Financial Institution Letter
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FDIC Advisory on Effective Risk Management Practices for Purchased Loans and Purchased Loan Participations

Financial institutions purchase loans and loan participations to achieve growth and earnings goals, diversify credit risk, and deploy excess liquidity. Some institutions have successfully purchased loans and 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.

Also, an increasing number of financial institutions are purchasing loans from nonbank third parties and are relying on third-party arrangements to facilitate the purchase of loans, including unsecured loans or loans underwritten using proprietary models that limit the purchasing institution's ability to assess underwriting quality, credit quality, and adequacy of loan pricing. In some situations, it is evident that financial institutions have not thoroughly analyzed the potential risks arising from third-party arrangements. 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 loans and loan participations.

This Advisory reminds FDIC-supervised institutions of the importance of underwriting and administering loan purchases and participations in the same diligent manner as if they were being directly originated by the purchasing institution. Furthermore, this Advisory reminds FDIC-supervised institutions that third-party arrangements to facilitate the purchase of loans and participations should be managed by an effective third-party risk management process. The following practices are recommended to ensure that loan and participation purchases are conducted in a safe and sound manner.

***Policy Guidelines for Purchased Loans and Participations* -** The loan policy should outline procedures for purchased and participation loans, define loan types that are acceptable for purchase, establish concentration limits, require thorough independent credit and collateral analysis, and mandate an assessment of the purchasing bank's rights, obligations, and limitations. The loan policy should establish credit underwriting and administration requirements that address the risks and characteristics unique to the loan types permitted for purchase. Loan policy concentration limits should be considered for aggregate purchased loans and participations, out-of-territory purchased loans and participations, loans originated by individual lead or originating institutions, loans and participations purchased through the same loan broker, and by loan type. If purchases are executed through a third-party relationship, the institution's policies and procedures should establish an effective and ongoing third-party risk management process.

***Independent Credit and Collateral Analysis* -** Financial institutions that purchase loans or participations should perform the same degree of independent credit and collateral analysis as if they were the originator. To do so, it is necessary for the institution to ensure it has the requisite knowledge and expertise specific to the type of loans or participations purchased and that it obtains all appropriate information from the seller to make an independent determination. The institution should perform a sufficient level of analysis to determine whether the loans or participations purchased are consistent with the board's risk appetite and comply with loan policy guidelines prior to committing funds, and on an ongoing basis. This assessment and determination should not be contracted out to a third party.

To the extent the purchasing institution relies on a third party's credit models for credit decisions (such as for consumer credits), the institution should perform due diligence to assess the validity of the credit model. Institutions are not prohibited from relying on a qualified and independent third party to perform model validation. However, the purchasing institution must review the model validation to determine if it is sufficient. Such review should be performed by staff that has the requisite knowledge and expertise to understand the validation.

***Profit Analysis* -** Institutions should conduct a profitability analysis of loan purchase and participation activity relative to the rate of return. This analysis should consider the additional costs of obtaining the expertise, such as credit analysts and additional loan review support that may be needed to properly oversee these credits. Institutions also 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 taken.

***Loan Purchase and Participation Agreements* -** A written loan sale or participation agreement should fully describe the roles and responsibilities of all parties to the agreement, including the lead institution, lender, broker, and purchaser/participant. The agreement also should establish requirements for obtaining timely information and reports, including ongoing credit information, if necessary for the loan type; address remedies upon default and bankruptcy; specify voting rights; and outline dispute resolution procedures. Institutions should assess thoroughly and understand all the terms, conditions, and limitations of the loan purchase or participation agreements. For example, the purchasing institution should understand that it may have an obligation to make additional credit advances; that control over credit decisions may be more limited than credits originated by the institution itself; and that the lead entity may have a right to convey its interest to another entity, including a noninsured depository institution entity.

Institutions also should understand what, if any, limitations the sales or participation agreement places on the purchasing institution, such as the ability to participate in loan modifications or take actions on defaulted credits; to sell or transfer its loan interest; to decline to make additional advances if the purchasing institution deems such advances are not prudent in relation to the credit's quality; to decline to purchase additional loans if the originator's credit standards are loosened; and to decline to purchase loans underwritten using revised models for which the purchasing institution has not yet performed due diligence. The institution should seek appropriate legal counsel to review purchase and participation agreements prior to finalization to determine the institution's rights, obligations, and limitations.

Ability to Transfer, Sell, or Assign Interest - Management should assess its ability to transfer, sell, or assign the interest, including an assessment of whether contractual terms or market conditions limit that ability and an assessment of the liquidity and marketability of the interest. Any limitations should be considered in the institution's liquidity management function and when managing credit concentration limits. Purchasing institutions should ensure that loan sale or participation agreements do not limit the institution's ability to transfer or sell the interest if necessary to maintain the institution's safety and soundness or in order to comply with regulatory requirements.

Due Diligence and Monitoring of Purchased Loans and Participations in Out-of-Territory or Unfamiliar Markets - Management should exercise caution and perform extensive due diligence and monitoring of purchases or participations involving an out-of-territory loan or credit facility or borrower in an unfamiliar industry prior to committing funds, and on an ongoing basis. Management should ensure the obligor, source of repayment, market conditions, and potential vulnerabilities are clearly understood and monitored. Management also should monitor changing economic conditions in such industries and markets and be responsive to changes.

Due Diligence of Third Parties - Management should perform due diligence prior to entering into a third-party relationship, as well as periodically during the course of the relationship. Due diligence should include a financial analysis to determine whether the third party has the financial capacity to meet its obligations to the purchasing institution. Due diligence also should include, but not be limited to, a review of the third party's business reputation, experience, and compliance with federal and state laws, rules, and regulations (such as consumer protection and anti-money laundering requirements). Such analysis should be performed for any third party the purchasing institution relies upon, such as the loan broker, seller, originator, or servicer. Institutions are reminded that the responsibility to perform appropriate due diligence cannot be outsourced.

Institutions also are reminded that the FDIC does not endorse any loan broker, seller, or originator, nor does the FDIC pre-approve any particular model, product type, or lending program. Therefore, institutions should not rely on such claims by third parties as a substitute for performing appropriate due diligence.

Financial Reporting - Institutions should report purchased interests in accordance with applicable generally accepted accounting principles.[1]

Audit - Institutions should ensure that loan purchase and participation programs are incorporated into the audit and loan review program.

Board Approval/Reporting - Management should ensure that prior approvals from the board, or an appropriate committee, are obtained as necessary, including prior to entering into material third-party arrangements. Additionally, management should ensure that reports to the board provide a sufficient account of the activity, performance, and risk of purchased loans and participations.

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[1] Note for participations: sale accounting treatment and the structure of a participation interest may impact the availability of safe harbor benefits under 12 CFR Section 360.6 of the FDIC Rules and Regulations relating to receiverships and resolutions.

Bank Secrecy Act (BSA)/Anti-Money Laundering (AML) - Institutions should ensure compliance with outstanding BSA/AML requirements and should consider purchased loans and participation portfolios for the institution's BSA/AML risk assessment.

Outstanding Guidance - The supervisory expectations addressed in this advisory are based upon principles established in outstanding guidance. Institutions should review and ensure proper implementation of outstanding guidance, such as:

- **Interagency Guidelines Establishing Standards for Safety and Soundness (Appendix A to Part 364 of the FDIC Rules and Regulations)**

  The Interagency Guidelines Establishing Standards for Safety and Soundness establish guidelines related to loan documentation, credit underwriting, asset growth, and asset quality, among other topics.

  Institutions are required to establish and maintain loan documentation practices that enable the institution to make an informed lending decision, assess repayment ability, and demonstrate appropriate loan administration and monitoring. Institutions also are required to establish and maintain prudent credit underwriting practices that are commensurate with the types of loans the institution will make; consider the nature of the markets in which loans will be made; consider, prior to credit commitment, the borrower's overall financial condition and resources and the nature and value of any underlying collateral protection; establish independent, ongoing credit review; and take adequate account of concentration of credit risk.

- **Guidance for Managing Third-Party Risk (Financial Institution Letter (FIL) 44-2008, June 6, 2008)**

  Institutions that enter into arrangements or relationships with third parties should ensure that sufficient procedures and policies are in place to control the risks associated with a third-party relationship. The Guidance for Managing Third-Party Risk provides a framework that boards of directors and senior management may use to provide appropriate oversight and risk management of significant third-party relationships.

- **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)**

  The Interagency Guidance on Leverage Lending establishes expectations for institutions that purchase leveraged loan participations to make a thorough and independent evaluation of risks before committing funds.