Loan Participations

This bulletin provides guidance to credit unions to help minimize the risks inherent in purchasing and selling loan interests.

Washington State chartered credit unions (WSCUs) are allowed to purchase and sell interests in participation loans. Loan participations as either a seller (lead lender) or buyer (participant) can facilitate diversification of loan portfolios and provide liquidity.

Loan participations may be contracted before origination between a lead lender and participants, or may be contracted after origination and funding by the lead lender. All participations should be covered by a detailed participation agreement that satisfactorily addresses the interests of each participant and the lead lender. Participants should have their legal counsel review the agreement to assure that their interests are adequately protected. You may want to consult legal counsel regarding whether the participation loan has been sold with or without recourse.

Legal Considerations
RCW 31.12.426(2) allows a credit union to purchase loans that meet its current underwriting policies and which the credit union is empowered to grant. Credit unions should not rely on the lead lender’s underwriting standards.

RCW 31.12.436(1) allows credit unions to buy loans from other credit unions and to buy loans made to members held by other lenders. However, a credit union must obtain prior approval from the Director of Credit Unions to buy loans made to nonmembers held by other lenders. A credit union should check with their legal counsel or the Director of Credit Unions if it has questions about the authority to purchase loans.
Additionally, all other applicable statutes and rules apply to loan purchases and sales. For example, if the purchase was a member business loan (MBL), then the credit union needs to fully comply with Washington State’s rule on member business loans, Chapter 208-460 WAC.

**Federal Parity**
The federal parity provision in RCW 31.12.404 (1) allows WSCUs to exercise the same powers and authorities a federally chartered credit union (FCU) had as of July 22, 2001. Under RCW 31.12.404 (2), the Director of the Division of Credit Unions may grant WSCUs the powers and authorities that FCUs have subsequent to July 22, 2001. When exercising a FCU power, WSCUs must comply with all the restrictions and limitations on the specific exercise of the power under the National Credit Union Administration (NCUA) statutes and rules, see RCW 31.12.404 (3). NCUA authorizes a FCU to enter into a loan participation in 12 C.F.R. 701.22.

**Safety and Soundness Guidelines Before Purchasing a Loan Participation**
We recommend that a credit union, interested in buying a loan participation interest, adopt policies and procedures that address the following:

1. The board of directors should approve a loan participation policy which covers the following:

   - States participation loans will meet the purchasing credit union’s internal underwriting standards;
   - Denotes how variances from the underwriting requirements for purchased loans will be approved by credit union officials;
   - Describes what actions credit union officials will take to reject loans that do not meet its requirements;
   - Designates which committee or individual has the authority to approve the purchase of a loan or pool of loans;
   - Addresses the required qualifications, experience and financial condition of the originating and loan servicing institution (lead lender);
   - Requires that management analyze the credit, interest rate, liquidity, compliance, and any other applicable risk that each purchased loan will add to the credit union’s risk structure; and
   - States that the loan purchases will conform to all applicable laws and regulatory requirements.
2. The credit union should enter into a loan participation agreement approved by the board of directors or a properly delegated committee. At a minimum, the participation agreement should provide the following:

- Identify the minimum underwriting requirements and how the underwriting documentation will be submitted to the credit union;
- Establish the protocol for distributing loan payment proceeds, and sharing expenses and losses;
- State how conflicts and disagreements between the parties will be resolved;
- Identify the types of loans to be purchased under the agreement and the loan parameters (minimum acceptable underwriting requirements);
- Address the loan servicing responsibilities and rights;
- Discuss the contractual obligations of each of the parties; and
- State what actions will be taken if default occurs on the underlying loan(s).

3. The credit union should have procedures for the following:

- Analyze thoroughly the credit quality, the condition and value of the collateral security, the adequacy of the appraisal reports, and whether the participation loans comply with applicable laws and regulations;
- Verify the accounting for loan participations meets generally accepted accounting principles;
- Maintain complete and current documentation for each credit file;
- Independently assess primary and secondary sources of repayment;
- Independently assess the servicer’s financial strength, and
- Stay apprised of conditions affecting the collectibility of the loan(s).

Loan participations need to be factored into the Allowance for Loan and Lease Loss (ALLL) funding calculation. Participated loans should not be treated differently than non-participated loans for ALLL funding purposes.

The intent of these guidelines is to ensure that credit unions purchase participation interests that are written to their own loan underwriting requirements and that the risks inherent in the underlying purchases have been fully evaluated. Each participant should analyze the creditworthiness of the borrower.
Other Important Considerations When Buying Loan Interests

- **Pricing** – The participant should carefully evaluate the loan pricing before purchasing a loan or pools of loans. For example, if your credit union purchases an interest in a member business loan (MBL), typically the participant will not receive any of the fee income generated from this MBL, and the participant will pay the servicing costs or fees. Consequently, your credit union’s return on this loan will likely be significantly below the return of the seller (lead lender). Thus, the reward (interest rate) may not be satisfactory (high enough) to compensate your credit union for the risk it accepts by purchasing an interest in this loan.

- **Loans Originated Out-of-State** – Participants should complete additional due diligence procedures before buying loans that are made to out-of-state borrowers and are subject to out-of-state laws and legal regulations. A credit union may want to hire legal counsel knowledgeable with the out-of-state laws regarding enforcement of contractual rights and obligations. Additionally, the credit union may be unfamiliar with the local and regional economic factors that will have an impact on the loan’s performance.

- **Risk of Not Being Paid by the Servicing Lender** – A participant should not rely on the servicer’s reputation for the decision to enter into the participation but make its own assessment as to the financial strength and reliability of the servicer. The banking industry has seen unwary participants who absorbed losses, which were due to inadequate credit underwriting evaluation by the loan originator/servicer, inadequate participation documents, poor loan documentation, and faulty servicing.

**Selling Participation Interests in Loans Originated by the Credit Union**

A credit union may sell, in whole or in part, its member loan obligations. Typically, a credit union sale of a loan interest to a financial institution, such as a bank or credit union, will be considered a loan sale. However, if a credit union loan is sold to a non-financial institution, the sale may be treated as a sale of an investment rather than a loan and compel compliance with specific securities registration requirements. The lead lender should consult with both legal counsel and a certified public accountant regarding legal, compliance and accounting issues. This should include being compliant with privacy regulation requirements to ensure your credit union is satisfactory protecting its member’s non-public information.
The selling of a participation loan interest also has safety and soundness concerns. Your credit union should have proper policies and procedures in place to assure that it satisfactorily recognizes and monitors the risks associated with selling loans. The risks inherent in selling a participation interest center mainly around the contractual and servicing obligations of the selling credit union, as well as any recourse the seller may have to the purchaser upon borrower default. Finally, the lead lender has an obligation to:

- Fully disclose the current status and the pertinent findings to participants to avoid liability for fiduciary responsibility in the event of default;
- Avoid the appearance of conflicts of interest when originating and servicing the loan; and
- Comply with all the terms of the participation agreement.

Please contact Doug Lacy-Roberts at (360) 902-0507, if you have any questions about this Bulletin.