CLIENT ALERT – NCUA ISSUES NEW OPINION REGARDING LOAN PARTICIPATION REGULATION

"provisions of the loan participation regulation must be met throughout the life of the transaction"

"each participated loan must be identified and treated independently"

On March 22, 2018, the National Credit Union Administration's Office of the General Counsel issued a new opinion on the loan participation regulation – 12 CFR 701.22. The Opinion makes clear that "*provisions of the loan participation regulation must be met throughout the life of the transaction*" and that "*each participated loan must be identified and treated independently*". The Opinion concludes that these requirements support the principle that each purchase or sale of a loan participation represents an interest in a single loan, which must be maintained throughout the life of the participated loan.

In the Opinion, the General Counsel offers two examples to illustrate these principles. First, that "a servicer [or lead credit union] generally cannot deduct a servicing fee related to a nonperforming loan participation from the principal and interest received from a performing loan participation, even when many loan participations are sold to the same purchasing credit union." And, second, "netting payments across multiple performing loans generally is considered permissible if there is proper accounting of each loan's individual status and the netting is in accordance with the loan participation agreement."

This Client Alert provides practical guidance on how credit unions can implement the Opinion to ensure compliance with the loan participation regulation. In particular, this Client Alert will cover the two examples given by the General Counsel and explain the permissible means of calculating servicing fees and "netting" payments by the originating (or lead) credit union on behalf of members and their loans, which often increases the principal balance of a loan. Importantly, this Client Alert will also review some of the hidden complexities of netting of payments across multiple performing loans and the corresponding accounting.

To help illustrate a regulatory compliant participation, consider the example of a simple, non-recourse participation between two credit unions consisting of two loans sold at the same time to the same purchasing credit union.

Loan Details (at time of sale)

	Loan 1	Loan 2	Total / WAVG
Beginning Balance	$20,000.00	$40,000.00	$60,000.00
Participant's Share of Balance	$18,000.00	$36,000.00	$54,000.00
Interest Rate	6.00%	4.00%	4.67%
Servicing Spread	0.25%	0.25%	0.25%
Net (Pass Through) Interest Rate	5.75%	3.75%	4.42%
Participant Ownership	90.0%	90.0%	90.0%

1. SERVICING FEES

The Opinion makes clear that, in order to comply with the participation regulation, each participated loan must be identified and treated independently and that originating (or lead) credit unions may not deduct a servicing fee for nonperforming loan participations from the principal and interest received from performing loan participations.

In order for an originating (or lead) credit union to calculate and then deduct servicing fees in a manner consistent with the obligation to treat each loan independently along with the other provisions of the loan participation regulation, the servicing fees should be calculated on each payment on each loan, deducting the servicing fee solely from the interest portion of any payment on a particular loan.

For example, consider the following single month's payment information on the two participated loans described above.

Month 1 Payment Details

	Loan 1	Loan 2	Total
Principal Payment Collected	$369.70	$0.00	$369.70
Interest Payment Collected	$100.00	$0.00	$100.00
Gross Interest (Participant Share)	$90.00	$0.00	$90.00

The proper formula for calculating the servicing fee is calculated as follows: (interest actually paid by the member) * (the ratio of servicing spread to gross interest rate) * (percentage ownership of the loan). Using this formula results in the following servicing fees deducted by the lead credit union and net interest payments to the purchasing credit union.

Proper Method

	Loan 1	Loan 2	Total/WAVG
Servicing Fee Deducted	$3.75	$0.00	$3.75
Net (Pass Through) Interest Received	$86.25	$0.00	$86.25
Net (Pass Through) Rate	5.75%	0.00%	1.92%

Using this equation for each interest payment received for each loan ensures that the lead credit union will never take proceeds from performing loans to pay for an improperly charged servicing fee on non-performing loans.

Any time a servicing fee is charged on a loan without a corresponding member payment (or deducted in the wrong amount due to the use of improper formulas) those additional or incorrectly deducted proceeds can only come from performing loans sold to the same, purchasing credit union, which results in the lead credit union failing to comply with the loan participation regulation and generally reduces returns to the purchasing credit union. One example of such an improperly deducted servicing fee is illustrated immediately below using the following formula: servicing fee equal to (total sum of beginning balances) * (servicing spread / 12) * (Percentage Ownership).

Example Improper Method

	Loan 1	Loan 2	Total/WAVG
Servicing Fee Deducted	$3.75	$7.50	$11.25
Net (Pass Through) Interest Received	$86.25	($7.50)	$78.75
Net (Pass Through) Rate	5.75%	-0.25%	1.75%

In this example the lead credit union has deducted from the proceeds of Loan 1 to incorrectly pay for the servicing fee on Loan 2. This common method of calculating servicing fees, i.e., charging servicing fees on nonperforming loans, and then deducting those amounts from the proceeds from performing loans, both fails to meet the requirements of the NCUA's regulatory guidance and also results in the purchasing credit union receiving less proceeds than it is entitled to receive. In fact, using this kind of improper method for calculating servicing fees results in the purchasing credit union receiving only $78.75 of interest instead of $86.25 of interest.

2. "NETTING" ACROSS PARTICIPATED LOANS

From time to time, the lead credit union makes expenditures (or other advances) on loans to protect or repossess collateral, purchase legal services or take other extraordinary steps as part of servicing loans. In many cases, the lead credit union may be entitled to reimbursement for these expenses and advances from the applicable participants. However, care must be taken that the reimbursement for such expenses is done in a regulatory compliant way that maintains the proper accounting of each participated loan's status as an interest in a single loan.

The Opinion makes clear that a lead credit union may be reimbursed immediately for advanced amounts on a loan participation out of the proceeds from other loans sold to the same credit union (often referred to as "netting" proceeds) so long as two independent conditions are met. **First**, that the lead credit union has a contractual right to immediate reimbursement and, **second**, that the proper loan level accounting for the payment is performed.

For example, using the same two participated loans from above, consider the treatment of an advance for collateral protection insurance (CPI). In this example, we have assumed the loans had the following monthly principal and interest payments.

Month 1 Payment Details

	Loan 1	Loan 2	Total
Principal Payment Collected	$369.70	$769.83	$1,139.53
Principal (Participant Share)	$332.73	$692.85	$1,025.58
Gross Interest Collected	$100.00	$133.33	$233.33
Gross Interest (Participant Share)	$90.00	$120.00	$210.00
Servicing Fee Deducted	$3.75	$7.50	$11.25
Net Interest (Participant Share)	$86.25	$112.50	$198.75
CPI Applied	($1,000.00)	$0.00	($1,000.00)
CPI Applied (Participant Share)	($900.00)	$0.00	($900.00)

Most participation agreements provide that a lead credit union can be reimbursed by participants for advances like CPI in proportion to their ownership in the participated loan. However, in general, lead credit unions do not have a right to immediate reimbursement for advances absent prior approval from the participants.[1]

If the lead credit union has not received prior approval from the participants (i.e., by taking a vote of the participants and obtaining their approvals), then the lead credit union generally can only be reimbursed over time as future payments from the member are made or other proceeds from that loan are received. Therefore, during the course of the loan, the lead credit union should establish an accounts receivable accounting table (with the participants showing an account payable table) for their respective portion of the CPI. This receivable (or payable) is paid from future member payments or other proceeds on that particular loan.

Proper Method Participant's Perspective

	Loan 1	Loan 2	Total	Loan 1 Balance
A/R Increase *(from Principal actually paid)*	$332.73	$692.85	$1,025.58	$17,667.27
A/R Increase *(from Net Interest actually paid)*	$86.25	$112.50	$198.75	

A/P Increase *(from CPI purchased)*	$900.00	$0.00	$900.00	$18,567.27

End of Month Balances & Distributions

Cash Received	$0.00	$805.35	$805.35	
A/P Balance	$481.02	$0.00	$481.02	

However, many credit unions fail to create these accounting entries and simply "net" the principal increase from other payments made on other loans notwithstanding the lack of a contractual right to do so. As the table below illustrates, "netting" the amounts advanced on Loan 1 results in immediate reimbursement to the lead credit union from the proceeds on Loan 2.

[1] Most participation agreements limit the ability of the lead credit union to make cash expenditures absent prior approval. Otherwise, without those limits, the participant would simply be writing a "blank check" to the lead credit union to incur costs as it pleases at the expense of the participant. In the case of expenditures absent approval, many participation agreements still allow for the lead credit union to be reimbursed but only out of future proceeds from the member or loan.

Improper Method Participant's Perspective

	Loan 1	Loan 2	Total	Loan 1 Balance
A/R Increase *(from Principal actually paid)*	$332.73	$692.85	$1,025.58	$17,667.27
A/R Increase *(from Net Interest actually paid)*	$86.25	$112.50	$198.75	
A/P Increase *(from CPI purchased)*	$900.00	$0.00	$900.00	$18,567.27

End of Month Balances & Distributions

Cash Received	($481.02)	$805.35	$324.33	
A/P Balance	$0.00	$0.00	$0.00	

Absent an explicit contractual right, such as approval by a vote of the participants for immediate reimbursement, the lead credit union would be improperly netting amounts or, in other words, taking returns from other performing loans that the purchasing credit union is otherwise entitled. In fact, in this example, an improper netting would result in the participant receiving $324.33 of total proceeds for the applicable month instead of $805.35 of total proceeds. "Netting" in this fashion fails to maintain the independent character of each participated loan as required by the loan participation regulation.

Although less common, the following example shows how to properly net advances or expenses when the lead credit union has a contractual right to immediate reimbursement. In our experience, the accounting for immediate reimbursement can be more complex than the accounting when the lead lender is reimbursed over time from future payments on a single, affected loan. The example below provides a simplified version of the proper accounting entries to track each loan independently of all other loans while "netting" advances and expenses across loans in a single pool.

In the case of a properly "netted" advance for CPI on Loan 1, the lead credit union should account for the payment of the advance amounts and resulting increase in principal balance of the loan by showing a new payment from the purchasing credit union to the lead credit union on Loan 1. This payment (often referred to as an inter-creditor payment) is ***the critical entry*** and represents an immediate settling of the "purchase" of additional principal added to Loan 1 as a result of the lead credit union's advance.

Proper Method Participant's Perspective

	Loan 1	Loan 2	Pool Proceeds	Total	Loan 1 Balance
A/R Increase *(from Principal actually paid)*	$332.73	$692.85		$1,025.58	$17,667.27
A/R Increase *(from Net Interest actually paid)*	$86.25	$112.50		$198.75	
A/P Increase *(from CPI purchased)*	$900.00	$0.00		$900.00	$18,567.27
A/P Decrease *(inter-creditor payment)*	($481.02)	$0.00		($481.02)	
Cash			($481.02)	($481.02)	

End of Month Balances & Distributions

Cash Received	$0.00	$805.35	($481.02)	$324.33	
A/P Balance	$0.00	$0.00	$0.00	$0.00	

Properly accounting for advances and expenses is rather simple to perform. Creating the applicable account payable (or receivable) tables enables a lead lender to track, account and be reimbursed for advances and expenses over time or immediately depending the contractual obligations. Moreover, doing so allows the lead credit union to fully comply with its obligation under the loan participation regulation to keep each loan independent and separate over the life of the participation.

If you have any questions regarding your participation and how to ensure that it meets your regulatory and contractual obligations over the entire life of the transaction, please contact LoanStreet so that we may offer more specific support. Our team is available at info@loan-street.com. You can also join the LinkedIn Loan Participation Group, or follow us at: