



Do OCC Guidelines and Regulations Governing the Conduct of Banks in Loan Participation Transactions Impose an Obligation Upon the Purchasing Bank to Conduct an Independent Credit Analysis of the Borrower?

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Do OCC Guidelines and Regulations Governing the Conduct of Banks in Loan Participation Transactions Impose an Obligation Upon the Purchasing Bank to Conduct an Independent Credit Analysis of the Borrower?

Written by Charles B. Jimerson, Esq. - 3/20/19

As the economy remains hot and the lending environment remains competitive, many OCC regulated banks will turn to loan participation transactions in order to turn a profit. Often these transactions are made in a bit of a vacuum with the participating/purchasing bank(s) relying on the diligence and underwriting of the lead/originating bank to vet the creditworthiness of the borrower. This can be a recipe for disaster for a purchasing bank in the event the underlying credit was not properly evaluated. While loss avoidance is critical, the question that loan participants of OCC banks need to ask themselves is whether OCC guidelines and regulations governing the conduct of banks in loan participation transactions impose an obligation upon the purchasing bank to conduct an independent credit analysis of the borrower? It is one thing to make a bad deal, but is another to violate banking regulations. Read on for an overview of banking circular 181.

Banking Circular 181

The short answer is yes, OCC regulations do require purchasing banks to conduct their own credit analysis of a borrower in a participation transaction. The primary source of authority referenced in case law and OCC enforcement actions governing the conduct of participating banks are the guidelines issued by the OCC in Banking Circular 181 titled "Purchases of Loans In Whole Or In Part – Participations". Banking Circular 181 provides that the purchasing bank should conduct an independent credit analysis to satisfy itself that the loan participation is a credit which it would make directly. Thus, loan participation transactions **require** purchasing banks to conduct independent analyses of the creditworthiness of the borrower as well as the value and lien status of the collateral. This requirement is set out by the Office of the Comptroller of the Currency (OCC) in Banking Circular 181.

A loan participation—an arrangement in which a bank makes a loan to a borrower and then sells all or a portion of that loan to a purchasing bank—does not afford purchasing banks the option to solely rely on statements by sellers about the creditworthiness of a given borrower. The primary source of authority referenced in case law^[1] and OCC enforcement actions governing the conduct of participating banks are the guidelines issued by the OCC in Banking Circular 181 titled "Purchases of Loans In Whole Or In Part – Participations". *Northern Trust Co. V. FDIC*, 619 F. Supp 1340, 1343 (W.D. Okla. 1985); *First State Bank of Wheatland v. American Nat. Bank*, 808 P. 2d 804, 806–07 (Wyo.

1991). Banking Circular 181 provides that the purchasing bank should conduct an independent credit analysis to satisfy itself that the loan participation is a credit which it would make directly.

Office Of Comptroller Of Currency (OCC) Guidance To Banks

Banking Circulars issued by the Office of Comptroller of Currency ("OCC") provide guidance to national banks. Conduct in contravention to those guidelines may constitute unsafe and unsound banking practices that are cause for an OCC enforcement action. Specifically, Banking Circular 181 was drafted to address the risks arising from the purchase of loans and participations in loans, where "participations in loans may constitute an unsafe or unsound banking practice in the absence of satisfactory documentation, credit analysis, and other controls over risk." See Comptroller of the Currency, Banking Circular 181 (rev. Aug. 2, 1984), Fed. Banking L. Rep. (CCH) ¶ 60,799 (the "Circular"). The Circular provides that satisfactory controls over the risks inherent in loan participation require an independent analysis of credit quality by the purchasing bank.

A reference to the purchasing bank's own policies on loan origination may provide guidance as to whether a purchasing bank made a prudent decision to participate in a loan. The OCC provides that banks should have written policies and procedures governing loan participation transactions, and such policies

should include “an analysis of the value and lien status of the collateral.”

How Is Loan Participation Defined By The OCC In Banking Circular 181?

Although the nature and extent of each credit analysis is transaction-specific, the Circular states that the purchasing bank should conduct an independent credit analysis to the extent that the loan participation is a credit which the purchasing bank would make directly. The seller is merely one source of information in regards to the borrower’s creditworthiness, which the purchaser cannot rely solely upon. Banking Circular 181 lists financial information that is ordinarily included in a loan participation agreement, including: the accrual status, the status of principal payments, financial statements, collateral values, lien status, and any factual information bearing on the continuing creditworthiness of the borrower.

Although purchasing banks may not rely solely on *statements* by the selling bank about the creditworthiness of the borrower, purchasing banks must often rely on the selling banks in order to obtain relevant financial information about the borrower. Generally, when engaging in loan participation, a purchaser will want to have a transfer agreement in order so that full credit information is made available by the seller. The need for these agreements is due to the indirect relationship between the borrower and the purchaser, which proves to be cumbersome when purchasers attempt to assess loan quality without a

cooperative relationship with the selling bank. The absence of these cooperative arrangements not only diminishes a purchasing bank's ability to gather relevant information about a loan portion up front before purchasing it, but also hinders a purchasing bank's ability to maintain sufficient credit information on the borrower throughout the remaining duration of the loan.

Conclusion

In summary, loan participation agreements impose a number of obligations on purchasing banks. First and foremost, purchasing banks are required to conduct independent analyses of the creditworthiness of the borrower as well as the value and lien status of the collateral. Second, prudent purchases of loans generally include an assessment of relevant financial information of the borrower in line with a bank's written policies and procedures governing loan participation. Generally, a bank should undertake an analysis such that it is satisfied it would have directly lent to the borrower in the first place. Third and finally, a purchasing bank ought to ensure that that the selling bank will be and remain cooperative regarding the continual transference of relevant financial information of the borrower.

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