Participation Loans: Due Diligence

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Lending money to small businesses is often a game of risk for financial institutions, which typically expose themselves to a large amount of potential loss if they lend money to someone who later defaults on a particularly high balance. Banks are therefore quite reluctant to participate in lending activities that demand very high loan amounts, particularly loans granted to developers, major construction projects, or growing small businesses that require a significant amount of capital in order to grow their operation and serve a larger market. Even so, without such loans the business community would largely stagnate and decline.

Participation loans offer a way to reduce the risk associated with lending a very large amount of money to a small business, developer, construction project, or another client with significant need. That's because these lending products essentially allow the bank to "buy in" and lend only a portion of the money to the consumer. Other banks within the market area also buy in, owning a segment of the loan that they would be held accountable for in the event of a default. By spreading out the liability for major losses among multiple financial institutions, banks are able to reduce the amount of risk that they take on when supporting small business borrowers and others. Less risk equates to more lending, and that’s good news for the business and construction industries.

While risk is greatly reduced, however, it is not entirely eliminated from the lending equation. Any loan, no matter if it's owned by a single bank or participated in by multiple banks, requires a great deal of due diligence to ensure that the borrower will not default on the balance at any point in the term. Furthermore, it requires careful scrutiny over the details of the loan and its intended purpose at the time of borrowing. By being careful when lending to consumers who request a participation loan, and understanding both the benefits and drawbacks of such an approach, bankers can lower the threat to their overall fiscal health and help their customers build bigger, stronger businesses and development projects.

With its Rather Complex Nature, Why Buy Into a Participation Loan at All?

In recent years, virtually all banks have become far more conservative when it comes to lending money to consumers of any type, and in any amount. That's understandable, of course, since the most recent financial downturn was due in large part to banks that loaned money without being able to sufficiently underwrite the potential losses if a customer defaulted on their obligations. The cascading effects of those decisions led to a smart and necessary tightening of the credit market that lasted several years and was among the most prolonged such periods in history.

That era is over, though, and banks are looking once again to lend. Whether it's due to higher employment, increased confidence, or historically low interest rates, banks once again are looking to generate a significant amount of revenue from loans of all types. Participation loans deserve to be one of the lending products that can bring in new customers and help a bank make a significant investment in not only a local business or construction project, but in their surrounding community as a whole. For banks considering whether or not to begin offering these programs and the greater level of scrutiny that they require, there are a few key reasons to get started right away.

Boost Small Business Viability in the Community

The participation loan is most effective when it is used by a small bank to help out a small business. That's because small businesses typically require very large loans in order to have the funds needed to build a retail store or shipment facility, market their products to customers, pay their employees, and get the operation off the ground. Large funds are often needed to expand a business as well. Banks, on the other hand, face stiff competition with the biggest banks nationwide when it comes to making such loans.

Generally, a single smaller bank simply cannot afford to incur such a risk and underwrite such a large loan. If they simply turn away a small business customer, though, these banks lose a major source of revenue and a potentially rewarding long-term partnership. Customers will go to big banks where larger loans are much more likely to be issued, and they'll never look back. By using a participation loan structure, smaller banks can lend like big banks, and that wins small business customers in a big way.

2. Build Loan Volume and Reduce Idle Deposits

Some small banks choose not only to serve as the lead bank on a participation loan, but also to buy into such loans made at other financial institutions nearby or nationwide. Doing so can help build loan volume at the bank, increasing its profits in a pretty dynamic way. This is most often done by banks that are suffering from low loan activity while sitting on relatively high-value deposit accounts at the same time.

3. Diversify the Loan Portfolio

Consumers and banks alike are always seeking to diversify their holdings in order to guard against significant loss in any one specific area or market. This is why participation loans make sense, especially for small to medium-sized banks. Buying a participation loan allows the bank to select an industry, a geographic region, or a construction interest, and place their bet on that project paying dividends in terms of long-term loan interest. By spanning multiple industries and regions, banks reduce their exposure to major loss in one lending area alone.

4. Greater Flexibility for In-House Lending

Federal regulations limit how much a bank can lend to its own employees or directors who also have a small business or development project that needs to be financed. Using a participation loan allows a bank to lend that maximum amount while selling the rest of the loan to one or more participating banks who wish to buy in. Because the rest of the loan is technically held by another bank, no regulations are broken and compliance with the law is maintained.

These four factors make participation loans an increasingly popular mechanism and smaller banks and many medium-sized institutions, but such loans often originate or are purchased by major banks nationwide as well. Taking part in this innovative method of lending, though, comes with a number of careful considerations as well as the benefits mentioned above. In fact, these considerations are the key ways to reduce risk and preserve the bank's healthy fiscal position when both buying and selling participation loans in the wide marketplace for such products.

Start with a Careful Examination of the Loan's Participation Agreement

The first thing that banks need to look into is the participation agreement that defines the term of the participation loan. This agreement is generally drafted by the bank originating the participation loan, and its terms are signed off on by the person receiving the loan for their small business or development project. Such agreements are not uniform, and they may contain terms that could either benefit or severely disadvantage a participating lender over the course of repayment.

Any bank purchasing a participation loan should pay particular attention to any clauses regarding the disclosure of loan repayment information collected by the originating, or selling, bank. Often, banks will write a provision that might restrict purchasing lenders from seeing all financial data or receiving regular financial reports about the status of the loan, the status of a project or business for which the loan originated, or any other key financial data associated with the lending procedure. Loans with such provisions should be avoided. Banks opting to buy and participate in a loan should always have the right to regular financial documentation, full lending transparency, and access to a wide array of numbers and analyses regarding the viability of the loan itself.

Banks should not hesitate to submit their own participation loan agreement to the originating institution for review, as it's entirely possible for the bank selling participation to adopt that agreement instead. If banks don't wish to submit their own participation loan agreement to potentially replace the agreement already in effect, they still have the right to negotiate some terms within the existing agreement so that they are more favorable to all parties engaged in buying or selling segments of the loan.

Such negotiations typically center on three key provisions of an existing participation loan agreement. Banks should be prepared to argue for all three of the following provisions:

1. Loan Servicing

Banks buying into a participation loan should understand who the primary loan servicer is and what their role is in servicing the loan. The key is to understand whether or not a buying bank can be held accountable for errors and customer service obligations typically undertaken by the bank actually selling the loan. For those banks that are functioning as the seller, including this provision in a participation loan agreement will greatly increase its chances of being bought by another lender without tense negotiations or considering an alternative loan agreement.

2. The Degree of Risk Incurred by Each Bank

In many cases, the bank selling the participation loan incurs the most risk from the lending product, but that's not a uniform rule and it is certainly not a requirement of the process. Loan participation agreements often make clear exactly what percentage of risk is required from each participating lender, and review or negotiation of this position can have both positive and negative effects on a bank's bottom line and its assumed risk if the loan defaults or becomes otherwise "troubled" during the course of its term with the borrower.

3. Rights and Responsibilities of Participating Institutions When Loan is Troubled

Much like the loan servicing guidelines, banks need to understand what they are responsible for regarding the participation loan if it becomes "troubled." Typically, troubled loans are those that miss more than one consecutive payment or where payments have been lowered to compensate for reduced income or a reduced ability to pay on behalf of the lender. Troubled loans also include all defaulted loans and those included in any form of bankruptcy liquidation, restructuring, or discharge. Some banks will not be required to do much of anything, as much proceedings and claims handling will be the obligation of the originating lender. In other cases, though, all of the banks participating in the loan share an equal responsibility when it comes to reporting the loan's balance, customer interactions, and financial data concerning the loan during its term and prior to any troubled circumstances with the borrower.

Always Arrive at a Consensus On Credit Risk Ratings within a Participation Loan

When bond rating agencies give a credit rating to a municipal government, a state or federal government, or a corporation, they do so using an industry-wide system that has been regulated and agreed upon by all ratings agencies. This is why a five-star rating at Standard & Poor’s, for example, means the same thing as a five-star rating at Moody's. Of course, ratings agencies are free to offer different bond ratings to each town, city, state, or company. Even if they disagree on an institutions' creditworthiness, though, they at least agree on the method of assessment and labeling that creditworthiness.

Banks do not enjoy this same kind of agreement, as most professional bankers should already know. Banks are free to develop their own, proprietary systems of credit ratings and lending risk, and that can lead to a bit of trouble when picking up participation loans or offering them for sale. Since one bank's five-star rating of a borrower might be another bank's four-star rating, or even a three-star rating, it can be hard for all institutions to arrive at the same conclusions about a borrower's assets, ability to pay, and likelihood of default.

For this reason, banks need to make sure that they clarify the credit rating associated with a lending product before they pick it up. A five-star rating might look really good, but that five-star rating might only have been earned using the originating bank's slightly lower standards for such ratings. In that event, the bank buying into a participation loan might actually be taking on more of a risk than they had actually intended at the outside.

The best way to solve this problem is simply to contact the originating bank before buying into the loan, discussing the criteria that define their credit rating system and assessing how that plays into the institution's own determination of risk. With a consensus about the credit rating, a loan's risk factor can be more easily understood and unnecessary losses can be more easily prevented when purchasing one of these loans.

Always Do Research Into the Bank's Performance and its Local Market Area Before Buying

For those banks that are more interested in buying participation loan segments than selling off those segments to outside institutions, one of the most important aspects of this process involves careful research of the originating institution as well as the market area that they primarily serve with their products. This goes well beyond establishing a concurrence with the bank's credit rating system, though, and involves a more comprehensive look at the bank's performance, history, and overall level of risk, to determine whether or not that institution represents a sound lending partner.

Purchasing banks need to look at the historical performance of the bank, as well as how likely it is to engage in risky lending behavior or unproven financial instruments. They should also examine the bank's underwriting processes and requirements, largely in an effort to understand if the bank is offering loans that it can't afford or whether its customers are generally lower-credit customers that pose a bigger financial risk to loan buyers.

Finally, research should be done into the bank's market area. This includes the performance of small businesses in the area, the average and median income for individuals and families, unemployment numbers, long-term trends, and overall fiscal health. Some communities and enclaves present a lower risk than others and, for banks that are particularly conservative, these areas represent the best options when buying part of a participation loan.

As a rule, banks buying into a participation loan should only agree to taking on part of that loan if they feel that the bank's practices are sound and that its local market area is in line with the bank's own expectations or their maximum level of risk. If not, it is entirely acceptable for the bank to turn down buying into that loan in favor of one that is soundly underwritten and in line with the bank's own requirements.

Always Apply Institutional Underwriting Standards to Outside Participation Loans

All banks originate loans to consumers, and that means that all banks have a series of underwriting procedures and guidelines to help them determine whether or not a given consumer is eligible for a loan of any amount. These guidelines are not applicable only for loans that the bank owns in their entirety, however. Buying a participation loan means that a bank is incurring the same amount of risk that it would incur by lending a smaller product, all on its own, to a consumer in need.

Accordingly, it is considered a best practice for banks to apply their own underwriting procedure to the segment of a participation loan that they are about to buy. Given the borrower's credit rating, borrowing history, business performance, location, and other factors, would the buying bank have loaned the same amount, under the same terms, as the selling bank? If they answer is yes, then the loan is likely a safe bet and a sound way for the institution to buy into a more diversified loan portfolio. If, however, the buying bank simply cannot feel confident that thy would have made the same loan, then it's worth moving on.

Whether or not the buying bank actually applies its underwriting procedures to a participation loan, they will still be held accountable for every cent lost if that loan defaults or encounters financial trouble down the road. It simply makes sense for banks to apply their own standards of loan origination to a loan that they're buying. If not, they could be seriously exposed to a high degree of risk that is incompatible not only with their fiscal goals, but with the bank's actual business practices and overall financial methodology.

Due Diligence is the Key Factor for Participation Loan Success

Participation loans are a pretty tempting financial instrument for a large number of banks, largely due to the prospect of a more diverse loan portfolio, the ability to offer bigger loans to small businesses and local developers, and the ability to make money on a product that someone else originated and underwrote. Even so, there are considerable downsides and risks to taking on such loans, especially when a bank isn't sure of the history, reputation, fiscal solvency, or underwriting procedures, in place at the institution selling the loan.

For the best combination of financial benefits and loan portfolio expansion, banks need to do a great deal of research and communication with the originating lender. Whether it's to understand that institution's credit rating system or to get greater clarity into their underwriting procedure, this research will reduce risk in a big way. It will also reduce the opportunity for unpleasant surprises at a later time, if the loan buyer eventually finds out that the loan was given to a customer with shaky financial data, tough repayment requirements that they just can't meet, or a project that doesn't look like it will pay off in the long run.

Banks should remember that asking more questions is never a bad thing, and that institutions buying a participation loan segment have the right to fully examine every page of the loan's terms. By loading up on information about the lender, the loan, the borrower, and the market where the borrower is located, banks will stand their best chance at making healthy profits while minimizing the risk incurred when buying in.