FDIC
Federal Deposit Insurance Corporation
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Financial Institution Letter
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FDIC Advisory on Effective Credit Risk Management Practices for Purchased Loan Participations

Summary: Financial institutions purchase loan participations to achieve growth and earnings goals, diversify credit risk, and deploy excess liquidity. Some institutions have successfully participated in shared credit facilities, which are arranged by bank and nonbank entities, by implementing effective due diligence and prudent credit risk management practices. However, purchasing banks' over-reliance on lead institutions has, in some instances, caused significant credit losses and contributed to bank failures, particularly for loans to out-of-territory borrowers and obligors involved in industries unfamiliar to the bank. This Advisory reminds state nonmember institutions of the importance of underwriting and administering loan participations in the same diligent manner as if they were being directly originated by the purchasing institution.

Statement of Applicability to Institutions With Total Assets Under $1 Billion: This Financial Institution Letter applies to all FDIC-supervised banks and savings associations, including community institutions.

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FDIC-Supervised Banks (Commercial and Savings)

Suggested Routing:
Chief Executive Officer
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Attachment:
FDIC Advisory on Effective Credit Risk Management Practices for Purchased Loan Participations

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Highlights:

- Financial institutions purchase loan participations to efficiently achieve growth and earnings goals, and diversify credit risk.
- Some institutions have successfully purchased loan participations by implementing effective due diligence and prudent credit risk management practices.
- Significant losses on purchased loan participations can result from an over-reliance on originating institutions, particularly in out-of-territory and unfamiliar credit markets.
- Before purchasing a participation loan, financial institutions should implement an appropriate credit risk management framework that includes effective loan policy guidelines, written loan participation agreements, independent credit analysis and review procedures, and a comprehensive due diligence process.

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Financial institutions purchase loan participations to achieve growth and earnings goals, diversify credit risk, and deploy excess liquidity. Some institutions have successfully participated in shared credit facilities, which are arranged by bank and nonbank entities, by implementing effective due diligence and prudent credit risk management practices. However, purchasing banks' over-reliance on lead institutions has in some instances caused significant credit losses and contributed to bank failures, particularly for loans to out-of-territory borrowers and obligors involved in industries unfamiliar to the bank. Although the FDIC strongly supports banks' efforts to prudently meet the credit needs of their communities, the FDIC expects institutions to exercise sound judgment and strong underwriting when originating and purchasing loan participations.

This Advisory reminds state nonmember institutions of the importance of underwriting and administering loan participations in the same diligent manner as if they were being directly originated by the purchasing institution. The following practices are recommended to ensure that participation lending is conducted in a safe-and-sound manner.

Loan Policy Guidelines for Participations - The loan policy should outline procedures for originating and purchasing participation loans, require thorough borrower due diligence at origination and over the life of the participation, and mandate an assessment of the purchasing bank's contractual rights and obligations. Commitment limits for aggregate purchased participations, out-of-territory participations, and loans originated by individual lead institutions should be considered.

Loan Participation Agreements - A written loan participation agreement should fully describe the lead institution's responsibilities, establish requirements for obtaining timely borrower credit information, address remedies upon default, and outline dispute resolution procedures.

Independent Credit and Collateral Analysis - Banks that purchase participation loans should perform the same degree of independent credit and collateral analysis as if they were the originator.

Due Diligence and Monitoring of Participations in Out-of-Territory or Unfamiliar Markets - Management should exercise caution and perform extensive due diligence of participations involving an out-of-territory loan or credit facility to a borrower in an unfamiliar industry. Management should ensure the obligor, source of repayment, market conditions, and potential vulnerabilities are clearly understood and monitored.