

SUBJECT: Participation Loans

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INTRODUCTION

This release applies to all state and federal credit unions that sell or buy interests in participation loans. It summarizes NCUA loan participation regulations and NCUA guidance for examiners on evaluating loan participation programs.

EXECUTIVE SUMMARY

The sorts of participation loans most familiar to credit unions involve a lender selling or assigning a part of a loan to one or more other lenders. (The seller is sometimes called the originating lender or lead lender, and the buyers may be called participating lenders.) In some situations, a lender plans to sell participation interests before a loan is even approved. For example, a credit union might approve a larger-than-usual loan only because other credit unions have agreed to buy interests in the loan. In other cases, the credit union might sell interests in a conventional existing loan. In participation loans, the borrower may deal only with the selling lender and not know that other lenders are participating.

In any participation loan arrangement, credit unions must keep two compliance topics in mind: NCUA regulations, and NCUA guidance for examiners evaluating loan participation programs.

NCUA Regulations

Section 701.22 of the NCUA Rules and Regulations applies to all federally insured credit unions, whether state or federally chartered. All Wisconsin credit unions are federally insured, and so they must comply with these rules.

Major components of the NCUA loan participation rules include the following:

- *Risk retention.* Originating federal credit unions must retain at least 10% of the outstanding balance of the loan through the life of the loan. Other loan originators (state chartered credit unions, CUSOs, banks and other financial organizations selling loan participations) must retain a minimum of 5% of the outstanding balance of the loan, through the life of the loan, unless a higher percentage is required by state law. There appears to be no waiver from this retention requirement, which applies for the life of the loan.
- *Concentration limits.* A purchasing credit union's total loan participations from a single originator are capped at the greater of \$5 million or 100% of net worth. The purchase of loan participations made to any one borrower or associated borrowers is capped at 15% of net worth. Credit unions may seek waivers from these limits.
- *Grandfathering.* A credit union that exceeds either of these concentration limits are automatically grandfathered and do not have to divest any loan participations it owns, but it cannot purchase any additional loan participations until its portfolio complies with the regulation (or it obtains a waiver).
- *Underwriting.* A credit union may purchase a loan participation for a type of loan it is authorized to make, even if it does not actually originate that kind of loan. NCUA allows a credit union to use different underwriting standards for loans it originates vs. loans it purchases.

- *Loan participation policies.* The rules require loan participation policies, which must cover certain issues, such as establishing limits on the amount of loan participations that may be purchased by each loan type as a percentage of net worth. The NCUA expects policies to cite the concentration limits in the regulation (or tighter limits if the credit union so decides).
- *Loan participation contracts.* Loan participation agreements must address nine items specified in the rules.
- *Waivers.* The NCUA's *Letter to Credit Union 13-CU-07* addresses waiver requests. The letter includes the *NCUA's Supervisory Guidance on Loan Participation Waivers*. It provides details on how to apply for a one-time waiver or a blanket waiver, and how NCUA examiners evaluate overall compliance with the loan participation rules during examinations.

NCUA Guidance

The NCUA published a Letter to Credit Unions in 2008 to help NCUA field staff examine credit unions' loan participation programs. The letter, *08-CU-26*, had two attachments: *A questionnaire* regarding evaluating loan participation programs and a *Supervisory Letter titled, "Evaluating Loan Participation Programs."*

The Supervisory Letter describes practices that examiners expect in well-run loan participation programs involving any types of loans, including automobiles, residential mortgages and member business loans. The "NCUA Guidance" section of this release summarizes the Supervisory Letter.

Overall, the guidance remains valid, despite amendments to the NCUA loan participation rules in 2013 and 2023. However, the guidance does contain references to older versions of the NCUA rules. The questionnaire was formerly attached to this release as an exhibit. Because the questionnaire contains numerous outdated references to NCUA regulations, The League removed the questionnaire from the release, to avoid confusion. Credit union may still want to refer to it, however, taking care to note that the regulations have changed.

The guidance stresses that credit unions should complete a risk assessment and perform due diligence before signing a participation loan arrangement with any third-party, whether it is a credit union, a credit union service organization (CUSO) or another financial institution.

Examiners will determine whether credit unions address and document the following concepts in a way that is appropriate for asset size, complexity and risk profile:

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

Wisconsin Law

Under section 186.098(9m) of the Wisconsin Statutes, a state-chartered credit union "may participate with other lenders in a loan of any type that the credit union may otherwise make." Office of Credit Union regulations that imposed various restrictions on participation lending were repealed in 2014.

NCUA LOAN PARTICIPATION RULES

The NCUA's loan participation rules are found in section 701.22 of the NCUA Rules and Regulations.

Definitions

The rules include the following definitions:

Associated Borrower

The term "associated borrower" means any person or entity that has a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with a borrower. This means any person or entity named as a borrower or debtor in a loan or extension of credit. Associated borrowers also include any person or entity (such as a drawer, endorser, or guarantor) that is engaged in a common enterprise with a borrower, or that derives a direct benefit from a loan to a borrower. Exceptions are made for partnerships, joint ventures and associations.

For more information, see the "Associated Borrower" section in The League's *ii Release No. B027*.

For further discussion and examples of determining whether an associated borrower relationship exists, see the *“Associated Borrower” material* in the NCUA Examiner’s Guide.

Common enterprise

Section 701.22(a) of the NCUA rules defines “common enterprise” this way:

- (1) The expected source of repayment for each loan or extension of credit is the same for each borrower and no individual borrower has another source of income from which the loan (together with the borrower’s other obligations) may be fully repaid. An employer will not be treated as a source of repayment because of wages and salaries paid to an employee, unless the standards described in paragraph (2) are met;
- (2) Loans or extensions of credit are made:
 - (i) To borrowers who are related directly or indirectly through common control, including where one borrower is directly or indirectly controlled by another borrower; and
 - (ii) Substantial financial interdependence exists between or among the borrowers. Substantial financial interdependence means 50 percent or more of one borrower’s gross receipts or gross expenditures (on an annual basis) are derived from transactions with another borrower. Gross receipts and expenditures include gross revenues or expenses, intercompany loans, dividends, capital contributions, and similar receipts or payments; or
- (3) Separate borrowers obtain loans or extensions of credit to acquire a business enterprise of which those borrowers will own more than 50 percent of the voting securities or voting interests.

Credit union

The term “credit union” means any federal or state-chartered credit union.

Credit union organization

The term “credit union organization” means any credit union service organization (CUSO) meeting the requirements of part 712 of the NCUA rules. This means that the term includes CUSOs that are subject to any requirement in part 712, including CUSOs invested in or loaned to federally insured state-chartered credit unions.

Eligible organization

The term “eligible organization” means a credit union, credit union organization, or financial organization. The definition is broad, and it includes a host of state and federal government sponsored and originated programs. Note that through the term “credit union,” an eligible organization includes any federal or state chartered credit union, including those that are privately insured.

Financial organization

The term “financial organization” means any federally chartered or federally insured financial institution; and any state or federal government agency and its subdivisions.

Loan participation

The term “loan participation” means a loan where one or more eligible organizations participate under a written agreement with the originating lender, and the written agreement requires the originating lender’s continuing participation throughout the life of the loan. This revised definition requires the originating lender to 1) participate in the loan throughout the life of the loan and 2) at a minimum, to be an eligible organization. Purchasing participants are not required to be eligible organizations.

Originating lender

The term “origination lender” means the participant with which the borrower initially or originally contracts for a loan and who sells participations to other lenders. [As explained in more detail in the next subsection of this Release, the term “originating lender” includes a participant that acquires a loan through an indirect arrangement as defined under § 701.22\(c\)\(9\).](#)

Only the originating lender can sell participations to other lenders. This does not permit the resale of a participation interest or the purchase of a participation interest in an eligible obligation. In a resale, a credit union cannot participate its interest in a

loan because it is not the originating lender. Similarly, a credit union that purchases a loan as an eligible obligation from a CUSO or another credit union cannot participate that loan to others because the credit union is not the originating lender.

Credit unions experiencing liquidity needs have several options for liquidating their participation interests in a way that is consistent with the NCUA rules. For example, a credit union may sell its participation interest back to the originating lender or it may sell its interest to another lender within the same participation arrangement. Subject to other NCUA rules (in § 701.23) a credit union may also sell its interest as an eligible obligation. A credit union may also enter into an assumption agreement whereby another lender agrees to assume, in whole, the credit union's participation interest in a loan.

Note that §701.23 and its "eligible obligation" rules only apply if the transaction does not meet the definition of "loan participation." Thus, when a transaction could fit under either definition, the rule defaults to the transaction being treated as a loan participation. Section 701.23 only applies if the transaction involves a borrower that is a credit union member and the transaction does not fit the definition of a loan participation, such as when the originating lender does not retain an interest in the loan. For details, please refer to *this NCUA's 2023 final rule* that amended §701.23.

Originating lenders & indirect lending

Under a 2023 amendment to the NCUA's rules, a federally insured credit union engaged in an indirect lending relationship can meet the definition of "originating lender" if it makes the final underwriting decision regarding the loan and if the loan is assigned to the purchaser very soon after the inception of the obligation to extend credit.

This means that, if interests in an indirect loan are divided and sold as participation interests, the "originating lender" that must retain an interest in the loan would not be the indirect lending partner (i.e., the auto dealership); instead, it would be the credit union that partnered with them and made the final underwriting decision.

America's Credit Unions advises credit unions to keep these points in mind:

- The final underwriting decision must be made by the credit union and cannot be made by employees or contractors working for an indirect lending partner on the credit union's behalf.
- For large loans, complex loans or both, a credit union may grant preliminary approval of the loan based on the indirect lending partner's representations to the credit union's loan officer that the loan conforms to the credit union's underwriting policies. The credit union must then review the loan application and determine that the loan, the application, and the transaction conform to its lending policies before the credit union grants its final approval and before the loan proceeds are sent to the indirect lending partner.
- In all indirect lending transactions, credit unions should retain the right to deny a loan should it discover the loan does not comply with the credit union's policies or standards upon receipt of the final paperwork. This should be specified in the indirect lending agreement.

For details, please refer to *the NCUA's 2023 final rule*.

Requirements for Loan Participation Purchases

A credit union may only purchase a loan participation if the seller is an eligible organization and if the loan is one the credit union can grant under the Federal Credit Union Act, applicable state law, NCUA regulations, and its own bylaws and internal policies. (Applicable state law – Wis. Stats. §186.098(9m) – says only that a state-chartered credit union "may participate with other lenders in a loan of any type that the credit union may otherwise make." Office of Credit Union regulations used to impose various restrictions on participation lending, but they were repealed in 2014.)

Other requirements for purchasing a loan participation include adopting a written loan participation agreement, establishing the borrower's membership in the originating credit union or one of the participating credit unions by the time the loan participation is purchased, and having a continuing participation interest by the originating lender for the loan's duration.

Such continuing interest by the originating lender must be at least 5% of the outstanding balance of the loan through the life of the loan. As required by the FCU Act, however, originating *federal* credit unions must retain at least 10%.

The NCUA requires a purchasing credit union to have a written loan participation policy, which must address, at a minimum, four topics:

- Establish underwriting standards for loan participations;
- Establish a limit on the aggregate amount of loan participations that may be purchased from any one originating lender, not to exceed the greater of \$5,000,000 or 100% percent of the federally insured credit union's net worth, unless this

amount is waived by the appropriate regional director, and, in the case of a federally insured, state-chartered credit union, with prior written concurrence of the appropriate state supervisory authority;

- Establish limits on the amount of loan participations that may be purchased by each loan type, not to exceed a specified percentage of the federally insured credit union's net worth; and
- Establish a limit on the aggregate amount of loan participations that may be purchased with respect to a single borrower, or group of associated borrowers, not to exceed 15 percent of the federally insured credit union's net worth, unless waived by the appropriate regional director, and, in the case of a federally insured, state-chartered credit union, with prior written concurrence of the appropriate state supervisory authority.

There may be other factors a credit union should consider in formulating a loan participation policy based on its size, complexity, and lending experience. It should consider all of these factors in establishing its policy. (In addition, see the "Participation Loan Policy" section later in this release. It describes NCUA guidance on what a prudent loan participation policy should cover.)

The NCUA says that it expects a credit union to set the parameters for review, including a periodic review for appropriateness, and adhere to such parameters.

Underwriting standards

A credit union must establish prudent underwriting standards for loan participations and conduct appropriate due diligence before purchasing a loan participation. Such due diligence should be independently conducted by the purchasing credit union or outsourced to a qualified third party that is not otherwise affiliated with the loan. A purchasing credit union may not rely on an originating lender's due diligence.

A credit union can purchase a participation in a loan that it is empowered to grant, even if it does not originate that type of loan or if the loan is underwritten using standards other than those it uses when originating loans. (Similarly, state law—Wis. Stats. §186.098(9m)—says allows a state-chartered credit union to "participate with other lenders in a loan of any type that the credit union may otherwise make." It appears that the credit union must only be able to make that type of loan, even if it does not actually do so.) If a credit union both originates and purchases participations in the same types of loans, it can establish different underwriting standards for originating such loans and for purchasing participations in those loans. For example, if a credit union is empowered to grant MBLs, it may establish in its loan policy two distinct sets of underwriting standards, one for purchasing participations in MBLs and one for originating MBLs.

Concentration limits on loan participations

The NCUA rules set concentration limits on loan participations, designed to mitigate NCUSIF risks without discouraging continued growth.

Single originator concentration limit. The rules limit loan participations involving a single originator to the greater of \$5 million or 100% of the credit union's net worth. A credit union may apply for a waiver from this single originator contribution limit.

Purchases of participation interests in loans originated by a CUSO will not be aggregated with participation interests in loans originated by the CUSO's owner credit union for purposes of the single originator limit. They will be treated as two separate originators. The NCUA has emphasized, however, that CUSO arrangements must not be used to circumvent the requirements of the final rules. For example, credit unions may not circumvent the rule by establishing "round-robin" participation arrangements in which participants take turns as the originating lender to effectively distribute the single originator concentration limit among multiple parties.

Single borrower concentration limit. The NCUA rules also limit a credit union's loan participation purchases involving any one borrower or group of associated borrowers to 15% of the credit union's net worth, unless the appropriate regional director grants a waiver.

The limit applies to both MBL and non-MBL participations. MBL originations and MBL participations are both subject to the 15% single borrower limit.

Self-imposed concentration limits. A credit union's loan participation policy must establish self-imposed limits on the amount of loan participations that a credit union may purchase by loan type, not to exceed a specified percentage of the credit union's net worth. It is important for a credit union to clearly identify and set reasonable limits. Consistent with NCUA guidance on the evaluation of concentration risk, concentration limits should be established commensurate with a credit union's net worth.

Grandfathering. A credit union that exceeds the single originator or single borrower concentration limits on the date the NCUA amended its participation rules (July 25, 2013) is not required to divest of any loan participations it held at that time. The credit union is not permitted to purchase any additional participations after that time, however; its participation portfolio must decrease as participations are paid off or sold until its portfolio complies with NCUA concentration limits.

A credit union may purchase additional participations if its portfolio is below regulatory concentration limits, but only in an amount up to the regulatory concentration limits, not up to its previously grandfathered amount.

Waivers. NCUA can grant waivers from both the single originator and single borrower concentration limits.

Credit unions are encouraged to contact NCUA examiners for guidance and help before submitting a waiver application. Regardless of the examiner's feedback, it remains a credit union's right to request a waiver. Further, it remains the regional director's decision to approve or disapprove a waiver request, however the examiner responded.

Waivers for federally insured state-chartered credit unions require the concurrence of the appropriate state supervisory authority.

If an originating lender obtains a waiver for a loan, the participating credit unions do not also have to obtain a waiver. If, however, the originating lender does not obtain a waiver for a loan, each participant must get its own waiver for its interest in the participated loan. In other words, a participating credit union's waiver does not pass to other participants.

The NCUA's *Letter to Credit Union 13-CU-07* addresses waiver requests. The letter includes the *NCUA's Supervisory Guidance on Loan Participation Waivers*. It provides details on how to apply for a one-time waiver or a blanket waiver, and how NCUA examiners evaluate overall compliance with the loan participation rules during examinations.

Minimum Requirements for a Loan Participation Agreement

The NCUA says that a successful loan participation relationship depends, in large part, on the quality and completeness of the participation agreement. A well-written agreement can minimize conflicts between creditors during the life of the loan, especially if the loan becomes delinquent.

The agreement must also be properly executed by authorized representatives of all parties; it must be properly authorized by the credit union's board of directors (or a designated committee or senior management official; and it must be retained in the credit union's office (original or copies).

Section 701.22(d) of the NCUA rules lists six issues a loan participation agreement must, at a minimum, address in order for a credit union to purchase the loan participation: The agreement must:

- Prior to purchase, identify the loan or loans in which a credit union is buying an interest (which, if the agreement involves multiple loans, can be an addendum or schedule attached to the agreement);
- Show the interest that the originating lender will retain;
- Identify the location and custodian of the original loan documents;
- Explain when the parties to the agreement can access financial and performance information about the loan, the borrower, and the servicer;
- Explain the servicing responsibilities for the loan; and
- Spell out the circumstances under which participants may replace the loan servicer.

Origination lender risk-retention requirement

A loan participation agreement must include a provision requiring an originating lender to retain a certain percentage interest in the loan throughout its duration:

- Originating federal credit unions must retain at least 10% percent of the outstanding balance of the loan through the life of the loan. FCUs may purchase loan participations from non-FCU originating lenders that retain at least 5% of the outstanding balance of the loan through the life of the loan, unless a higher percentage is required by state law. The 10% retention requirement applies only where the FCU is the originating lender in a participation arrangement.
- The loan participation agreement must require originating federally insured or privately insured state chartered credit unions, CUSOs, and other eligible organizations to retain at least 5%, or higher, depending on applicable state law.

NCUA GUIDANCE

The NCUA published a Letter to Credit Unions in 2008 to help NCUA field staff examine credit unions' loan participation programs. The letter, *08-CU-26*, had two attachments: *A questionnaire* regarding evaluating loan participation programs and a *Supervisory Letter titled, "Evaluating Loan Participation Programs."* This portion of the release summarizes the Supervisory Letter.

The questionnaire was formerly attached to this release as an exhibit. Because the questionnaire contains numerous now-outdated references to NCUA regulations (which were amended in 2013), The League removed the questionnaire from the release, to avoid confusion. Credit union may still want to refer to it, however, taking care to note that the NCUA regulations have changed.

The NCUA guidance points out that properly managed loan participation programs can benefit both selling and buying credit unions. Selling credit unions gain a way to manage regulatory limits, interest rate, liquidity, credit and geographic concentration risks, plus an enhanced ability to serve members. Buying credit unions diversify their balance sheets, use excess liquidity, and increase revenue.

Potential risks accompany these benefits, including interest rate, liquidity, transaction, compliance, strategic, and reputation risks. The degree of risk depends on whether the credit union is the seller or buyer, whether the sale is with recourse, 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.

Credit unions must evaluate and thoroughly understand the potential risks, as well as the benefits, before starting a loan participation program. The credit union's management should complete a risk assessment and perform due diligence before starting a third-party arrangement, whether the third party is a credit union, a CUSO, or another financial institution. Management must continue to monitor and control the program and the underlying loans.

The NCUA describes practices that examiners expect to find in a well-run loan participation program involving any type of loans, including automobiles, residential mortgages, and member business loans. Examiners will see whether credit unions address and document the following concepts in a way that is appropriate for asset size, complexity, and risk profile:

- Risk assessment and strategic planning;
- Due diligence; and
- Risk measurement, monitoring and control.
- The NCUA guidance describes risks and issues for *buying* credit unions and *selling* credit unions. Both selling and buying credit unions need to control risk with initial risk assessments, strategic planning, and due diligence over their 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. Issues for buying credit unions also include contracts and legal review, underwriting credit risk, and internal controls. Issues for selling credit unions also include regulatory compliance, full disclosure, and credit administration.

NCUA Guidance for Buying Credit Unions

The NCUA's guidance addresses several issues for buying credit unions, divided into three main categories: risk assessment and strategic planning; due diligence; and risk measurement, monitoring and control.

Risk Assessment & Strategic Planning

Before starting a loan participation program or signing a loan participation agreement, credit union officials must evaluate whether the program is compatible with the board's risk tolerance, loan policies and overall strategic plan. Officials can lower risk by fully understanding all aspects of the third-party relationship. Examiners expect to see documentation of an initial risk assessment that (at a minimum) addresses seven risk categories: credit risk, interest rate risk, liquidity risk, transaction risk, compliance risk, strategic risk and reputation risk.

Credit Risk Assessment. Credit risk can vary widely depending on the loan type, size, structure, collateral type, and sources of repayment. When evaluating credit risk, buying credit unions should consider a many 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;
- Feasibility of speculative development projects;
- Use of borrower information provided by brokers; and
- Full analysis of appraisal assumptions and final valuations.

Management must decide 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. (State and NCUA rules require a written policy for a credit union to either sell or buy participation loans, as explained earlier in this release.)

Prudent loan participation policies establish reasonable concentration limits for collateral types, geographical locations, loan participations purchased from one seller, and other key factors. A policy should specify the trade area or market area where loans will be purchased. Management must be able to monitor and adjust to changing market conditions on before deciding to expand the trade area. (See the “Participation Loan Policy” section later in this release.)

Interest Rate Risk Assessment. The interest rate risk for individual loans depends on the loan type, size, and whether the interest rate is fixed or variable. Interest rate risk increases the longer the term of the loan. A buying credit union should thoroughly evaluate 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. If a borrower’s financial condition deteriorates, that may also prompt 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 enough liquidity to meet the obligations in their loan participation agreements, as well as the underlying loan documents. Revolving lines of credit and loans with unfunded commitments (like 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 buying loan participations;
- Management reporting systems to measure and monitor cash flows, including disbursements and scheduled payments; and
- Funding sources to meet all potential calls to fund loan disbursements.

Transaction Risk Assessment. Buying credit unions need to understand all parts of the loan participation arrangement to assess transaction risk. The risk is reduced by a strong internal control culture that results in sound systems, internal controls, audit, and contingency and business recovery plans.

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

Compliance Risk Assessment. The buying credit union needs to understand all the regulations that apply to loan participations to the same degree as loans it originates. The regulations that apply include:

- Federal and state regulations applicable to loan participations;
- NCUA regulations governing appraisals (explained in The League’s *ii Release No. B008*);
- The Bank Secrecy Act (discussed in The League’s *ii Release No. 0071*); and
- Consumer protection regulations, such as Truth in Lending, Equal Credit Opportunity Act, and Real Estate Settlement Procedures Act. For The League’s resources on these topics, please visit www.theleague.coop > compliance > Topics A to Z.

A credit union's compliance risk assessment should address the controls needed to assure compliance with all applicable regulations. This is particularly important if the buyer and seller are subject to different regulations 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.

Strategic Risk Assessment. Credit union officials must decide whether a proposed relationship complements the credit union's overall mission and philosophy. They 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 on time. Delays or defaults could jeopardize the relationship 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 for many credit unions. The length of experience in a lending activity should be an essential part of concentration limits for buying credit unions. "Caveat emptor" – let the buyer beware – and diversification are the keys to a successful loan participation relationship and program.

Spotting potential risks during the planning and initial risk assessment gives the credit union more chance to lower losses by deciding in advance what controls and reporting systems are needed.

Due Diligence for Loan Participation Programs

The credit union must have adequate ongoing due diligence in the areas listed below, given the credit union's risk profile, internal controls and overall complexity. 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 because of 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. (NCUA waivers are discussed earlier in this release.)

Buying credit unions should also consider the following factors:

- To maintain volume, a CUSO may use different underwriting standards for loans it sells (rather than retain them in portfolio). Buyers need to be sure the loan they buy meets their risk tolerance thresholds and underwriting standards.
- Based on call reports, financial performance reports or other financial information, the seller must have a demonstrated ability to repurchase the participation (if required by the participation agreement).
- 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.
- Be sure the seller has maintained enough expertise in all the types of loans being underwritten and serviced.
- Be sure that there is diversification in the trade area, that underwriters know market conditions throughout the trade area, and that the servicer can handle servicing effectively, especially in the case of default.
- One of the biggest risks buyers face is the loss of control in monitoring and managing credit risk. Buyers need to be sure they have mechanisms in place to oversee the party servicing loan participations.

Contract Issues and Legal Review. A contract is critical in any third-party relationship. It establishes the parties' rights and obligations, and it should set out clearly how the relationship works. A loan participation agreement is the typical form of contract. When credit unions expect multiple loan participation transactions, they may sign a master participation agreement, with a separate certificate for each loan participation.

Buying credit unions should get legal advice about their participation agreement to be sure their legal and business interests are protected. Both parties have the right to negotiate terms for contracts that benefit them.

The League advises that both credit unions have legal counsel review any proposed participation loan agreement. An attorney that one credit union retains has the duty only to guard the interests of that credit union, not any other parties to the agreement. An alternative to each credit union retaining separate counsel (or some going unrepresented) is for the credit unions to jointly retain an attorney to represent all of them.

The representations and warranties in a participation agreement are important. For example, the selling credit union will often represent that a 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 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 does not meet the seller's warranties.

The loan participation agreement should define how the parties will share risks, 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 repayment rights differ among participants.

The loan participation agreement should address credit documents and information that the seller must 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 needed to manage credit risk.

Loan Underwriting. The buying credit union must underwrite the loan to its own standards; it cannot rely on the seller's or broker's analysis. 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 people.
- Many borrowers form a separate limited liability company for each investment property, so loan documents should identify all responsible parties and 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. (State and NCUA concentration limits are described earlier in this release.)
- 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 show 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) of the NCUA Rules and Regulations 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.

Buying credit unions should maintain copies of all documents and information used in its underwriting and analysis. This includes regular management reporting to the board of directors of any exceptions to the 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 review all loan documents after closing to verify that all terms and conditions match the original terms presented. If terms changed, the credit union should notify the seller of the corrective action it wants. Loan participation agreements should include language that requires a seller to buy back loans with missing documents, loan made outside of policy, or loans that otherwise do not conform to 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, giving them the chance to put procedures and controls in place to reduce the risks.

On-going credit administration must include, at a minimum, monitoring member business loans for annual financial statement review.

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

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

NCUA Guidance for Selling Credit Unions

The risk assessment, strategic planning, and due diligence guidance described above for buying credit unions also applies to selling credit unions. These steps assure that officials are fully informed about the program, giving them the chance to put procedures and controls in place to reduce risks.

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. They must monitor potential liability from maturing balloon extensions or rollovers, particularly with multiple participants on large 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 if the loan participants do not renew their involvement.

In addition, examiners want to see documentation that management has addressed the following issues, which are specific to selling credit unions.

Credit Union Service Organizations (CUSOs)

Selling credit unions often use CUSOs to underwrite, document, and service loans. Some CUSOs find prospective borrowers through loan brokers then pick 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 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 transactions, and in compliance with regulatory guidance.

Regulatory Compliance

Selling loan participations is a common way for credit unions to manage their portfolios within regulatory limits.

For FCUs, participation MBLs must comply with Part 723 of the NCUA's Rules and Regulations. For state-chartered credit unions, Chapter DFI-CU 72 governs. These MBL rules address: aggregate member business loans, loan-to-value limits, loan-to-one borrower or associated borrowers, construction and development loans, and unsecured loans.

A credit union may not exceed regulatory limits. If a loan would exceed the limits, the selling credit union must make the loan approval conditioned on getting 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 NCUA Regional Director must approve the waiver application before the loan is funded. Federally-insured state chartered credit unions need to first apply to the Wisconsin Office of Credit Unions. Regional Director approval is also needed.

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 about the transaction and the borrower's creditworthiness at the outset and during the life of the loan. If a buying credit union successfully claims these representations and warranties were breached, 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
- Disclosing potential conflicts of interest.

Credit unions occasionally modify their loan policies as economic conditions change. A selling credit union may decide to relax standards when conditions are improving; if economic conditions are worsening, it may decide to sell participations in riskier loans and retain the higher quality credits. In ongoing participation relationships, selling credit unions should advise buying credit unions when underwriting standards are modified.

Credit Administration

If a borrower does not comply with covenants in a loan agreement, that is technically a default, which the selling credit union needs to address to assure the loan is collectable. Minimal covenant compliance monitoring includes:

- Notifying the borrower, in writing and promptly, about events of technical default;
- Giving buying credit unions the financial information that the loan agreement requires; and
- Reporting the results of loan monitoring to buying credit unions.

Not meeting servicing responsibilities could increase credit, transaction, and reputation risks for the selling credit union.

Safety and Soundness Considerations

The NCUA Examiner's Guide identifies the following as possible unsafe and unsound operating policies and practices:

- Purchase of loans without investigation of borrowers' credit positions, the condition of secured properties, and the adequacy of appraisal reports;
- Purchase of unacceptably high risk loans to obtain purchase discounts or net yields that are higher than current market averages;
- Sales of high-yield loans and replacement of those loans with lower-yield loans;
- Sales of loans at a time when there is no current or projected demand for "loanable" funds; and
- Participation sales made only to create income based on yield differential. This is particularly dangerous when the condition described immediately above exists.

Participation Loan Policy

Rules described earlier in this release require written participation lending policies. Prudent policies establish reasonable concentration limits for collateral types, geographical locations, loan participations purchased from one seller, and other key factors.

The NCUA had cautioned credit unions that "...prudence dictates that at a minimum the [participation loan] agreement shall:

1. Identify types of loans;
2. State servicing and collection requirements;
3. Provide that in the event of loss each participant shall share in the loss equal to its interest in the participation loan;
4. Provide for the distribution of payments of principal to each participant proportionate to its interest in the participation loan;

5. Provide for loan status reports to each participant; and
6. State the terms or conditions under which the agreement may be terminated or modified.”

WISCONSIN LAW

Under section 186.098(9m) of the Wisconsin Statutes, a state-chartered credit union “may participate with other lenders in a loan of any type that the credit union may otherwise make.” Office of Credit Union regulations that imposed restrictions on participation lending were repealed in 2014.

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Legal Affairs Department

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