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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Loan Participations

As bank regulatory agencies continue to focus and raise concerns about concentrations in commercial real estate, participations have declined. Other reasons for the decline in participations during the past year reflect the concerns of banks in general in shrinking their balance sheets and preserving their capital while also tightening underwriting standards and staying away from loans outside of their market because of a lack of control by the participant.

The banking industry has seen an increase in loan portfolio problems in part from loan participations made by multiple lenders to a single borrower. An originating bank will normally act as the lead bank and enlist other banks as participants in a loan. The originating bank deals directly with the borrower and will service and manage the loan.

Loan participations are useful in those situations when (i) a loan would otherwise be too large for the originating bank to handle by itself, (ii) participating banks in a slow market can team up with the originating bank to generate more income, (iii) participating banks can diversify their loan portfolio by reducing risks and diversifying in different communities and geographic areas, (iv) the originating bank reduces its risk to the borrower and in a specific geographical area, and (v) the originating bank continues its relationship with the borrower through the servicing of the loan.

A loan participation, as distinguished from a multibank loan transaction, i.e., a syndicated loan, is an arrangement in which the originating bank makes a loan to a borrower, and then sells off a portion of the loan to one or more banks. All the documentation of the loan is drafted in the name of the originating bank and the participant's share of the loan is evidenced by a certificate which assigns an interest in the loan and any related collateral. This certificate is generally part of a loan participation agreement between the originating bank and one or more participants in the loan.

In order to constitute safe and sound banking practices, bank regulatory agencies require controls to be in place in connection with loan participation transactions to include (i) written lending policies and procedures, (ii) an independent analysis of the credit quality by the participant bank, (iii) agreement by the borrower to make full credit information available to the originating bank, (iv) agreement by the originating bank to provide available information on the borrower and maintenance of credit information by the participant bank, and (v) written documentation outlining the rights and obligations of each party to the transaction.

Written lending policies and procedures should include a complete analysis and documentation of the credit quality of the obligation to be purchased by the participant bank, an analysis of the value and lien status of the underlying collateral and the maintenance of full credit information on the borrower during the term of the loan.

A loan participant needs to obtain full credit information on a borrower before a loan participation is purchased in order to make an informed and independent evaluation of the credit. Once the purchase of the participation is made, the loan participant also needs timely credit information to monitor the status of the loan. Such information can often be obtained from the originating bank.

Loan participations are subject to the provisions of Financial Accounting Standard 140 ("FAS 140") which establishes the accounting treatment for both the originating bank and the participant bank. Loan participations are accounted for as sales under FAS 140 if (i) the participant's interest in the loan is isolated from the interest of the originating bank and is beyond the reach of the originating bank and its creditors, (ii) the participating bank must control the interest acquired with the right to pledge or exchange the interest, and (iii) the originating bank must not maintain effective control over the interest transferred to the participant bank such as the ability of the originating bank to cause the repurchase or redemption of the interest held by the participant bank before its maturity. In order to satisfy the criteria, the participant bank must not have any formal recourse with the originating bank.

In connection with the contractual terms of the loan participation agreement, matters need to be addressed such as the right of the originating bank without the prior consent of the loan participant to (i) make any amendment to the terms and conditions of the loan, (ii) waive or release any claim against a borrower or a guarantor, (iii) make or consent to any release, substitution or exchange of collateral, (iv) accelerate payment under the loan, (v) commence any type of collection proceeding against the borrower or a guarantor or exercise any rights against the collateral securing the loan. In the event that there is more than one participant involved in the loan, the loan participation agreement needs to address the percentage of ownership, i.e., 100% of all interests or a lesser percentage of all interests, to do any of the foregoing.

The Federal Deposit Insurance Corporation ("FDIC") reports that the volume of criticized credits of Shared National Credits, loan commitments of $20 million or more and held by three or more federally supervised institutions, increased to $373.4 billion or 13.4% and classified credits increased to $163.1 billion or 5.8%. The Report by the FDIC reflected an inordinate volume of syndicated loans with structurally weak underwriting characteristics. The report is available on the website of the FDIC at *www.fdic.gov*.

Our firm has extensive experience and is available to assist and answer questions involving loan participation agreements.

Quarterly Banking Profile

The Federal Deposit Insurance Corporation ("FDIC") has issued its *Quarterly Banking Profile* reflecting the financial results for the third quarter of this year. More than half of all insured institutions reported lower net income in the third quarter and almost one out of four institutions reported a net loss. Loans that were not current (90 days or more past due or in nonaccrual status) increased by 13.1% during the third quarter. The FDIC's problem list of banks grew during the quarter from 117 to 171, which is the largest number since 1995.

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The report is available on the website of the FDIC at *www.fdic.gov*.

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