Loan Participation Purchases

Loan participation purchases can be an effective way for lenders to supplement organic loan portfolio growth, increase asset yields, assist balance sheet management, and enhance loan portfolio diversification across different geographic regions, industries, and product types. However, these transactions are not free of risk. Risks of loan participation purchases include loss of flexibility and control; becoming overly reliant on the lead lender; the inability to obtain timely information; and loss exposure under workout or liquidation. Appropriate management of participation purchase loans is required not only by statutory and regulatory requirements but also necessary in the proper exercise of ordinary credit judgment and due diligence by the purchasing financial institution.

Significant risk exposure faced in participations are loan restructures and borrower defaults and including bankruptcy and foreclosure. Due to the significant financial risk exposure in these events, there are certain scenarios that should be addressed in the participation agreement. It should be required that the lead lender consult with participants prior to taking any action on defaulted loans. Resolution procedures should also be drafted in case one or more of the following events occur: participating lenders can't agree on how to handle a defaulted loan; potential conflicts arise when more than one loan to the borrower defaults; and when instances like breach of duty, negligence, or misappropriation requires the termination of the relationship between lead and participating lenders. Institutions should also consider incorporating risk mitigating factors to address a potential change to the lead participant due to a bank closure.

Department Rules 80-1-5-.04 and 80-2-12-.03 for banks and credit unions, respectively, requires that loan participation purchases must conform to all laws and regulations applicable to that category of loan to the same extent as if the purchasing financial institution had originated the loan itself. Applicable statutory and regulatory requirements, including, but not limited to, collateral documentation requirements, loan to collateral value requirements, and loan limitations must be met. The purchasing financial institution shall obtain from the selling lender copies of all pertinent collateral and credit documents or, solely in the case of a loan participation, a summary of information sufficient to conclude that all legal and regulatory requirements have been met. In addition, the purchasing financial institution has the responsibility of conducting loan underwriting procedures to determine that it complies with the financial institution's policies and credit standards. **Participating financial institutions are required to perform their own underwriting and not rely on underwriting performed by the loan originator.** All necessary credit and collateral documentation should be obtained **prior** to funding the loan. In the case of loan participation pools, the above cited Rule also contains specific requirements for purchases.

Factors to consider prior to purchasing participation loans include ensuring loan policies address relevant purchases; understanding the terms and limitations of agreements; performing appropriate due diligence; limiting concentrations to a lead lender, industry, or collateral type; determining if the participation fits loan criteria by analyzing the credit and collateral of the loan; obtaining necessary board or committee approvals; agreeing to the terms of the participation contract; and maintaining borrower credit information for the duration of the loan. Most importantly, financial institutions should only participate in loans that they would actually make themselves.

Numerous resources exist in identifying and detailing risk management considerations and strategies including:

- Federal Reserve System Community Banking Connections Second Quarter 2013 article titled "Loan Participations: Lessons Learned During a Period of Economic Malaise" https://communitybankingconnections.org/articles/2013/q2/loan-participations
- FDIC FIL-49-2015 "FDIC Advisory on Effective Management Practices for Purchased Loans and Purchased Loan Participations" https://www.fdic.gov/news/financial-institution-letters/2015/fil15049a.pdf
- NCUA Supervisory Letter "Loan Participation Programs" https://www.ncua.gov/files/supervisory-letters/LCU2008-26Enc-2.pdf
- CSBS Job Aid titled "Considerations for Reviewing Participation Credits" https://www.csbs.org/system/files/2017-11/CSBS_loan_participation_job_aid.pdf.

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