

Farm Credit Administration

1501 Farm Credit Drive
McLean, Virginia 22102-5090
(703) 883-4000

INFORMATIONAL MEMORANDUM



July 10, 1998

To: Chairman, Board of Directors
Chief Executive Officer
Each Farm Credit Institution

From: Roland E. Smith, Chief Examiner
Office of Examination

Subject: Examination of Loans Guaranteed by Federal and Local Government Agencies

The purpose of this memorandum is to provide guidance and clarification regarding the examination treatment of loans guaranteed by the Farm Services Agency (FSA) and other agencies and instrumentalities of the United States (U.S.) Government. The guidance in this memorandum will be applied by Farm Credit Administration (FCA) examiners to loan guarantees made by certain state and local Government units and agencies that have the wherewithal to honor such guarantees.

Guarantees issued by the FSA and other Government agencies are an effective risk management tool for lenders when used in accordance with the guidelines of the individual guarantor programs. In addition, such guarantees provide lenders the opportunity to reach a larger portion of the agricultural community. Therefore, the Office of Examination encourages Farm Credit System (FCS) lenders to obtain valid guarantees to reduce risk and meet the needs of the agricultural community as circumstances warrant.

The vast majority of FCS loans having guarantees will be guaranteed by the FSA. This agency issues loss-oriented guarantees that normally cover up to 90 percent of the amount of loss (uncollectible portion after liquidation of all collateral) of the originating lender's principal and interest. FCA examiners may also encounter guarantees issued by other U.S. Government or local agencies. The specific terms and conditions of these guarantee programs vary and are beyond the scope of this memorandum. Nevertheless, institutions must comply with the provisions of guarantee agreements to ensure they remain in good standing with the issuing agency and keep the guarantee in effect. The agreements typically require lenders to assume responsibility to ensure payment upon activation of the guarantee. In the event of borrower default, the FSA typically issues a Notice of Foreclosure that directs the lender to initiate formal collection.

FCA examiners will examine the terms and conditions of such guarantees and appropriately test and examine Government guaranteed loans to determine whether the institution is adhering to the terms and conditions of the guarantee. The examination of guaranteed loans will also assess whether the institution has internal control systems that effectively identify and control risk and properly classify loans. Normally, loans guaranteed by the FSA or other U.S. Government agencies that are performing as agreed will be classified as Acceptable/Performing.

Even though repayment problems or other credit weaknesses may exist, assuming there is a valid enforceable guarantee and no apparent risk of loss, the examiners will not take exception if the institution maintains the loan in an accrual status. This accounting treatment is consistent with FCA Regulation 621.6(c) in that loans, which are being serviced in accordance with the terms of a Government guarantee, are normally presumed to be in process of collection and adequately secured. However, if a loan with a valid guarantee and no risk of loss does become 90 days past due, it must be disclosed in the performance category “Loans 90 days past due still accruing interest.”

If it becomes evident there is risk of loss and the guaranteed loan is no longer fully collectible despite the existence of the guarantee, the loan must be transferred to nonaccrual as prescribed by FCA Regulation 621.6(a). Thus, the accrual of interest should cease when the institution can no longer expect to recover the full amount of principal and interest. The accrual of interest also typically will cease when the FSA or other Government agency has initiated a Notice of Foreclosure or other formal collection action. Any portion of the loan on which collectability is questionable should be provided for in the allowance for loan losses; known losses should be charged off. The portion of the loan on which collection is in doubt or not collectible should be classified as Doubtful or Loss, respectively. That portion of the loan that is collectible through the guarantee may be classified acceptable. The determination of the appropriate accounting and classification treatment should be based on a review of both the terms and conditions of the guarantee and an assessment of the individual credit factors, including collateral.

In some instances, the collectability or enforceability of the Government guarantee may be in doubt because the lender’s compliance with the terms of the guarantee is questionable. In those instances, the loan should be classified, accounted for, and reported in a manner consistent with its own unique risks without reliance upon the guarantee for ultimate collection.

Questions concerning this memorandum may be directed to Thomas J. Holland, Chief Accountant and Director, Special Examination and Enforcement Division, Office of Examination, at (703) 883-4484, or on the Internet at e-mail address *hollandt@fca.gov*.