

June 2010



Significant Accounting and Regulatory Implications to Accounting for Loan Participation and Other Partial Loan Sales

FASB Accounting Standards Codification (ASC) Topic 860 (formerly Statement of Financial Accounting Standards (FAS) 140 and 166) has modified the accounting for transfers and servicing of financial assets.

While this amended guidance has a meaningful impact on companies that have “qualifying special-purpose entities,” it also introduced a new definition for “participating interest” which has a significant impact on how community banks account for loan participations and other partial loan sales such as the guaranteed portion of Small Business Administration (SBA) loans. This amended guidance becomes effective for transfers of participating interests on or after the beginning of the first annual reporting period beginning after November 15, 2009 (January 1, 2010 for calendar year companies). Application issues specific to participations and other partial loan sales have come to light in the months that have elapsed since the 2009 issuance of FAS No. 166. A summary of those issues and recommended action plan follows.

Accounting Insights is a publication of McGladrey & Pullen, LLP and should not be construed as accounting, auditing, consulting, or legal advice on any specific circumstances or facts. The contents are intended for general information purposes only. You are urged to consult your McGladrey service provider concerning your situation and any specific questions you may have.

Introduction of New Participating Interest Definition

Prior to the issuance of FAS No. 166, transfers under participation agreements and other partial loan sales fell under the general guidance for transfers of financial assets. FAS No. 166, introduces a new definition for a participating interest along with the requirement for partial loan sales to meet the definition of a participating interest for sale treatment to occur. If a participation or other partial loan sale does not meet the definition, the portion sold should remain on the books and the proceeds recorded as a secured borrowing until the definition is met. Additionally, other requirements previously contained in SFAS No. 140 related to surrendering control were retained with the amendments brought about by SFAS No. 166. These provisions require the transferred assets to be isolated from the originating institution (transferor), that the transferor does not maintain effective control through certain agreements to repurchase or redeem the transferred assets and that the purchasing institution (transferee) has the right to pledge or exchange the assets acquired.

A participating interest by definition requires 1) proportionate ownership interest in an entire financial asset; 2) 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; 3) that 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); and 4) that no party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to do so.

A discussion of some common conditions that could cause the transfer of a partial loan to fail to qualify for sale accounting follows.

Criteria: Cash Flows Divided in Proportion to Share of Ownership

Problem conditions:

- Participation agreements with provisions for the lead bank to be paid its principal or interest after the other participants or before the other participants
- Excess servicing or other fees paid to the lead bank or any other participant
- Cash flows for services performed (such as reasonable compensation for servicing) are given a higher priority than distributions to participating interest holders
- Sold or participating portion is passed through to the buyer or participant with a different rate of interest (something other than the contractual rate reduced for servicing fees)
- Differences in interest rates among participants (other than as allowable compensation for servicing and other services) that may be established in lieu of a premium or discount to the sale price to account for changes in market interest rates or liquidity since the loan origination
- Different interest rate applied to the portion of a loan sold as compared to the portion of the loan held. With loans guaranteed by the Small Business Administration (SBA) as an example, it is not uncommon for lenders to charge customers, or pass through to purchasers, a different rate on the guaranteed portion than the non-guaranteed portion.

Criteria: Rights of Each Participating Interest Holder Have the Same Priority

Problem conditions:

- Recourse beyond standard representations and warranties (excluding third party guaranties)
- Sales at a premium of the SBA guaranteed portion of a loan. Under the standard SBA loan sale agreement (SBA Form 1086), there is a 90-day warranty period during which the selling institution would be required to refund any premium received upon the occurrence of certain events such as if the borrower prepays the loan within that period or fails to make the first three monthly payments due after the sale (transfer) date and the borrower enters uncured default within 275 calendar days. Once the recourse provision expires, the transferred portion should be reevaluated to determine if it meets the participating interest definition.

The SBA recently solicited views from the public on the impact this amended accounting guidance is having on the SBA 7(a) program in an effort to consider potential revisions to the program that may minimize any adverse impact on the program. The deadline for providing comments to the SBA was April 19, 2010.

Criteria: Right to Pledge or Exchange

Problem condition:

- Agreements that implicitly or explicitly enable one of the parties to the agreement to pledge or exchange the entire financial asset (rather than just the portion held)

Regulatory Considerations

Bank regulations follow generally accepted accounting principles with regards to when a transfer of a financial asset constitutes a sale. As such, transfers that fail to qualify for sale treatment are considered as loans for purposes of determining compliance with legal lending limitations and are reflected on the quarterly reports of condition as secured borrowings with the "sold" portion of the loan remaining on the books, impacting regulatory capital ratios.

Recommended Action Plan

A recommended first step is to attempt to quantify the significance of the potential exposure brought about by the new requirements. Consideration needs to be given not only to new participation or partial loan sale agreements with transfers occurring on or after the effective date, but also pre-existing agreements with transfers occurring or potentially occurring on or after the effective date such as new advances under lines of credit or construction loans. Consideration should also be given to the anticipated level of participations or other partial loan sales going forward. When drawing a conclusion as to the potential significance in the aggregate of certain transfers failing to qualify as sales, consideration should be given not only to the impact to the balance sheet and income statement but also to regulatory capital ratios, compliance with legal lending limitations and other relevant factors.

Once the significance of the potential exposure is known, decisions can be made with regards to actions to be taken, such as the following:

- 1) **Review relevant agreements for transfers of significance that occurred on or after the effective date or could occur (such as lines of credit or construction loans) to determine if the transfers meet all requirements for sale treatment.** Consideration can be given to amending agreements to address the problematic provisions where feasible.

- 2) **Establish procedures and controls to ensure new arrangements are structured in a manner that achieves the desired accounting treatment.** The use of standard agreements that have been reviewed by legal counsel to consider whether the true sale requirements have been met helps avoid unpleasant surprises. Due to the complexities of the accounting requirements, reviewing the proposed accounting with the independent accountants is advised also.
- 3) **Put a system in place to appropriately segregate transfers that do not qualify for sale treatment and the related accrued interest to facilitate proper reporting as secured borrowings.**
- 4) **Put a system in place to re-evaluate transfers upon the occurrence of a certain event that could impact the determination of sale treatment.** This could include as an example the expiration of a warranty or recourse period or modifications to a participation or sale agreement.

About McGladrey & Pullen, LLP

McGladrey is the brand under which McGladrey & Pullen, LLP and RSM McGladrey, Inc. serve clients' business needs. The two firms operate as separate legal entities in an alternative practice structure. McGladrey & Pullen is a licensed CPA firm providing assurance services. RSM McGladrey provides tax and consulting services.

McGladrey & Pullen, LLP and RSM McGladrey, Inc. are members of the RSM International ("RSMi") network of independent accounting, tax and consulting firms. The member firms of RSMi collaborate to provide services to global clients, but are separate and distinct legal entities which cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party.

McGladrey, the McGladrey signature, The McGladrey Classic logo, *The power of being understood*, *Power comes from being understood* and *Experience the power of being understood* are trademarks of McGladrey & Pullen, LLP and RSM McGladrey, Inc.