Department of Financial Institutions

Memo

To: Credit Union Management and Lending Staff

From: Corey J. Krebs

Date: 12/20/2013

Re: Participation Loans

NCUA recently made several changes to part 701.22 related to loan participations. The regulation makes several pieces of the participation loan rule applicable to State Chartered credit unions. It does not replace 13-03-20 of the North Dakota Administrative code, rather mostly parallels and supplements this regulation. Please review these regulations and your existing policy to ensure compliance.

To assist in the review process, a generic participation write up has been included below. This write-up includes the major policy and practice items that must be part of your participation loan program. While your policy and program will likely need to address additional items related to institution specific requirements and risk, this should afford you a base in which to assess compliance of your current program and policy.

A common area of confusion is the retention requirement for State Chartered institutions. NCUA's 701 indicates that a purchase of loan on which the originating lender retains 5% is acceptable if state statute authorizes this activity. Since North Dakota's participation authority is driven from parity provisions of statute and not specifically authorized powers, the administrative code requires that the originating lender retain at least 10% on any participation purchased. You also need to continue to retain a 10% interest in credits you sell to comply with regulation.

A second significant change is the ability of credit unions to purchase credits from banks. Credit unions can now buy a loan participation from a bank. The regulation requires that the borrower also become a member of at least one credit union participant, so a deposit account may be necessary as part of the process.

Additionally, a change in accounting standards governing participation loans went into effect in 2010 governing true sales accounting treatment on loan sales. The significant change was a requirement to use pro rata treatment instead of the commonly used last in first out method (LIFO). This was addressed by the Department in a prior letter to the industry. Since that time, some institutions have begun to use a hybrid between these two methods, essentially the LIFO method for funding a loan and pro rata for repayments. It is the Department's understanding that this hybrid method allows for true sales accounting treatment, and would allow a selling institution to fund their portion of multiple advance loans first prior to funding the purchasing intuition's share. Repayment would still need to be proportionate to each institution's interest in the credit. You are encouraged to consult with your accounting firm and legal counsel to determine the loan sales approach that best meets your institution's needs and to ensure your loan sales continue to qualify for true sales accounting treatment.

Participation Loan Policy Requirements

1. Changes have recently been made to part 701.22 of NCUA's Rules and Regulations. These rules are effective 9/23/2013. The following are some general characteristics loans must have to be purchased:
   - Loans purchased can only be loans the institution is empowered to grant
   - The loan purchased must comply with all other applicable regulations including individual loan limits and loan to value requirements of 723.
   - This institution needs to have executed a written loan participation agreement with the originating lender.
   - If purchased from a credit union, the borrower must be a member of the originating credit union.

2. The following are items need to be made to be addressed in participation loan policy to comply with this regulation:
   - Policy need to establish underwriting standards. This should define the minimum documentation that will be obtained from the originating credit union, the types of additional analysis the Credit Union will perform to include the completion of the purchasing Credit Union's credit grading sheet. It also needs to include a requirement that enough documentation is obtained to validate the originating credit union's analysis, or ideally be used to generate independent analysis not dependent on the originating institution's analysis. A credit presentation should be generated by the purchasing credit union.
   - The regulation limits loans from any single originator to the greater of $5,000,0000 or 100% of net worth. Policy should reflect this new regulatory limit and make it clear that the limit is calculated using the net member business loan balance, including unfunded commitments.
   - Establish a portfolio limit per loan type purchased as a percentage of net worth.
   - Establish a limit that may be purchased with respect to any single borrower, not to exceed 15% on the credit union's net worth. This should make it clear that this limit will be calculated using net member business loan balances including unfunded commitments.

3. In addition to policy, the participation agreement is also addressed within this new regulation, and now must:
   - Be properly executed by authorized representatives of all parties
   - Be authorized by the designated credit union officials.
   - Be retained, either as an original or as a copy.
   - Address the following provisions:
     - The agreement must clearly identify the specific loan purchased
     - The agreement will make clear a requirement that the originating lender retain at least a 10% interest in the outstanding balance of the loan for the life of the loan.
     - The agreement will identify the location and custodian for all original loan documents
     - Outline the conditions for gaining access to financial and other performance information about the loans, the borrower, and servicer.
     - Provisions outlining the duties and responsibilities of the originating lender, servicer, and participants with respect to all aspects of servicing, default, foreclosure, and collections.
     - Circumstances and conditions which participants may replace the servicer.