Evaluating Loan Participation Programs

Loan Participation Programs

Properly managed loan participation programs can be beneficial to both selling and buying credit unions. Loan participations may provide selling credit unions with a mechanism to manage regulatory limits, interest rate, liquidity, credit and geographic concentration risks, as well as an enhanced ability to serve members. Credit unions buying loan participations may benefit from diversifying the balance sheet, using excess liquidity, and increasing revenue.

Loan participation credit and concentration risks are increasing more rapidly than credit unions’ overall loan portfolio risk.

- Outstanding loan participations more than doubled between 2003 and 2008.
- Loan participation losses almost doubled in 2008.
- Loan participation delinquencies more than doubled from 2006 to 2008.\(^1\)

Credit unions can control risks by starting small and gaining experience over time, using best practices to measure, monitor, and control loan participation programs. When evaluating loan participation programs, examiners should determine whether credit unions address and document the following concepts in a manner commensurate with asset size, complexity, and risk profile:

- Risk assessment and strategic planning;
- Due diligence; and,
- Risk measurement, monitoring and control.

The same principles that apply to evaluating third party relationships apply to loan participations. A loan participation is a third-party relationship between a seller and a buyer, and as with any third-party relationship, the benefits of loan participations are accompanied by a variety of potential risks. Management should complete a risk assessment and perform due diligence prior to entering the third-party arrangement,

\(^1\) Outstanding loan participations increased 262% between 2003 and 2008, compared to a 149% increase in total loans. Annualized total dollars of loan participations charged off in 2008 were twice 2006 levels, resulting in the charge-off ratio increasing from 0.41% in 2006 to 0.64% in 2008. The charge-off ratio for total loans increased from 0.46% in 2006 to 0.75% in 2008. Loan participation delinquency was 1.10% in 2006 and 2.27% in 2008. Total loan delinquency was 0.68% in 2006 and 1.13% in 2008.
regardless of whether the third party is a credit union, a credit union service organization (CUSO), or another financial institution.

This guidance describes practices examiners will find in a well-run loan participation program involving any type of loans, including automobiles, residential mortgages, and member business loans. Credit unions sometimes engage in loan participations with eligible organizations other than federally-insured credit unions. This Supervisory Letter is relevant to those relationships as well, although other regulatory issues may apply.²

Examining Loan Participation Risks

A credit union involved in loan participations is exposed to a full range of risks including credit, interest rate, liquidity, transaction, compliance, strategic, and reputation risks. The degree of risk varies depending on whether the credit union is the seller or buyer, the sale is with recourse or non-recourse,³ the size and complexity of the individual loans, aggregate exposure to net worth, portfolio size including unfunded commitments, the level of experience and expertise on both sides of the transaction, and external economic factors.

When examining a loan participation program, field staff should evaluate management’s understanding of risks in the following key areas, and ensure management has addressed the various issues below.

Buying Credit Unions – Risks & Issues

Risk Assessment & Strategic Planning

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.

Officials can mitigate risk by fully understanding all aspects of the third-party relationship. Examiners will expect officials to provide documentation of an initial risk assessment which, at a minimum, addresses the following issues.

Credit Risk Assessment
Credit risk can vary widely depending on the loan type, size, structure, collateral type, and sources of repayment. When evaluating acceptable credit risk, buying credit unions should consider a broad range of issues including:

- Credit scores;
- Loan-to-value limits;
- Cash flow analysis;
- Concentrations in volatile or unstable markets;
- Concentrations in geographical locations;
- Concentrations in certain types of investment properties;

² See Exhibit A, Summary of NCUA Rules Applicable to Loan Participations.
³ See Examiner’s Guide, Chapter 10, Loans, for discussion of “recourse”.

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• 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 buying credit union needs to adopt a policy permitting loan participations, including the specific types of loans to be participated and any deviations from existing underwriting standards.\(^4\)

Prudent loan participation policies establish reasonable concentration limits for collateral types, geographical locations, loan participations purchased from one seller, and other key factors.

Loan policies should specify the trade area or market area where loans will be purchased. Management must have the ability to monitor and adjust to changing market conditions on an ongoing basis before deciding to expand the trade area.

**Interest Rate Risk Assessment**

The interest rate risk for individual loans varies depending on loan type, size, and whether the interest rate is fixed or variable. Interest rate risk increases as the term of the loan extends. Examiners should confirm that a buying credit union has thoroughly evaluated the potential impact of extended maturities on the fair value of their balance sheet.

Competitive and economic conditions may pressure buying credit unions to consider approving reduced rates and terms. A deterioration in a borrower’s financial condition may also prompt the consideration of a rate adjustment. These types of adjustments may require the credit union to re-evaluate its asset liability management (ALM) strategies.

**Liquidity Risk Assessment**

Buying credit unions must have sufficient liquidity available to fulfill obligations in the loan participation agreement, as well as the underlying loan documents. Revolving lines of credit and loans with unfunded commitments (such as construction loans) add to the complexity of monitoring liquidity needs.

Buying 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 disbursements and scheduled payments.
- Funding sources to meet all potential calls to fund loan disbursements.

**Transaction Risk Assessment**

Buying credit unions must fully understand all aspects of the loan participation arrangement to assess the potential impact on transaction risk. Transaction risk is

\(^4\) Section 701.22(c)(4) requires a selling credit union to use the same underwriting standards for loan participations as used for loans that are not being sold in a participation. Section 701.22(d)(1) permits a buying credit union to participate “only in loans it is empowered to grant, having a participation policy in place which sets forth the loan underwriting standards prior to entering into a participation agreement.”
mitigated by a strong internal control culture that results in sound systems, internal controls, audit, and contingency and business recovery plans.

Credit unions must determine how to properly account for and control cash flow streams between themselves and the seller. Management should determine whether bond coverage is adequate for the new products and services.

**Compliance Risk Assessment**
The buying credit union needs to understand all regulations that apply to loan participations to the same degree as loans originated by the buying credit union, including:

- NCUA regulations applicable to loan participations;\(^5\)
- NCUA regulations governing appraisals;\(^6\)
- Applicable state laws for state-chartered credit unions;
- Bank Secrecy Act;\(^7\) and,
- Consumer protection regulations, such as Truth in Lending, Equal Credit Opportunity Act, and Real Estate Settlement Procedures Act.

A credit union’s compliance risk assessment should address the necessary controls to assure conformance with all applicable regulations. This is particularly important if the buyer and seller are subject to different regulations, such as different charter types (federal or state), or loan documents are governed by laws from another state. Loan participation agreements should clearly define which party has the authority and accountability to monitor and enforce compliance. A buyer of loan participations must conform with applicable rules, regulations, and compliance laws.

**Strategic Risk Assessment**
Officials must determine whether the proposed relationship complements the credit union’s overall mission and philosophy. Officials need to document how the relationship will relate to their credit union’s strategic plan, considering long-term goals, objectives, and resource allocation requirements.

**Reputation Risk Assessment**
Buying credit unions must have adequate internal controls, staffing, business recovery plans, and other resources to meet their contractual commitments to the seller in a timely manner. Delays or defaults in fulfilling obligations could jeopardize the ongoing relationship between the seller and loan participants, and expose the credit union to litigation or financial loss.

A seller (credit union, CUSO, or other eligible organization) can create systemic underwriting and loan servicing risk to a large group of credit unions. The length of experience in a lending activity should be an essential component of concentration limits

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\(^5\) See Exhibit A, “NCUA Regulations Applicable to Loan Participations”.

\(^6\) See Part 722 of NCUA’s regulations “Appraisals”, and Letters to Credit Unions No. 03-CU-17, “Independent Appraisal and Evaluation Functions for Real Estate-Related Transactions”; No. 05-CU-06, “Frequently Asked Questions on Independent Appraisal and Evaluation Functions”; and No. 05-CU-12, “NCUA and other FFIEC agencies issue Frequently Asked Questions on Residential Tract Development Lending.”

\(^7\) See Letters to Credit Unions 08-CU-12, “Suspected Money Laundering in Residential Real Estate Industry Report” and 08-CU-10, “Mortgage Loan Fraud Report.”
for buying credit unions. “Caveat emptor” – let the buyer beware – and diversify, is the key to a successful loan participation relationship and program.

Identifying potential risks during the planning and initial risk assessment process increases the opportunity to mitigate losses by determining in advance the necessary controls and reporting systems. Loan participations expose credit unions to all seven risk categories; examiners should evaluate the effectiveness of the credit union’s risk assessment relative to each type of risk.

**Due Diligence for Loan Participation Programs**

Examiners should consider the adequacy of the buying credit union’s ongoing due diligence in the areas below, given their risk profile, internal controls, and overall complexity. The credit union’s due diligence should be tailored to the complexity of the third-party relationship, and may consist of alternatives to mitigate risk.

**Business Model**

New business models often emerge due to changes in the regulatory, technological, or economic environments. When evaluating a seller’s loan participation program, a buying credit union should be aware of recent or pending changes. Regulatory changes might affect loan underwriting practices if the seller has been approved for loan waivers or meets regulatory flexibility requirements. A buying credit union that does not have the same type of waivers, or does not meet regulatory flexibility requirements, cannot buy loan participations without meeting the same criteria.

Buying credit unions should also consider the following factors:

- The possibility of conflicting interests. A CUSO may use different underwriting standards for loans it sells (rather than retain them in portfolio), in order to maintain volume. Buyers need to ensure the product they are purchasing is within their established risk tolerance thresholds, including adherence to established underwriting standards.

- Financial condition. Based on call reports, Financial Performance Reports (FPRs) or other financial information, the seller must have a demonstrated ability to repurchase the participation if required under the terms of the loan participation agreement.

- The product being sold is time-tested. It is preferable that the seller’s loan portfolio has been through several economic cycles. Buyers need to strongly consider the additional risk being taken if the seller is inexperienced in the product and/or the product has not weathered a full economic and interest rate cycle.

- Significant staffing changes. It is important to determine whether the seller has maintained sufficient expertise in all types of loans being underwritten and serviced.

- Trade area. Ensure there is diversification in the trade area, underwriters are knowledgeable of market conditions throughout the trade area, and the servicer has the ability to handle servicing effectively, especially in the case of default.

- Possibility of loss of control. One of the biggest risks faced by buyers of loan participations is the loss of control in monitoring and managing the credit risk.
Buyers need to ensure they have the mechanisms in place to maintain proper oversight over the party servicing loan participations.

**Contract Issues and Legal Review**

The contract is a critical component of any third-party relationship because, in addition to establishing rights and obligations of the parties, it should clearly address how the relationship operates. Buying credit unions should obtain legal advice regarding the contract\(^8\) to ensure legal and business interests are appropriately protected. Both parties have the right to negotiate terms for mutually beneficial contracts.

The representations and warranties in the participation agreement set out the premises on which the parties contract, and will often have important contractual promises. For example, the selling credit union will often represent that the loan meets all regulatory and legal requirements or the underwriting criteria as agreed in the contract. The buying credit union may warrant that it is authorized to and can legally enter into the agreement. The breach of a warranty or representation may provide the basis for one party’s remedy against the other. The participation agreement may provide specific remedies for breach of particular warranties or representations; for example, a selling credit union’s re-purchase of a loan interest that fails to meet the warranties the seller has given.

The loan participation agreement should clearly define how risk will be shared among the participants, including whether the transaction qualifies, per FAS 140, for true sale accounting or is a secured borrowing. Risk may be shared equally, pro-rata, or on a senior/subordinated basis where the priority of rights to repayment differs among participants.

The loan participation agreement should also clearly define how and when information will be shared and what actions require the mutual approval of both parties. Specifically, the agreement should address credit documents and information that the seller is required to share with the buying credit union, status reports on payments and interest accrual, exit strategies, procedures for modifying loan terms, standard loan covenants, including limiting borrower’s future loans, notification of adverse loan events, collection procedures, turnover in key staff, and other provisions necessary to effectively manage credit risk.

**Loan Underwriting**

The buying credit union must underwrite the loan to their own standards; they cannot rely on the analysis performed by the seller or the broker. Underwriting should identify all risks that could materially influence a buyer’s decision to participate.

Buyers should request the following information for member business loans (MBLs) and/or construction and development loans unless it is described in the seller’s loan presentation or supported by loan documentation:

- Cash flow analysis, particularly for businesses and self-employed individuals.
- Many borrowers form a separate limited liability company for each investment property, so loan documents should indentify all responsible parties and

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\(^8\) A loan participation agreement is the typical form of contract. When credit unions anticipate multiple loan participation transactions, they may execute a Master Participation Agreement, with each loan participation represented by a separate certificate.
guarantors to the agreement. Underwriting and cash flow analysis should identify all obligations, direct and contingent, of the borrower and all guarantors.

- All associated borrowing relationships should be fully disclosed to meet regulatory requirements for loans to one borrower and to limit concentration risk.

- Verification that all conditions of approval were satisfied before the loan was funded. A take-out commitment for long-term financing is a common repayment source for a construction and development loan. Satisfying all conditions of approval protects enforceability of the take-out commitment.

- Appraisal reviews should evidence that appraisal assumptions were valid and relevant to the collateral property. A seller should inform the appraiser if a lease(s) is not arm’s length because leases of owner-occupied properties may not reflect current market conditions.

- Sources of borrower’s equity for construction and development loans should be identified. It is possible additional financing will be required if the borrower’s balance sheet does not reflect “hard equity” in the form of cash or unencumbered equity in the property, required to be invested by the borrower.

- Progress inspections should be verified. Section 723.3(c) requires on-site progress inspections before release of funds. Sellers should provide participants with copies of the written inspection reports when requesting construction draws.

Sellers sometimes arrange for an outside underwriter for all participants to use. This compromises independence and is prohibited for MBLs.

Examiners should request buying credit unions provide copies of all documentation and information used in the underwriting and analysis of the loan participation. Documentation should include regular management reporting to the board of directors of any exceptions to the buying credit union’s policies.

Buying credit unions should consider the risk represented by the total loan commitment. For example, if a credit union buys a $2 million portion of a $25 million loan, their independent analysis needs to be based on the borrower’s ability to service the total debt as well as the borrower’s other existing and proposed obligations and commitments.

**Risk Measurement, Monitoring and Control**

The buying credit union must complete a post-closing review of all loan documents to determine that all terms and conditions are in accordance with the original terms presented. If the buying credit union finds that terms changed, it should notify the seller of its findings and the corrective action it desires. 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.

Management must fully understand the terms of the loan participation agreement and underlying loan transaction(s) and be able to explain them to all interested parties, including regulators. Risk assessment, strategic planning, and due diligence assure that officials are fully informed about the program, and provide the opportunity to design and implement procedures and controls to mitigate the risks.
On-going credit administration must include, at a minimum, monitoring member business loans for annual financial statement review. Examiners should analyze documentation of these annual reviews and any changes in risk ratings triggered by results of the reviews.

Independent third-party audits or reviews of a seller’s loan participation program can provide buying credit unions with important information regarding sufficiency of underwriting, collateral evaluation, loan documentation, credit risk grading processes, and servicing practices and procedures. The seller should provide the buying credit union with copies of regularly updated audits and the seller’s written response to findings and recommendations for corrective action.

Buying credit unions should regularly monitor the liquidity and financial health of the originating credit union. They should also monitor how a CUSO is structured and funded and the financial stability of the CUSO owners.

**Selling Credit Unions – Risk & Issues**

**Risk Assessment & Strategic Planning**

The risk assessment, strategic planning, and due diligence issues described above for buying credit unions also apply to selling credit unions. Examiners will review documentation that management addressed these risks in addition to the following risks and issues specific to selling credit unions.

Selling credit unions must fully understand the terms of the loan participation agreement and underlying loan transaction(s) and be able to explain them to all interested parties, including regulators. Risk assessment, strategic planning, and due diligence assure that officials are fully informed about the program and provide the opportunity to design and implement procedures and controls to mitigate the risks.

Selling credit unions must monitor potential liability from maturing balloon extensions or rollovers, particularly with multiple participants on large member business loans. As participants are generally not legally bound to continue to fund the extensions or rollovers, the selling credit union could have significant liquidity, compliance and credit risk in the event the participants decline to renew their involvement.

**Credit Union Service Organizations (CUSOs)**

Selling credit unions frequently use CUSOs to underwrite, document, and service loans. Some CUSOs locate prospective borrowers through loan brokers then select a credit union to be the seller, based on where the borrower is a member or would qualify for membership.

Selling credit unions should notify buying credit unions if a loan was sourced through a loan broker and the borrower was not an existing member. This puts participants on notice that information about the borrower may not be based on direct knowledge of the seller. In these type transactions, selling credit unions should verify that all third-party
reports, such as appraisals and environmental studies, were obtained in an arm’s length, independent transaction, and in full compliance with regulatory guidance.

**Regulatory Compliance**
Selling loan participations is a common way for credit unions to manage their portfolios within regulatory limits. Part 723 of NCUA’s regulations, “Member Business Loans,” contains regulatory limits with which participation member business loans must comply: aggregate member business loans, loan-to-value limits, loan-to-one borrower or associated borrowers, construction and development loans, and unsecured loans.

It is not permissible for a credit union to exceed regulatory limits. If a loan would exceed any of the regulatory limits, the originating lender (selling credit union) must make the loan approval conditioned on obtaining firm loan participation agreements from buying credit unions. Also, buying and selling credit unions must fund the full amount of their participation interest in the loan concurrently. Credit unions that are selling participations to stay within a regulatory limit need to distinguish between non-recourse and recourse transactions. Recourse sales (if treated as secured borrowings) count toward regulatory limits.

A selling credit union must request a waiver before exceeding regulatory limits. The Regional Director must approve the waiver application before the loan is funded. Federally-insured state chartered credit unions need to first apply to their state supervisory authority. Regional Director approval is also required.

**Full Disclosure**
Selling credit unions should fully disclose to potential buyers all available historical information about the borrower, the collateral, and any potential conflicts of interest. Loan participation agreements ordinarily include representations and warranties that the seller will fully disclose all facts pertaining to the transaction and the borrower’s creditworthiness at the outset and during the life of the loan. If a buying credit union successfully asserts rights under contract representations and warranties, it could subject the seller to liquidity, interest rate, and reputation risk if forced to take back the loan.

Examples of full disclosure documentation include:
- Stating whether prior loans have been paid as agreed or rewritten, modified, or extended;
- Providing details on the borrower’s depository relationships;
- Disclosing policy exceptions and regulatory waivers related to the loan; and
- Potential conflicts of interest.⁹

Credit unions occasionally modify their loan policies in response to changing economic conditions. A selling credit union may determine it is prudent to relax standards when conditions are improving; on the other hand, if economic conditions are worsening, they may decide to sell participations in riskier loans and retain the higher quality credits. In

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⁹ In particular for MBLs, Section 723.5(b) of NCUA’s regulations permits a credit union to use the services of a CUSO even though the CUSO is not independent from the transaction, provided the credit union has a controlling financial interest in the CUSO as determined under Generally Accepted Accounting Principles. Some state supervisory authorities have adopted other MBL Rules & Regulations which may vary in some respects.

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ongoing participation relationships, selling credit unions should advise buying credit unions when underwriting standards are modified.

Credit Administration
A borrower’s non-compliance with loan agreement covenants represents a technical default which the selling credit union needs to address to assure there is no impairment to the ultimate collectability of the loan. Minimal covenant compliance monitoring includes:

- Notifying the borrower, in writing and on a timely basis, regarding events of technical default.
- Providing buying credit unions with the financial information required by the loan agreement.
- Reporting the results of loan monitoring to buying credit unions.

Failure to fulfill servicing responsibilities could materially increase credit, transaction, and reputation risks for the selling credit union.

Summary
Loan participation programs offer various benefits to credit unions. Credit unions must evaluate and thoroughly understand the potential risks, as well as the benefits, before starting a loan participation program. Management must continue to monitor and control the program and the underlying loans.

Whether selling or buying, credit unions have similar risks in monitoring and managing loan participations. Selling credit unions’ risks are centered in regulatory compliance, full disclosure, and credit administration. Buying credit unions’ risks are centered in risk assessments, strategic planning, due diligence, contracts and legal review, underwriting credit risk, and internal controls.

Selling and buying credit unions need to control risk with initial risk assessments, strategic planning, and due diligence over loan participation partners, appraisers, auditors, and other third parties. The due diligence process should be well-documented, ongoing, and focus on the other participant’s business model, policies and practices, contract issues, and loan administration.

Examiners must evaluate the safety and soundness of a credit union’s loan participation program based on the adequacy of documented risk analysis, strategic planning, and due diligence within the framework of the risk-focused examination process.
EXHIBIT A
Summary of NCUA Rules Applicable to Loan Participations

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. 12 C.F.R. §701.22(a)(1). Buying 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 (FCU) that is the originating lender must retain at least 10% of each loan in which it sells a participation interest. 12 C.F.R. §701.22(c)(2). An originating lender that is not an FCU must retain a meaningful ownership interest in a loan participation to avoid the appearance that the parties are trying to circumvent the loan participation rule’s requirements. See OGC Opinion 07-1035 (October 26, 2007). FCUs can only participate in loans they are empowered to grant. 12 C.F.R. §701.22(b).

If a transaction does not meet the requirements of a loan participation under §701.22, refer to the purchase and assumption rule, 12 C.F.R. §741.8.

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%.

Prepayment Penalties. FCUs cannot impose or collect prepayment penalties. 12 U.S.C. §1757(5)(A)(viii). If a prepayment penalty is included in the loan’s terms, an FCU cannot collect its share of the penalty. Additionally, the remaining participants cannot receive a windfall due to an FCU’s inability to collect a prepayment penalty, but the FCU’s share must be forgiven. OGC Opinion 02-0824 (November 5, 2002).

Interest in a Loan versus Interest in a Pool. The participation agreement must establish that an FCU is buying an interest in a particular loan; FCUs are not authorized under the loan participation rule to purchase a participation certificate as a percentage interest in a pool of loans. 12 C.F.R. §701.22(a)(1) (“participation loan” defined as “a loan”). Where a participation agreement involves multiple loans, the documentation, for example, can be as simple as an addendum or schedule for identifying each loan and a participant’s interest in that loan.
List of Resources

1. NCUA -regulations, Parts 701, 722, 723, and 741.  


3. NCUA Letter to Credit Unions No. 08-CU-20, September 2008 - Risks to Credit Unions.

4. NCUA Letter to Credit Unions No. 08-CU-10 April 2008 – Mortgage Loan Fraud Report.

5. NCUA Letter to Credit Unions No. 08-CU-12 May 2008 – Suspected Money Laundering in Residential Real Estate Industry Report

6. NCUA AIRES Questionnaire - Loan Participations.  
   http://www.ncua.gov/CreditUnionResources/aires/aires.html

   http://www.fdic.gov/regulations/safety/manual/section3-2.html#introduction


   http://fasb.org/pdf/fas140.pdf