
FDIC Issues Advisory on Loan Purchases and Participations

November 10, 2015

The Federal Deposit Insurance Corporation (“FDIC”) has issued an advisory on effective risk management practices for purchased loans and purchased loan participations (the “Advisory”). The Advisory addresses the importance of underwriting and administering purchased loans as if the loans were originated by the purchasing bank, and also addresses the need for a risk management process to address the use of third-party arrangements to facilitate loans and loan participation purchases.

November 6, 2015, Advisory discusses how a purchasing bank’s overreliance on lead institutions can sometimes lead to significant credit losses and bank failures, particularly for loans involving out-of-territory borrowers and industries unfamiliar to a purchasing bank. To guard against such losses, the FDIC has set forth certain recommended practices that are designed “to ensure that loan and participation purchases are conducted in a safe and sound manner.” A summary of these recommended practices is set forth below.

Policy Guidelines

Loan policies should outline procedures for purchased and participation loans, including credit underwriting and administration requirements to address each loan’s risks and characteristics. The loan policy should also define acceptable loan types for purchase, establish and consider concentration limits, and require thorough independent credit and collateral analysis along with an assessment of the purchasing bank’s rights, obligations and limitations. If purchases are executed through third-parties, the institution should establish an effective and ongoing third-party risk management process.

Independent Credit and Collateral Analysis

A purchasing financial institution should perform the same degree of independent credit and collateral analysis as if it were the originator. The financial institution must have the requisite knowledge and experience for each purchased loan type. An analysis should be conducted to determine whether the loans or participations purchased are consistent with the board’s risk appetite and loan policy guidelines. This assessment should not be contracted to third parties. If a purchasing institution relies on a third party’s credit models, due diligence should be performed to assess the validity of such credit models.

Profit Analysis

A purchasing financial institution should conduct a profitability analysis of loan purchase and participation activity relative to the rate of return. Institutions should conduct a comprehensive assessment of each credit's rate of return (net of fees paid) and determine whether it is commensurate with the level of risk.

Loan Purchase and Participation Agreements

Written loan sale and participation agreements should fully describe the roles of all parties, including the lead institution, lender, broker, and the purchaser/participant. The agreement should also establish requirements for obtaining timely information and reports, such as ongoing credit information, if necessary. Institutions should also, with the assistance of appropriate legal counsel, understand any limitations the agreements place on purchasing institutions, such as the ability to participate in loan modifications.

Ability to Transfer, Sell or Assign Interest

Management at a purchasing financial institution should ensure that the loan sale or participation agreement does not limit the institution's ability to transfer or sell its interest.

Due Diligence

Financial Institutions should perform extensive due diligence on purchases and participation involving out-of-territory loans or unfamiliar industries. Management should monitor and clearly understand any source of repayment, market conditions and vulnerabilities.

Due diligence should also be performed prior to entering any third-party relationship or relying on third parties, such as loan brokers, sellers, originators, and services. The analysis should include the third party's financial capacity to meet its obligations, business reputation, and compliance with all federal and state laws (such as anti-money laundering requirements).

Financial Reporting/ Audit/ Board of Approval and Reporting

Institutions should report purchased interests in accordance with applicable generally accepted accounting principles. All loan purchase and participation programs should be incorporated into the audit and loan review program. Finally, prior approval from the board should be obtained prior to entering any material third-party arrangements. The board should also be provided with a sufficient account of all activity, performance, and risk of purchased loans and participation.

Bank Secrecy Act (BSA)/ Anti-Money Laundering (AML)

Institutions should ensure that all purchased loans and participation portfolios are in compliance with BSA/AML requirements and are in line with the institution's BSA/AML risk assessment.

The FDIC recommends that financial institutions should review and ensure proper implementation of all outstanding guidance, including:

- Interagency Guidelines Establishing Standards for Safety and Soundness (Appendix A to Part 364 of the FDIC Rules and Regulations) available at <https://www.fdic.gov/regulations/laws/rules/2000-8630.html#fdic2000appendixatopart364>
- Guidance for Managing Third-Party Risk (Financial Institution Letter (FIL) 44-2008, June 6, 2008) available at <https://www.fdic.gov/news/news/financial/2008/fil08044.html>
- Final Joint Guidance on Leveraged Lending (FIL 13-2013, March 27, 2013) and Frequently Asked Questions for Implementing March 2013 Interagency Guidance on Leveraged Lending (FIL 53-2014, November 13, 2014) available at <https://www.fdic.gov/news/news/financial/2014/fil14053.html>

Please note that Cullen and Dykman has extensive experience representing financial institutions on loan purchases and sales, as well as on loan participations and syndications. If you have any questions regarding such transactions or the FDIC Advisory, please feel free to contact Joseph D. Simon at 516-357-3710 or via email at jsimon@cullenanddykman.com, Kevin Patterson at 516-296-9196 or via email at kpatterson@cullenanddykman.com, or Diana Acosta at 516-357-3739 or via email at dacosta@cullenanddykman.com.

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