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Recent Changes to Accounting Standards and Their Impact on Loan Participations

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Many community banks and their holding companies rely on loan participations as an important source of liquidity for their lending operations. Traditionally, these programs have allowed lenders to diversify assets, comply with lending limits, and spread credit risk by getting participated assets off their balance sheets.

HOWEVER, RECENT CHANGES to accounting standards have impacted existing participation programs and created compliance uncertainties for both lead lenders and their participants. Following is a summary of those changes and what they mean to financial institutions.

Summary of FAS 166

On June 12, 2009, the Financial Accounting Standards Board (FASB) issued Statement No. 166 (FAS 166), Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140 (FAS 140). FAS 166 responded to concerns regarding certain transfers of financial assets and their qualification for sales treatment under FAS 140. For institutions with a calendar-year fiscal year, FAS 166 was effective as of Jan. 1, 2010.

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Accounting Standards

Among other things, FAS 166 amends and clarifies the accounting de-recognition criteria to be applied to transfers of participating interests in an entire financial asset. In order to obtain the traditional sale treatment for the sale of a portion of a loan, the sale must meet the new test for a "participating interest."

A participating interest possesses all of the following characteristics:

- It must be nonrecourse;
- It must represent a proportionate or pro rata ownership interest in the entire loan through maturity;
- From the date of the transfer, all cash flows (after payment of a reasonable servicing fee) received must be divided proportionately among the participating interest holders in an amount equal to their share of ownership;
- Each participating interest holder must have the same priority with no participating interest holder subordinate to another (i.e., LIFO participations are no longer treated as true participations); and
- No party may have the right to pledge or exchange the entire financial asset unless all participating interest holders agree to the pledge or exchange.

Community banks should prepare new participation agreement forms that are FAS 166 compliant for all new participations.

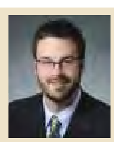
Impact of Changes

If a participation does not qualify for sale accounting treatment, adverse consequences may occur for both the transferring lender and the participant. Among other things, the balance sheet of the transferring lender will show the entire loan as an asset with capital and loan loss reserve requirements and the participation amount will be a secured liability. With respect to the participant, the participant must maintain capital on its loan to the transferring lender, thereby causing both to have capital maintenance requirements. In addition, lending limits will apply not to the underlying loan obligor but to the transferring lender as the "borrower." Furthermore, if the transferring lender and participant are affiliated, the participant has a "covered loan," which is subject to Regulation W quantitative and collateral requirements unless the two banks are "sister banks" for Regulation W purposes. Finally, upon the entry into receivership of the transferring lender, the FDIC may treat the transaction as a secured loan to the transferring lender, and exercise its authority to disaffirm or repudiate the participation agreements to reclaim, recover, or recharacterize the transferred assets.

Regulators have granted some relief in this area. The FDIC has adopted a transitional safe harbor which provides that it will not, as conservator or receiver, exercise its authority to disaffirm or repudiate contracts or reclaim assets transferred prior to Sept. 30, 2010, if the participation satisfied all conditions for sale accounting treatment under generally accepted accounting principles in effect prior to the enactment of FAS 166. This safe harbor, however, does not delay the lending limit or capital ramifications of a failure to meet the new "participating interest" test. In addition, regarding regulatory capital requirements, there is: a) an optional two-quarter implementation delay followed by an optional two-quarter partial implementation of the effect on risk-weighted assets that will result from the accounting changes, and b) an optional two-quarter delay, followed by an optional two-quarter phase-in, of the application of the regulatory limit on the inclusion of the allowance of loan and lease losses (ALLL) in Tier 2 capital for the portion of the ALLL associated with the assets which are consolidated as a result of accounting changes.

Compliance

Community banks should prepare new participation agreement forms that are FAS 166 compliant for all new participations. In addition, existing participations covering revolving and construction loan facilities for which new advances will be required should be amended to meet the requirements of FAS 166, as FAS 166 applies to any advance or draw on a loan commitment, even if the underlying participation agreement was outstanding prior to the effective date of FAS 166. The changes should be communicated to all lending personnel and participation policies should be modified in consultation with the institution's accountants and other advisors. Among other things, a participant in a non-compliant transaction should file a UCC financing statement showing the transferring bank as "debtor." Finally, regulatory developments should be closely monitored, as regulators and other interested parties continue to react to these accounting changes.



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