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| **Type**: | Bookletter |
| **Section Number**: | BL-010 |
| **Section Title**: | Farmers Home Administration (FmHA) Guaranteed Loans -- Capitalization of Interest |
| **Old/Additional ID**: | (Original # 271-OE) |

October 16, 1990

To: The Chief Executive Officer

All Farm Credit Institutions

From: David C. Baer, Director

Office of Examination

Subject: Farmers Home Administration (FmHA) Guaranteed Loans—Capitalization of Interest

During the course of certain Farm Credit institution (FCI) examinations, Farm Credit Administration examiners have found that provisions in notes on FmHA-guaranteed loans permit the compounding of interest. We requested the FmHA to review those provisions and inform us of any impact on the validity of the guarantee.

The FmHA has responded that all guaranteed loans governed by Lender Agreements revised May 16, 1983, and later, are void if the promissory note provides for the payment of interest on interest.

The two examples that FmHA reviewed and indicated would void the guarantee are shown below:

1. COMPOUNDING AT MATURITY-DEFAULT INTEREST. If all or any part of this total amount due under this Note or any installment thereof is not paid at maturity, whether maturity occurs by reason of acceleration or otherwise, then at the Association's option, all remaining accrued interest shall be added to the past due principal balance. After maturity, the outstanding principal balance, including compounded interest, if any, shall bear interest at the default rate.

2. ADDITIONAL AGREEMENTS AND OBLIGATIONS OF PARTIES. The borrowers, endorsers, sureties, guarantors, and all other persons who may become liable for all or any part of the indebtedness evidenced hereby severally agree to the following:

"That if this Note is placed in the hands of an attorney for collection or to protect or enforce any of the Association's rights hereunder, their liability to the Association shall extend to and include, to the extent permitted by applicable federal or state law, reasonable attorney's fees not to be less than 20% of the sum of unpaid principal, compounded interest, and accrued interest together with all court costs and all other fees, costs and expenses paid or incurred by the Association in connection with the collection of this loan."

If your institution's note form contains the above or similar provisions which permit capitalizing interest at default on FmHA-guaranteed loans, then the note must be corrected to ensure the FmHA guarantee is valid.

The FmHA has suggested that affected FCIs contact the respective FmHA state director concerning making any necessary amendments to promissory notes.

FCA examines will continue to review and classify FmHA-guaranteed loans based upon a determination of the validity of the guarantee.