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Loan Participations and Statement 166 - Be Careful!

Important new accounting rules for community banks selling loan participations went into effect on January 1, 2010. The Financial Accounting Standards Board ("FASB") in June of 2009 adopted new guideline, Statement 166, amending Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*. The new rules apply to loan securitizations as well as loan participations. Unfortunately, some of the participation agreements we have seen over the last several weeks do not satisfy the new requirements. Lenders should spend time reviewing the bank's "standard" participation agreement to insure that they are in compliance with the new rules.

As a general matter, the effective date for Statement 166 was January 1, 2010. The new rules issued by the FASB relate primarily to three general areas: (i) the sale of loans with retention of servicing rights; (ii) the securitization of loans; and (iii) the sale of participation interests in loans. This ebrief focuses on the third category which is of particular importance to community banks, the sale of participation interests in loans to other banks.

Under Statement 166 a bank selling a loan participation cannot remove the loan participation interest from its books unless the participation is sold strictly on a pro-rata basis, as to both principal and default. Participations not sold on a pro-rata basis will be treated as a secured borrowing and remain on the transferring bank's balance sheet, leading to potential violations of legal lending limits and (possibly) increasing the amount of capital and loan loss reserves the transferring bank must hold.

To qualify for sale treatment, the participation needs to satisfy these requirements:

- all cash flows received from the loan should be divided proportionately among the participants in amounts equal to their share of ownership (except, as noted below, market-rate fees may be charged by the lead bank for services rendered such as servicing the loan);
- the rights of each participating interest holder (including the transferring bank in its role as a participant interest holder) should have the same priorities such that

no participating interest holder's interest is subordinated to the interest of another participating interest holder;

- participating interest holders must have no recourse to the transferor or to each other, other than for matters set out in the loan participation agreement such as standard representations and warranties, ongoing contractual obligations to service the loan and contractual obligations to share in any set-off benefits received by any participating interest holder; and
- no party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the financial asset.

Reviewing your participation agreements to ensure you are in compliance with Statement 166 makes good sense. If nothing else, it helps you avoid sticky conversations with the auditors and regulators. For example, "last-in, first-out" clauses allowing one or more participants to receive payments on its interest in the asset before other participants receive theirs will no longer comply. Also, pass-through interest rates that are substantially less than the contract rate may jeopardize or void the sale of the participation interest. However, Statement 166 allows "market rate" charges for servicing the loan.

As always, call us if you have questions or concerns.

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