FEDERAL RESERVE BANK
OF DALLAS

WILLIAM H. WALLACE
FIRST VICE PRESIDENT

DALLAS, TEXAS 75222

May 15, 1985

Circular 85-61

TO: The Chief Executive Officer of all state member banks, bank holding companies, and other concerned in the Eleventh Federal Reserve District

SUBJECT

Supervisory policy for institutions that participate in the purchase and sale of loans guaranteed by the U.S. government

SUMMARY

The Board of Governors of the Federal Reserve System has announced the adoption of a revised policy for supervising financial institutions that participate in the purchase and sale of loans guaranteed by the U.S. government. The revised policy particularly addresses excessive purchase premiums.

ATTACHMENTS

The Board's press release and the Supervisory Policy are attached.

MORE INFORMATION

Supervisory policy questions pertaining to the purchase and sale of U.S. government guaranteed loans should be directed to the following Supervision & Regulation Department personnel:

State member banks: Linda Myers, (214) 651-6670
Gary Krumm, (214) 651-6671
Bank holding companies: Richard Burda, (214) 651-6472.

Sincerely yours,

William H Wallace

FEDERAL RESERVE press release

For immediate release April 10, 1985

The Federal Reserve Board today adopted a revised policy for supervising financial institutions that participate in the purchase and sale of loans guaranteed by the U.S. government. The policy updates guidelines first approved in 1979 which established prudential standards for handling such loans.

The revised policy reminds financial institutions that premiums received in lieu of servicing fees, with respect to the selling and servicing bank, are to be amortized over the life of the loan; and that, with respect to the purchasing bank, the premiums paid over the face value of the note are not guaranteed and are not paid by the guaranteeing federal agency when the loans are prepaid or in default. For this reason, the statement cautions banks against paying inappropriate or excessive premiums.

The policy statement is attached.

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Attachment

1776 G Street, NW, Suite 701 • Washington, DC 20006

Federal Financial Institutions Examination Council

Supervisory Policy

THE SALE OF U.S. GOVERNMENT GUARANTEED LOANS AND SALE PREMIUMS

Recommendations for Originating and Selling Institutions

Examiners should review the extent and nature of activities in connection with the sale of government guaranteed loans. Lax or improper management of the selling institution's servicing responsibilities should be criticized. Out-of-trade area lending for the purpose of resale of any portion of U.S. government guaranteed loans should be carefully reviewed to ensure that the practice is conducted in a safe and sound manner.

All income, including servicing fees and premiums charged in lieu of servicing fees, associated with the sale of U.S. government guaranteed loans, should be recognized only as earned and amortized to appropriate income accounts over the life of the loan.

Recommendations for Purchasing Institutions

Purchasers of U.S. government guaranteed loans should be aware that the purchase premiums are not guaranteed and are not paid by the guaranteeing Federal agency when the loans are prepaid. Because payment of premiums which do not reasonably relate to the yield on the loan can distort published financial reports by overstating the value of a financial institution's assets, it will generally be viewed as an unsafe and unsound banking practice for a financial institution to pay purchase premiums which result in a significant overstatement in the value of bank assets.

Many government guaranteed loans currently being originated and sold are variable rate. These variable rate loans normally should not trade at anything more than a modest premium or discount from par. Examiners will be directed to carefully review any loans being sold or purchased at significant premiums and will criticize any involvement with excessive premiums as an unsafe and unsound business practice. Excessive purchase premiums will be classified loss. The loans will be required to be revalued to the market value at the time of the acquisition and the excessive premiums will be charged against current earnings.

In addition, any unamortized loan premium on a government guaranteed loan must be immediately charged against income if the loan is prepaid, regardless of whether payment is received from the borrower or the guaranteeing agency.

Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency

Institutions supervised by the above agencies are advised that guaranteed portions of U.S. government guaranteed loans should not be recorded or carried as U.S. government or federal agency securities. They should be carried and reported as U.S. government guaranteed loans.

Additional Information

Questions concerning this supervisory policy should be addressed to the appropriate regulatory agency.