LOAN PARTICIPATION PROGRAM MANUAL

JUNE 2013

CALLAHAN FINANCIAL SERVICES

CUFSLP
CALLAHAN CREDIT UNION FINANCIAL SERVICES LIMITED PARTNERSHIPS

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INTRODUCTION AND PURPOSE

A loan participation is a sharing or selling of interests in a loan. Credit unions can use loan participations as an integral part of their balance sheet strategies. Credit unions that sell participations may enhance their liquidity, interest rate risk management, and ability to serve members. Credit unions that purchase participations may benefit from a diversified balance sheet, higher loan-to-share ratio, and increased earnings.

This handbook is meant to serve as a basic resource for credit unions that purchase or buy loan participations. It contains fundamental issues that any credit union should consider before establishing a participation program.

PARTICIPATION OVERVIEW

WHAT IS A LOAN PARTICIPATION?

A loan participation is an instrument which allows multiple lenders to participate or share in the funding of a loan. The originating (lead) lender underwrites and closes the loan, and subsequently, or sometimes simulaneously, sells portions of the loan to other pparticipants In most cases, the originating lender will service the loan and remit each participant's share of principal and interest to them as they are received by the servicer. Participating institutions share in the funding of a loan, becoming an “owner” of a portion of the loan with all benefits of full performance and, if non-recourse, all associated risks of loss — as if the participant had originated the loan itself.

WHY LOAN PARTICIPATIONS?

A major motivation for a loan participation program is to meet the needs of members in conjunction with certain requirements of the institution. While participations provide a mechanism for improving lender volume, increasing geographic diversification, and diversifying risk, credit unions that are considering the purchase of loan participations must avoid an overreliance on the lead institution and perform their own due diligence.

HOW MANY CREDIT UNIONS USE LOAN PARTICIPATIONS?

Credit unions over $1B in assets are the most active in the market with approximately 70% of those institutions utilizing participations. However, as asset size decreases, the percentage of credit unions utilizing participations drops significantly. Less than 30% of credit unions with assets under $100M use participations as of 2012.

PARTICIPATION LOAN PEER GROUP COMPARISON

DATA AS OF SEPTEMBER 30, 2012

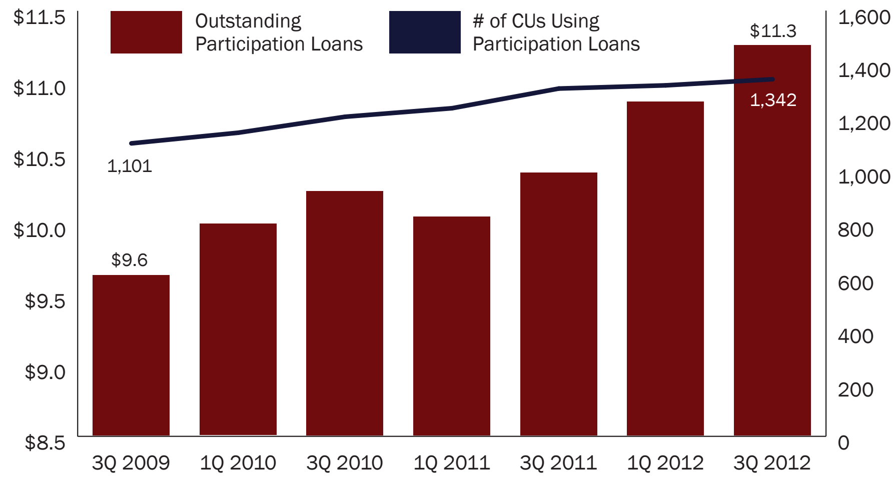
Peer Group	# of CUs with Participation Loans Outstanding	% of CUs In Peer Group with Participations Outstanding
CUs Less Than $10M	72	2.9%
CUs $10M – $20M	67	6.6%
CUs $20M – $50M	213	16.4%
CUs $50M – $100M	221	27.5%
CUs $100M – $250M	305	43.3%
CUs $250M – $500M	193	55.6%
CUs $500M – $1B	135	62.5%
CUs Over $1B	136	69.7%
TOTAL	**1,342**	**19.1%**

SOURCE: CALLAHAN & ASSOCIATES’ PEER-TO-PEER ANALYTICS

MORE CREDIT UNIONS ARE UTILIZING PARTICIPATION LOANS

Outstanding Participation Loans And Number Of Credit Unions With Outstanding Balances

DATA AS OF SEPTEMBER 30, 2012

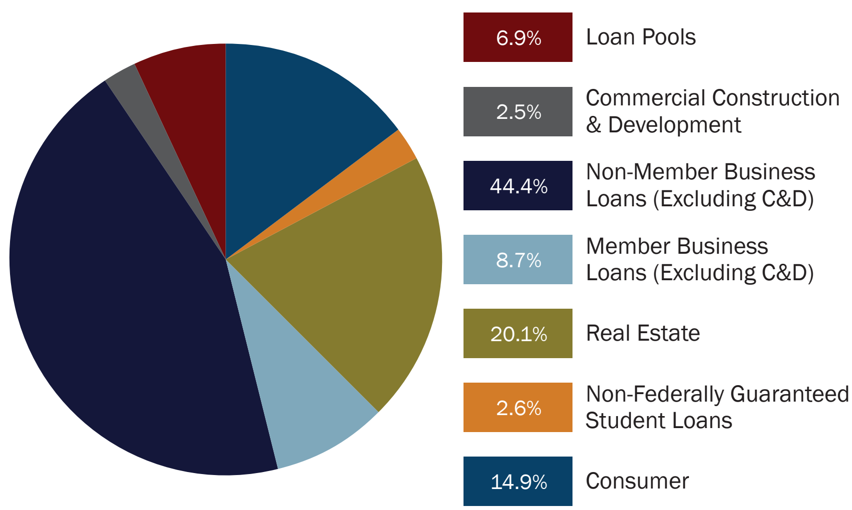


SOURCE: CALLAHAN & ASSOCIATES' PEER-TO-PEER ANALYTICS

OVER HALF OF THE OUTSTANDING PARTICIPATIONS ARE BUSINESS LOANS

Participation Loan Portfolio

DATA AS OF SEPTEMBER 30, 2012



SOURCE: CALLAHAN & ASSOCIATES' PEER-TO-PEER ANALYTICS

IS THERE A FIXED PERCENTAGE THAT THE ORIGINATING CREDIT UNION MUST RETAIN?

For Federal credit unions, the originating credit union must retain at least 10% of each loan. Retention requirements for state-chartered vary state by state, and should be confirmed with legal counsel. Whatever split is decided upon, the participating credit unions should achieve a desired level of comfort that is agreeable to all parties involved.

WHO IS RESPONSIBLE FOR SERVICING?

If the originating lender possesses the capabilities to handle the servicing, that institution may service the loan on behalf of the participants. This includes monthly reports and distribution of principal and interest.

However, many credit unions don't have the operational capacity to service multiple loan participations. Therefore, it may be preferable to employ a third party servicer to service the loan on behalf of the lead institution. This arrangement is usually specified in the participation agreement.

RULES AND REGULATION CHECKLIST AND COMPLIANCE

The NCUA has a vested interest in ensuring that Loan Participations are well-thought-out by both parties. Loan participations may pose a systemic risk to the National Credit Union Share Insurance Fund. Therefore, it is important to the NCUSIF that all federally insured credit unions adhere to the same minimum standards for engaging in loan participations. Before entering into a transaction, the NCUA suggests, and the examiners may ensure, that purchasing and selling credit unions evaluate all components and stages of a loan participation.

DUE DILIGENCE REVIEW

PURCHASING CREDIT UNIONS SHOULD CONSIDER THE FOLLOWING FACTORS:

- Seller must have demonstrated ability to repurchase the participation if required under the terms of the participation agreement.
- Participation Agreement should define how risk will be shared among the participants, including whether the transaction qualifies for true sale accounting or is a secured borrowing.
- Product being sold is time-tested. Seller must demonstrate experience in underwriting product, and product should have weathered full economic and interest rate cycle.
- Purchasing credit union must underwrite the loan to their own standards — it cannot rely on the analysis performed by the seller or the broker.

RISK ASSESSMENTS

Prior to starting a loan participation program or entering into a loan participation agreement with a third party, officials must evaluate whether the program is compatible with the board's risk tolerance, loan policies and overall strategic plan.

CREDIT RISK ASSESSMENT

When evaluating acceptable credit risk, purchasing credit unions should consider a broad range of issues, including:

- Credit scores
- LTV limits
- Cash flow analysis
- Concentrations in volatile or unstable markets
- Concentrations in geographical locations
- Concentrations in certain types of investment properties
- Feasibility of speculative development projects
- Use of borrower information provided by brokers, and
- Full analysis of appraisal assumptions and final valuations

Management must determine in advance the types of loan participations to purchase, based on the depth of staff experience and expertise, and other necessary resources, including management information systems to track changing risks.

The originating and purchasing credit unions need to adopt a policy permitting loan participations, including the specific types of loans to be participated and any deviations from existing underwriting standards. The purchasing credit union should review the originating credit union's policies as part of its due diligence procedures.

RECOURSE VS NON-RECOURSE

When considering credit risk, a purchasing credit union will likely want to evaluate whether the purchased participation is being sold without recourse to the originating credit union. Participation agreements with or without recourse to the originator are different than loans with or without recourse to the borrower.

If a credit union purchases a participation pool without recourse to the originating credit union, then the credit union passes the loan pool's credit risk to the purchasing credit union. If the purchase participation is with recourse, the purchasing credit union may be able to demand that the originating credit union repurchase the loan and pay its ratable share of the unpaid balance. Both the originating and purchasing credit unions should examine the participation agreement for language which indicates whether the transaction is recourse or non-recourse, and the obligations due to the other party as a result.

INTEREST RATE RISK ASSESSMENT

Examiners will confirm whether a purchasing credit union has thoroughly evaluated the potential impact of interest rate risk, especially from extended maturities, on the fair value of their balance sheet.

LIQUIDITY RISK ASSESSMENT

Purchasing credit unions must evaluate the adequacy of:

- Liquidity to meet their own members' future loan demand before purchasing loan participations
- Management reporting systems to measure and monitor cash flows including disbursement and scheduled payments
- Funding sources to meet all potential calls to fund loan disbursements

TRANSACTION RISK ASSESSMENT

Purchasing credit unions must determine how to properly account for and control cash flow streams between themselves and the seller. *(An example of accounting treatment is provided below.)*

COMPLIANCE RISK ASSESSMENT

A buyer of loan participations must conform with applicable rules, regulations and compliance laws. These will include:

- NCUA Regulations applicable to loan participations *(A summary of applicable regulations is provided below.)*
- NCUA Regulations governing appraisals
- Applicable state laws for state-chartered credit unions
- Bank Secrecy Act; and
- Consumer protection regulations, such as Truth in Lending, Equal Credit Opportunity Act and Real Estate Settlement Procedures Act

STRATEGIC RISK ASSESSMENT

Credit unions should document how the relationship will relate to their credit union's strategic plan, considering long-term goals, objectives, and resource allocation requirements.

CONCENTRATION RISK ASSESSMENT

Both the originating and purchasing credit unions should consider their concentration risks when entering into a transaction. A purchasing credit union should ensure that its Board and Senior Managers are aware of how the acquisition of the purchased loans may increase its concentration in an asset category. Additionally, an originating credit union that sells its loans should be aware of how the sale of a particular category of loans could inadvertently increase the concentration of other categories of loans retained on its books.

REPUTATION RISK ASSESSMENT

Purchasing credit unions should have adequate internal controls, staffing, business recovery plans and other resources to meet their contractual commitments to the originating credit union in a timely manner.

Additionally, purchasing credit unions should consider the ramifications of a loan participation where the borrower would not fit the normal purview of the purchasing credit union. This consideration becomes especially important if the loan defaults or loses the credit union money. For example, a purchasing credit union's members may become unhappy to learn that a borrower 500 miles away defaulted on a loan that was purchased.

CONTINUED MONITORING

Even after the prior due diligence and risk assessments, NCUA recommends that purchasing credit unions should complete a post-closing review of all loan documents to determine that all terms and conditions are in accordance with the original terms presented. Loan participation Agreements should include language that requires a seller to buy back loans with missing documents, made outside of policy or otherwise not in conformance with representations and warranties.

Additionally, management of both purchasing and selling credit unions should fully understand the terms of the loan participation Agreement and underlying loan transaction in order to explain them to interested parties and regulators.

Finally, selling credit unions should continually monitor potential liability from maturing balloon extensions or rollovers since participants are generally not legally bound to continue to fund the extensions or rollovers, potentially creating significant liquidity, compliance and credit risk in the event the participants decline to renew their involvement.

SUMMARY OF NCUA RULES APPLICABLE TO LOAN PARTICIPATIONS

§701.22 – PROPOSED RULE 76 FR 79548 – NEW LOAN PARTICIPATION

In December 2011, the NCUA proposed new loan participation rules for Section 701.22. As of publication of this guide, the NCUA has yet to issue a final rule, but the proposed rule provides greater detail and regulatory expectations regarding key aspects of a loan participation purchase, including the loan participation policy, the loan participation agreement and the ongoing monitoring of the loan participation.

Some of the most significant changes to the rule include more enumerated requirements in loan participation agreements and policies, including revised language to clarify that the originating lender must participate in the loan throughout the life of the loan. The newly proposed rule also will not offer exemptions for differing underwriting standards, meaning that the originating credit union's underwriting must be as stringent, or more so, than the purchasing credit union's standards. Additionally, many of the requirements that are currently in place only for Federal credit unions would be expanded to all Federally-insured state chartered credit unions. Finally, loan participation purchases involving a single originator is limited to a maximum of 25% of the credit union's net worth, and loan participation purchases involving one borrower to 15% of net worth (both these limits will likely be increased when the final rule is released).

Though the rule has yet to be finalized, it may be prudent to take the proposed provisions into consideration when developing a loan participation program and policy.

Other details of the newly proposed rule are highlighted below:

LOAN PARTICIPATION CONDITIONS

The following conditions must be satisfied:

- The purchase complies with all regulations to the same extent as if the credit union had originated the loan
- The credit union has executed a written loan participation agreement with the originating lender
- The originating lender retains at least a 10% interest in the outstanding balance of the loan

- The borrower is a member of a participating credit union before the credit union purchases a loan participation
- Purchase complies with the credit union's written loan participation policies

LOAN PARTICIPATION POLICY

A credit union must establish a loan participation policy, which must:

- Establish underwriting standards for loan participations that at least meet the same underwriting standards the credit union uses when it originates a loan
- Limit the aggregate amount of loan participations that may be purchased from any one originating lender *(not to exceed 25% of credit union's net worth is proposed — likely will be revised in Final Rule)*
- Limit the amount of loan participations that may be purchased by each loan type, not to exceed a specified percentage of the credit union's net worth
- Limit on the aggregate amount of loan participations that may be purchased with respect to a single borrower *(not to exceed 15% of credit union's net worth is proposed — likely will be revised in Final Rule)*

LOAN PARTICIPATION AGREEMENT

A loan participation agreement must include:

- Prior to purchase, the identification of the specific loan participations being purchased
- The percent of the loan participation being retained by the originating lender throughout the life of the loan (which must be at least 10%)
- The location and custodian for the original loan documents
- Access to periodic financial and other performance information about the loan
- Enumerated duties and responsibilities of the originating lender, servicer, and participants in respect of servicing, default and foreclosure

RULES §701.22(A)(1); (C)(2) REQUIRED AND PERMISSIBLE LOAN PARTICIPANTS

Generally, a loan participation is a loan in which one or more "eligible organizations" participate pursuant to a written agreement with the originating lender.

Purchasing credit unions may only participate in loans in which the original lender remains as a participant. *(OGC Opinion 07-1035 (October 26, 2007))*

A Federal Credit Union that is the originating lender must retain at least 10%, or a meaningful interest if not an FCU, of each loan in which it sells a participation interest *(OGC Opinion 07-1035, October 26, 2007)*

RULE §701.22 INTEREST RATE

Because FCUs can only participate in loans they are empowered to grant, FCUs cannot participate in loans with an interest rate greater than the maximum allowable interest rate, which is currently 18%. *(12 CFR 701.22(b))*

PROCESS OVERVIEW

The general participation process is as follows (refer to appendix for sample agreements and loan certificates):

1. A list of loans the originating credit union is willing to participate is created.
2. The credit union makes any electronic files available to the purchasing credit union, if applicable.
3. The purchasing credit union's underwriter reviews the loans and makes selections. Sometimes, a loan that is a special program, for instance a high LTV for a physician loan, may result in the purchasing credit union passing on it based on their written loan policies.
4. Originating credit union agrees to the selections and the participation %.
5. Originating credit union sends the documents for the participation.
6. Purchasing credit union wires funds to originating credit union.
7. Originating credit union follows up with copies of the Notes and Deed of Trust.

APPENDIX

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* THESE SAMPLES PROVIDE GENERAL GUIDELINES AND ARE USED FOR INFORMATIONAL PURPOSES ONLY.

PLEASE CONSULT YOUR ATTORNEY OR CPA WHEN IMPLEMENTING ANY POLICY OR AGREEMENT.

BOARD APPROVAL LOAN PARTICIPATION POLICY

PURPOSE

(State/Federal) Statutes, (Section XXXX.xx), provides that a credit union may agree to participate in the risk liability and income of loans to credit union members jointly with other credit unions, credit union organizations, financial institutions or financial organizations.

POLICY

It is the policy of the credit union to participate in loans to credit union members jointly with eligible organizations up to a funding percentage not to exceed a 90% undivided interest of the total loan(s).

DEFINITIONS

1. "Participation loan" means a loan where one or more eligible organizations participate pursuant to a written agreement with the originating lender.
2. "Eligible organizations" means a credit union, credit union organization, financial institution, or financial organization.
3. "Originating lender" means the participant with which the member contracts.

GENERAL CONSIDERATIONS

1. The originating credit union will comply with applicable state or federal lending regulations.
2. If the total interest in a participation loan combined with prior participation loan purchases and other indebtedness owing to the credit union exceeds 10% of total assets, management will complete a credit concentration study.
3. A written master participation agreement will be properly executed by ____________________ on behalf of the credit union. The master agreement will include provisions for identifying the participation loan or loans prior to their sale.
4. The credit union will screen each new originator offering loan participation pools.
5. Upon approval of a loan participation program the board of directors will adopt the program originator's policies, procedures, and guidelines as its own loan policy, either directly or by reference.
6. Management will conduct periodic audits and reviews with loan participation originators to verify the accounting process, separation of duties for internal control, and maintenance of proper contingency plans.
7. To control the risk of loss resulting from increases in the level of interest rates, defaults, and forced sale of loans, the maturity of the loan participation portfolio is restricted to a 6-year maximum.
8. There are two distinct types of loan participation agreements which may be entered into by the credit union:
   a. Loans purchased with recourse to the selling organization.
   b. Loans purchased without recourse to the selling organization.

Each type demands a unique due diligence procedure as outlined in the due diligence section below.

DUE DILIGENCE PROCEDURES

The due diligence examination will consist of the following:

Due diligence procedures for selection and approval of originating organization:

- A review of the past 24 months financial performance will be performed, including:
    - Audited Annual Financial Statements, and Audited Quarterly Financial Statements, if available
    - 5300 Call Reports
- A financial analysis of the originator will be performed to determine trending analysis in the areas of capital, earnings, delinquency and loan loss ratios.
- Minimal Data for Analysis:
    - Equity Capital/Total Assets
    - Net Income and Cash Flow Statements
    - Delinquent Loans/Total Loans
    - Repossessions/Originations (if material)
    - Net Charge-Offs/Average Loans
- A review of loan policies and delinquency and collection procedures.
- References will be requested and verified. Prior loan participation experience is preferred.
- Visit originator's operations to review the concept of the business and verify that operating systems, policies, and procedures support the business model and are consistent with this policy.
    - Organization is capable of segregating the loans to be sold on their computer system.
    - Documentation required: A file or printout of segregated loan portfolio.
    - The form and substance of the monthly and other periodic reports will be accurate and provide adequate information for accounting and delinquency reporting purposes.
- Evaluate the financial management and risk factors associated with the program to ensure they are consistent with this policy, including:
    - Financial responsibility of the originator supporting the program.
    - Known adverse information regarding the originator appearing in the press will be reported by management to the board of directors.
    - Risk of default and estimated risk exposure should default occur.
    - Special features that may mitigate credit union's exposure.
    - Credit enhancement features that are part of the program.

All documentation will be filed with the master loan participation agreement and will be retained until the loan participation purchased has been paid in full, returned to the originator, or charged-off.

Due diligence procedures for RECOURSE AND NON-RECOURSE loan purchases:

A. Obtain a copy of the loan underwriting policy and review to establish that the policy is reasonable and meets the requirements of the credit union.

B. The selling organization's collection policy and actual procedures are appropriate and effective for the type of loans being sold.
   - Review collection policies and procedures.
   - Interview personnel regarding implementation of these procedures.

C. The seller's operational procedures are adequate to properly service the loans.
   - Review payment-processing procedures.

D. The projected net yield for the pool of loans being considered has been calculated.

E. The projected net yield will be compared to net yields available on other investments to determine if the compensation is adequate for the risk assumed.

Additional due diligence procedures for NON-RECOURSE loan purchases:

F. The loan underwriting practices of the seller are compliant with their internal policies.
   - Review a random sample of loans from the proposed participation pool.

G. The historical loss ratio for the pool of loans being considered for purchase will be calculated. If the pool does not have an historical loss ratio the loss ratio for similar loans held by the originator may be substituted.

H. Minimum acceptable underwriting standards for the type of loans being purchased may include:
   - Type of loans in the pool
   - Securing titles
   - Insurance for collateral
   - Debt ratio limitations
   - Loan terms
   - Credit report standards

STANDARDS FOR THE ORIGINATING LENDER

An originating lender will:

1. Underwrite loans based on the lending policy and guidelines provided to the credit union and agree to send updates to the lending policy and guidelines as they are made.
2. Only make loans to individuals eligible for membership in one of the participating credit unions.
3. Retain an interest of at least 10% of the face amount of each loan. If the originating lender is not the organization selling the loans the organization selling the loans will retain a minimum 10% interest in each loan.
4. Retain the original loan documents or legal substitute loan documents.
5. Require the use of the same underwriting standards and collections standards

for participation loans as for loans that are not being sold.

STANDARDS FOR THE CREDIT UNION

As a participating lender, the credit union will:

1. Have a lending or participation policy in place that sets forth the loan underwriting standards for the particular type of loans prior to entering into a participation agreement.
2. Retain the original or a copy of the written participation loan agreement and a schedule of the loans covered by the agreement.
3. Include provisions in its policies, approved by the Board of Directors, which govern the purchase and funding of participations.
4. When the loan type is outside of the general business practices or the level of internal expertise of the credit union, an experienced underwriter with expertise in the field identified will be used as a consultant.

ON-GOING DUE DILIGENCE PROCESS

Financial Review: At lease semi-annually, obtain and review financial information provided by the originator. Obtain certified, audited, or regulatory financial information when available.

Participation Status: Review actual program performance against this policy and overall goals in order to ensure the program is meeting expectations.

UNDERWRITING PROCEDURES

Underwriting procedures will vary for each type of loan participation based upon loan type and whether portfolio is with or without recourse to selling organization.

For Portfolios with recourse, the following minimum information will be analyzed:

A. Most Recent Audited Financials
B. NCUA 5300 or FPR and FPR ratios reports (if applicable)
C. Loan Policy
D. Delinquency and Collection Procedures

For portfolios without recourse the following will be reviewed on a random sample of loans:

AUTOMOBILE LOAN PARTICIPATION

A. Loan application
B. Evaluate credit report
C. Examine proof of income and ability to pay
D. Verify collateral value
E. Recalculate loan to value
F. Verify that the terms of the loan are within the originator's loan policy limits

MORTGAGE LOANS

G. Review loan application

H. Evaluate credit report

I. Examine proof of income and ability to pay

J. Verify LTV and appraisal

K. Verify that the terms of the loan are within originator's loan policy limits

LOAN ORIGINATION AND ADMINISTRATION

Credit guidelines and loan origination will be completed as follows:

- Originator prepares the loan documents that comply with applicable state and federal regulations.
- Loan documents will be fully completed and will result in valid and binding obligation of all borrowers to pay the loan according its term and with a valid and enforceable first lien on the collateral.
- Originator will verify the borrower has appropriate insurance in the full amount of the collateral as shown on the purchase contracts. Insurance will be payable to the originator, or the credit union or both as applicable.
- Originator will maintain in its possession all documents and records necessary for evidencing, securing, and servicing the loan. Originator will provide access to these documents at any reasonable time.

ANNUAL REVIEW

This policy is subject to annual review by the board of directors.

APPROVED BY THE BOARD: ________________________________

DATE: ____

ACCOUNTING TREATMENT

INITIAL BALANCE RECONCILIATION

Upon the initial transfer of funds to Originating Credit Union: the Originating Credit Union accountant will debit cash and credit a contra account.

MONTHLY REPORTING:

Within 3 business days of month end, the Originating Credit Union accountant will prepare the following reports for the Participating Credit Union:

- Delinquency Report — Participation Loans
- Escrow Advance Report — Participation Loans
- Payment Activity Report — Participation Loans
- Remittance Report — Participation Loans
- Trial Balance Report — Participation Loans

REMITTANCE PROCESSING:

Remittance is sent from the Originating Credit Union to Participating Credit Union on the fourth business day after month end.

AGREEMENTS

SAMPLE MASTER LOAN PARTICIPATION AGREEMENT

Document

NON-DISCLOSURE AGREEMENT

Document

SUB-SERVICER AGREEMENT

Document