Thrift Bulletin

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Interagency Statement on Sales of 100% Loan Participations

Summary: The federal banking and thrift regulatory agencies have issued interagency guidelines on certain 100% short-term loan participation programs.

For Further Information Contact: For Further Information Contact Supervision Policy, OTS, Washington, D.C.

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The attached interagency statement provides guidance to financial institutions with respect to policies and procedures for structuring certain 100% short-term loan participation programs. These programs involve loans originated and structured with the intention of selling off the entire underlying loan amount. The statement pertains solely to 100% loan participation programs of the type addressed in a 1992 federal case "Banco Espanol de Credito v. Security Pacific National Bank" in which the court concluded that such programs did not involve the sale of securities under federal securities laws. The court, however, acknowledged that such programs that depart substantially from the criteria set forth in the case may inadvertently involve the sale of securities and be subject to federal securities laws. To ensure that 100% loan participations of the type addressed in the federal case are structured as commercial undertakings and not as investments in securities, financial institutions should follow the guidance in the attached interagency statement.

Attachment

John F. Downey
Executive Director,
Supervision

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
FEDERAL DEPOSIT INSURANCE CORPORATION
OFFICE OF THE COMPTROLLER OF THE CURRENCY
OFFICE OF THRIFT SUPERVISION

INTERAGENCY STATEMENT ON SALES OF 100% LOAN PARTICIPATIONS

April 10, 1997

INTRODUCTION

A loan participation is a sharing or selling of interests in a loan. Depository institutions use loan participations as an integral part of their lending operations. Participations in underlying loans may be sold to enhance an institution's liquidity, interest rate risk management, capital, and earnings; diversify its loan portfolio; and serve the credit needs of its borrowers. When depository institutions reach internal or legal lending limits for particular borrowers, loan participations enable the institutions to continue providing needed credit to borrowers. This statement does not apply to the vast majority of loan participations typically engaged in by insured depository institutions, as described below.

In some cases, depository institutions structure loan originations and participations with the intention of selling off 100% of the underlying loan amount. Certain 100% loan participation programs raise unique safety and soundness issues that should be addressed by an institution's policies, procedures and practices.[1] The "100% loan participation programs" that are the

[1] *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51 (2nd Cir. 1992), *cert. denied*, 113 S. Ct. 2992 (1993) ("*Banco*"), provides relevant information for institutions structuring 100% loan participation programs. In *Banco*, the court concluded the defendant bank's (the "Bank's") 100% loan participation program did not involve the sale of

subject of this statement include only programs involving the sale of participations like those

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securities under the federal securities laws. In reaching its decision, however, the court did not preclude the possibility that 100% loan participation programs similar to the Bank's that depart substantially from the criteria set forth in the case may inadvertently involve the sale of securities for federal securities law purposes. A bank that sells notes that are securities within the federal securities laws may be subject to civil liability under the anti-fraud provisions of those laws.

In *Banco*, the Bank made a series of short-term loans and endeavored to sell 100% participations in these loans mostly to various institutional investors and commercial institutions. Each purchaser of loan participations was required to enter into a Master Participation Agreement ("MPA"), which contained a general disclaimer that the purchaser made its own credit analysis and did not rely on the Bank. Under the MPA, the participations could not be resold without the Bank's written consent, and the Bank assumed no responsibility for the ability of the underlying borrower to repay its loans.

When one borrower began to encounter financial difficulties, the Bank refused to extend additional credit to the borrower, but continued to sell loan participations in the borrower's debt. Subsequently, the borrower declared bankruptcy. Suit was filed by those who purchased loan participations after the Bank's refusal to extend further credit to the borrower. The suit alleged that the loan participations were "securities" under the Securities Act of 1933 (the "Act"), and that the Bank violated § 12(2) of the Act by failing to disclose material facts about the borrower's financial condition at the time the Bank sold the loan participations. The purchasers acknowledged that traditional loan participations are not "securities" within the meaning of the Act. They argued, however, that the unique nature of the Bank's loan participation program brought these loan participations within the Act's definition of "notes" that constitute "securities."

The court applied the "family resemblance" test articulated by the Supreme Court in *Reves v. Ernst & Young*, 494 U.S. 56 (1990). Under the family resemblance test, a note is presumed to be a security unless an examination of the note based on four factors reveals a strong resemblance between the note and one of a judicially-enumerated list of instruments that are not securities. The four factors to be considered are: (1) the motivations that would prompt a reasonable buyer and seller to enter into the transaction; (2) the plan of distribution of the instrument; (3) the reasonable expectations of the investing public; and (4) whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the securities laws unnecessary. Applying the four *Reves* factors, the court held that the 100% loan participations were analogous to commercial loans and therefore did not meet the statutory definition of "securities" under the Act. However, the court cautioned that the holding was specific to the facts of the case and that even if an underlying instrument is not a security, the manner in which participations in that instrument are used, pooled or marketed might establish that such participations are securities.

involved in *Banco,* that are short-term loans originated by an institution that sells off, without recourse, 100% participation under a continuing program, and retains no further interest in the originated loan. The four federal banking agencies -- the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision -- are issuing this statement to provide uniform guidance for depository institutions that structure these 100% loan participation programs. This statement does not apply to other sales of participations or assignments of entire loans, such as sales of 100% participation in problem loans from the bank's portfolio, or sales in connection with loan trading activities.

SAFETY AND SOUNDNESS CONSIDERATIONS

If not appropriately structured, a 100% participation program can present unwarranted risks to the originating institution, including legal, reputation and compliance risks. The policies of a depository institution engaged in the origination of 100% loan participations should address safety and soundness concerns and include criteria for these programs. This criteria should address (1) the program's objectives, (2) the plan of distribution, (3) the credit requirements applicable to the borrower, and (4) the access afforded program participants to financial information on the borrower. In addition, the institution should establish procedures for ensuring compliance with applicable regulations and consistency with the institution's policies and procedures.

ADOPTION OF POLICIES AND PROCEDURES

Participation Agreements. The originating institution should use written participation agreements to set forth the rights and obligations of the parties participating in the program. The agreements should clearly state the limitations the originating and participating institutions impose on each other and the rights all parties retain. The originating institution should state, unequivocally, that loan participants are participating in loans and are not investing in a business enterprise.

Program Objectives. A 100% loan participation program should be structured to accommodate commercial objectives and not objectives geared primarily to investment in a business enterprise. Therefore, the motivations of the parties involved in the program (the originating institution, the borrower, and the participants) should be of a commercial nature.[2] For example, banks may structure 100% loan participation programs to provide borrowers with short-term credit to finance their current operations, and to provide parties with excess cash the opportunity to obtain a short-term return by purchasing interests in these loans.

Plan of Distribution. The originating institution should take reasonable steps to ensure that the general public does not become the target of marketing efforts as a result of resales by loan participants. For example, the originating institution should have a program in place to ensure that participants are limited to sophisticated financial and commercial entities, and

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[2]For additional discussion on this issue *see* the underlying district court decision in *Banco Espanol de Credito v. Security Pacific National Bank,* 763 F.Supp. 36 (S.D.N.Y. 1991) at 42-43.

sophisticated persons, and that the participations are not sold directly to the general public. Steps that might be taken by the originating institution include retaining a right of first refusal on any bona-fide offer to a participant from a third party, or requiring the originating institution's permission, not to be unreasonably withheld, before a participant could sell or pledge a loan participation interest.

Credit Condition of the Borrower. The originating institution should structure 100% loan participation programs only for borrowers who meet the originating institution's credit requirements. Loan participations will also have to meet the credit requirements of the loan participants. In the event the originating institution decides to terminate its credit relationship with a borrower, or materially downgrades its relationship with the borrower, the institution should reevaluate whether originating new loans for that borrower for 100% loan participations is appropriate.

Access to Credit Information. The originating institution should allow potential loan participants to obtain and review appropriate credit and other information on the borrower to enable the participants to make an informed credit decision. Promotional materials should clearly state that the participants and not the originating depository institution are responsible for making the ultimate credit decision through the participant's own review of information pertaining to the borrower.

ADDITIONAL GUIDANCE AVAILABLE

Additional guidance and information may be obtained by reviewing:

1. The OCC's Banking Circular 181 (Rev.) "Purchases of Loan in Whole or in Part-Participations" (August 2, 1984);

2. "Loan Participation Agreements: ABA/RMA Industry Guidelines" published jointly by the American Bankers Association and Robert Morris Associates; and

3. Banker's Guide to Loan Participations, American Bankers Association.

4. Federal Deposit Insurance Corporation's Division of Supervision Manual of Examination Policies, discussion on loan participations.

5. Office of Thrift Supervision's Thrift Activities Handbook, Section 211, Loan Portfolio Diversification, pages 211.2 & 211.3.

SUPERVISION BY BANKING AGENCIES

The federal banking agencies will continue to review a depository institution's policies and procedures governing the sale of 100% loan participations as part of their normal examination function. The banking agencies will monitor these programs to determine if they comply with the originating institution's applicable policies, procedures and practices.

Questions on the Statement may be submitted to:

FRB -- Division of Banking Supervision and Regulation, Securities Regulation Section, (202) 452-2781; Legal Division, (202) 452-3750.

FDIC -- Office of Policy, Division of Supervision, (202) 898-6918; Regulation and Legislation Section, Legal Division (202) 898-8876.

OCC -- Office of the Chief National Bank Examiner, Credit and Management Policy Group, (202) 874-5170 or Capital Markets Group, (202) 874-5070; Office of Chief Counsel, Securities & Corporate Practices Division, (202) 874-5210.

OTS -- Office of Supervision Policy, (202) 906-7067; Business Transactions Division, (202) 906-6990.

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