding balance of the loan through the life of the loan.</p>	<p>Federally Insured Credit Unions and Federally Insured State-Chartered Credit Unions (FISCU) may only purchase loan participations from originators who retain at least a 5 percent interest:</p> <ul style="list-style-type: none"> • Originating FCUs must retain at least a 10 percent interest, as required by the Federal Credit Union Act. • Other originating eligible organizations (including FISCUs, Credit Union Service Organizations, privately insured credit unions, and banks) must retain at least a 5 percent interest, unless higher under state law, before selling to FICUs, consistent with other risk retention standards, such as Dodd-Frank requirement for securitizers.
	<p>Restrict a FICU, as a condition for purchase, to loan participations where the borrower is a member of a participating credit union <u>before</u> the purchase is made.</p>	<p>Same as proposed.</p>
<p>Loan Participation Policy, §701.22</p>	<p>Add minimum requirements for a FICU's written loan participation policy including underwriting standards which, at a minimum, meet the same underwriting standards the FICU uses when it originates a loan.</p>	<p>FICU's written loan participation policy must establish underwriting standards for loan participations.</p> <ul style="list-style-type: none"> • Purchasing FICU may participate in types of loans it does not originate. • FICU may establish different, or, where appropriate, even less stringent, underwriting standards for loan participations than it uses when originating its own loans. • If FICU both originates and purchases participations in the same types of loans, it may establish different underwriting standards for originating such loans and for purchasing participations in those loans.

Final Rule: Loan Participations; Eligible Obligations; Purchase of Assets and Assumptions of Liabilities

	PROPOSED RULE	FINAL RULE
<p>Loan Participation Agreement, §701.22</p>	<p>A loan participation agreement must:</p> <ul style="list-style-type: none"> • Be properly executed; • Be acted on by the FICU's board of directors or designated committee. <p>Minimal provisions a FICU must require be included in a loan participation agreement:</p> <ul style="list-style-type: none"> • Identification of specific loan participation(s) purchased; • Amount of loan retained by originating lender (at least 10 percent); • Originating lender's participation for the loan's duration documented; • Access to periodic financial and other performance information regarding the loan, borrower, and the servicer; • Enumerated duties and responsibilities of the originating lender, servicer, and participants regarding the servicing, default, foreclosure, collection, and ongoing administration of the loan; • Circumstances and conditions for replacing the servicer. 	<p><i>Same as proposed.</i></p> <p>Same as proposed, except amount of loan retained by originating lender must be at least:</p> <ul style="list-style-type: none"> • 10 percent for originating FCUs, as required by the Federal Credit Union Act; • 5 percent for originating FISCUs and other eligible organizations, unless higher under state law, consistent with other risk retention standards, such as Dodd-Frank requirement for securitizers.
<p>Eligible Obligations, §701.23</p>	<p>Add an introductory paragraph to §701.23 explaining this section covers the purchase, sale or pledge of all or part of a loan to an FCU's member and does not involve any continuing contractual obligation between the seller and the purchaser.</p> <p>The introductory text also explains the borrower must be a member of the purchasing FCU before the purchase is made and expressly states an FCU may not purchase a nonmember loan to hold in its portfolio.</p>	<p>Substantially as proposed, but with some amendments to conform introductory paragraph to 2012 rule eliminating RegFlex.</p> <p>2012 rule eliminating RegFlex provides limited exception to permit FCUs that meet the well capitalized standard to buy loans from other FICUs without regard to whether the loans are eligible obligations of the purchasing FCU's members or the members of a liquidating credit union.</p>

Final Rule: Loan Participations; Eligible Obligations; Purchase of Assets and Assumptions of Liabilities

	PROPOSED RULE	FINAL RULE
Purchase and Assumption, §741.8	Currently, we do not require an FCU to obtain Regional Director approval for the purchase of a loan participation from a non-NCUSIF entity provided the purchase conforms to §701.22. FISCUs are not subject to §701.22 and must request RD approval to purchase a loan participation from a non-NCUSIF entity. As the proposed rule covers FISCUs, similarly exclude FISCUs from this requirement provided the purchase conforms to §701.22.	<i>Same as proposed.</i>
Requirements for Insurance, §741.225	Extend the requirements of §701.22 to FISCUs.	Substantially as proposed, with minor change to clarify that FISCUs, but not FCUs, are exempt from membership requirement in §701.22(b)(4).

Regulatory Changes

- Minimum standards
- Underwriting standards must be “same” as underwriting standards buying credit union utilizes
- Limit aggregate amount of loan participations purchased from any one originating credit union

Regulatory Changes

- Establish limits on amount of loan participation
 - by each loan type
 - not to exceed a specified percentage of credit union's net worth
- Establish a limit on the aggregate amount of loan participations to be purchased
- POTENTIAL CUSO IMPACT
 - Based on new CUSO regulations

21

Due Diligence Items/Checklists

- Inspection of property/In person
- Review and analysis of appraisal
- Environmental Assessment
- Likelihood of resale
- Guarantors
- Loan servicer
- NCUA regulations & guidelines
- Selling credit union

Contract Issues/Checklists

- Loan servicer rights
- Representation & Warranties
 - Underwriting policies
 - Collection procedures
 - Review of loan documentation
- Notice Provisions
- Attorney review of contract

Other Guidance

- Supervisory NCUA Letter 08-CU026 – Evaluating Loan Participation Programs
- NCUA Examiner’s Guide – Chapter 10, Pages 10A-34 (participation loan & impermissible policies & practices)
- NCUA Letter to Credit Unions 07-CU-13 – Evaluating Third Party Relationships
- NCUA AIREs Questionnaire – Loan Participations
- Kaufman & Canoles’ Credit Union Newsletter(s)



Tips to Avoid Risks, Abuses & Potential Liability

- Originating lender must manage the loan relationship with same standard of care as it would with any other loan it originates & services

Tips

- Participating credit union should
 - Perform independent underwriting & risk analysis as though originating & servicing the loan themselves
 - Evaluate the financial condition of the borrower
 - Due diligence to see if the originating credit union has the expertise & systems in place

Tips

- Financial analysis of the credit unions involved in the transaction
- With multiple lenders – well-written master participation loan agreement
 - Identification of the roles & responsibilities of all parties involved
 - Verification that all parties have performed independent financial analysis

Tips

- Requirement that each loan participant has reviewed the loan documents prior to closing
- Identification of loans sold with & without recourse
- Identification & due diligence regarding any guarantors
- Servicing issues

Tips

- Loan modification issues – **DECISIONS**
 - Change in terms requiring what % of consent of the loan participants – majority rules unanimous consent
- Buy-back rights
- Attorney review of contract

Some Contract Tips

- Sample form agreements since 2003 – updated?
- Pre-printed form contracts
- Guarantor(s) information to be included in definition of Loan Documents
- Servicer
 - Defined/described
 - Due diligence
 - Any right to make loan modifications
 - Fees & delinquencies
- Opinion of Counsel

Some Contract Tips

- Privacy & Confidentiality
- Broker's rights/responsibilities/payments
- Right to buy back
 - For cause
 - For convenience
- Representations & warranties
- Notification

Some Contract Tips

- Voting rights
- Custody of loan documents
- Separate trust accounts for funds
- Statutory liens
- Prepayment penalty
- Defaults

Best Practices

- Due Diligence
- Obtain proposed contract early in the process
- Regulatory compliance checklist
- Evaluate the borrower
- Evaluate the seller
- Annual review/updates/inspections
- Negotiate



E. Andrew Keeney, Esq.

Kaufman & Canoles, P.C.

150 West Main Street, Suite 2100

Norfolk, VA 23510

(757) 624-3153

eakeeney@kaufcan.com

KAUFMAN & CANOLES
attorneys at law



Strategic Loan Participations: The Good, the Bad and Maybe the Ugly

E. Andrew Keeney, Esq.

Kaufman & Canoles, P.C.

January 14, 2014

