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FDIC Issues Advisory to Banks for Purchased Loans and Loan Participations

On November 6, 2015, the Federal Deposit Insurance Company ("FDIC") issued an important Financial Institution Letter (FIL492015) (the "FIL") cautioning banks about the risks of purchasing loans and loan participations originated by nonbank "alternative" lenders, and advising how to manage those risks. Specifically, the new FIL imposes additional requirements on banks purchasing interests in loans that have been originated by nonbank, peer-to-peer or marketplace lenders.

The explosive growth of consumer and small-business lending by alternative nonbank lenders, such as Lending Club, Prosper and Kabbage, is reported on almost daily in the Wall Street Journal and American Banker. Using their Internet and mobile data-driven automated platforms, these financial technology companies likely will originate more than $10 billion in new loans in 2015; much of it at the expense of banks that have seen their total market share decline in these spaces, according to FDIC data.

What does the FIL require from banks purchasing whole loans or participations from nonbanks? Certainly, the purchase of loan participations by banks from banks is not a new phenomenon, and has been going on for decades. But the purchase by banks of whole loans and participations from "alternative" nonbank lenders is a new and rapidly growing trend, and clearly is sounding alarms in the risk management area of the FDIC.

While the FIL acknowledges that many banks historically have purchased loans and participations to achieve growth, diversify credit risk and deploy liquidity, the FDIC points to concerns it has about the increasing number of banks purchasing loans from nonbank third parties, when the banks are relying entirely on these third parties to underwrite and facilitate the loan origination. This underwriting is often based upon unspecified, proprietary, electronic, data-driven credit underwriting models, which the bank purchaser typically has not even been allowed to review and analyze.

After reminding "purchasing" banks that their over-reliance on "lead" institutions has often caused significant credit losses and resulted in many bank failures, the FIL then states rather starkly that it is "evident that banks are not carefully analyzing the potential risks arising from nonbank third-party loan originators."

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The FIL reminds banks that loan participations should be underwritten and administered in the same manner and with the same diligence as if the loan was originated by the purchaser. In addition, the bank must employ effective third-party risk management practices as it would do in connection with any material vendor or third party, and much of the FIL focuses on this subject.

The FIL notes that a bank should have a clear and detailed loan policy outlining all of its guidelines and procedures for loans and loan participations that it purchases. This policy should address collateral, limits, concentrations, out-of-territory loans, and should describe the third-party risk management process if purchases are executed through a third party.

Significantly, the FIL notes that to the extent the purchasing bank relies on a third party's credit model for credit decisions (such as for a consumer loan application to Lending Club), the bank "should perform due diligence to assess the validity of the credit model." The FDIC states that "institutions" are not prohibited from relying on a qualified and independent third party to perform model validations. The FIL notes, however, that "banks are reminded that the responsibility to perform appropriate due diligence of a third party cannot be outsourced."

According to the FIL, bank management should exercise particular diligence and caution when considering the purchase of an out-of-territory loan or credit facility, or if the borrower is in an industry unfamiliar to the bank.

Banks are cautioned to carefully review and prepare their loan purchase or participation agreements with the advice of legal counsel, and the FIL reminds banks of a host of matters that ought to be addressed in any well-drafted participation or purchase document. It appears the days of a participant merely accepting without comment a loan seller's "boilerplate" form of participation agreement are over.

Finally, the FIL reminds banks to obtain all necessary committee and board approvals prior to entering into any material third-party loan purchase arrangement.

While the FDIC's new cautionary FIL does not exactly tell banks to stop buying loans and participations from nonbank third parties, the overall effect of this guidance will clearly be to chill many banks' appetites to purchase these loans. Please call or email Jim Sheriff or John Reichert if you would like to discuss this e-alert.

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