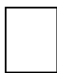

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Sale of Loans into the Federal Agricultural Mortgage Corporation Program

INTRODUCTION

This circular presents the legal and supervisory limits governing proposed ways in which national banks may participate as loan sellers in the Federal Agricultural Mortgage Corporation ("Farmer Mac") program. Part I explains the regulatory accounting, capital, and legal lending limit treatments for three ways a national bank might sell loans into the Farmer Mac program. Part II sets forth important supervisory restrictions that apply to all national banks that sell loans into the program. Detailed accounting guidance, additional information on capital requirements, and further legal analysis is contained in the appendices.

SUMMARY

Under the first of the three proposals, a national bank would sell loans to a Farmer Mac-certified pooler without recourse and would not assume any risk of loss from the resulting Farmer Mac loan pool. Under the second proposal, a national bank would sell loans to a Farmer Mac-certified pooler and retain subordinated participation interests in those loans. Under the third proposal, a national bank would sell loans to a Farmer Mac-certified pooler and acquire a subordinated security backed by the resulting loan pool.

If a bank sells a loan to a pooler without recourse, no capital is required against the sold loan and the sold loan is not included when calculating the amount outstanding to the borrower under the bank's legal lending limit.

If a bank sells a loan to a pooler and retains a subordinated interest in that loan, capital must be held against the sold and retained portions and both portions of the loan must be included when calculating the amount outstanding to the borrower under the bank's legal lending limit. Consistent with safe and sound banking practices, a national bank may not acquire a direct subordinated interest in loans other lenders sell into the Farmer Mac program.

If a national bank sells a loan to a pooler and acquires a subordinated security in the resulting pool, capital must be held against the loan sold as well as the subordinated security. However, the loan is not included when calculating the amount outstanding to the borrower under the bank's legal lending limit and the subordinated security is not considered a loan to any borrower for lending limit purposes. Consistent with safe and sound banking practices, a national bank

may only acquire a subordinated security issued by a Farmer Mac loan pool in connection with the sale of its loans into that pool.

As a matter of supervisory policy, the total holdings by a national bank of subordinated securities and subordinated participation interests acquired through participation in the Farmer Mac program must be limited to 25 percent of the bank's capital.

BACKGROUND

Farmer Mac is a federally-chartered instrumentality of the United States created by the Agricultural Credit Act of 1987 ("Act") to help develop a secondary market for agricultural real estate loans. Farmer Mac was created to provide guarantees for the timely repayment of principal and interest on securities that represent interests in, or obligations collateralized by, pools of qualified agricultural real estate loans. The Act requires Farmer Mac to develop uniform underwriting standards for qualified loans and to issue standards for the certification of institutions as agricultural mortgage marketing facilities ("poolers"), authorized to create Farmer Mac loan pools.

A pool may receive the Farmer Mac guarantee only if the pooler has established a reserve or retained a subordinated participation interest equal to at least 10 percent of the outstanding principal value of the loans in the pool (the "reserve"). Farmer Mac is authorized to establish higher reserve requirements for any pool. The reserve may be funded by the pooler, by the loan originators whose loans are sold into the pool, or by other sources. The full amount of the reserve must be exhausted before the Farmer Mac guarantee may be drawn upon to pay investors. Thus, 100 percent of the losses from any Farmer Mac pool, up to the balance of the reserve, must be absorbed by whoever funds the reserve.

The Farmer Mac guarantee structure is not patterned on any existing government-sponsored guarantee program. Rather, the reserve requirement is unique to the Farmer Mac statute and is designed to protect Farmer Mac from at least the normal, predictable credit risk associated with the underlying mortgages in the pool. The statute permits this credit risk to be retained by the banks and other agricultural lenders that sell their loans into Farmer Mac pools.

Program Description: Farmer Mac requires agricultural lenders to purchase specified levels of its common stock to become eligible to participate in the program. The OCC has previously determined that such stock purchase is permissible for national banks. See OCC Interpretive

Letter No. 427, reprinted in, [1988-89 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,651 (May 9, 1988).

Under the Farmer Mac program, eligible agricultural lenders sell qualified loans to a Farmer Mac-certified pooler. In general, qualified loans are loans secured by first liens on agricultural real estate or rural residential dwellings that comply with Farmer Mac's underwriting standards. Farmer Mac may waive certain of its underwriting standards on a case-by-case basis, but may not waive the minimum standards prescribed by the statute.

After purchasing the qualified loans, the pooler assembles a loan pool following Farmer Mac's pool diversification requirements, which incorporate minimum statutory standards. Generally, the Act requires Farmer Mac loan pools to be diversified as to the underlying borrowers and to consist of no fewer than 50 loans of varying principal amounts. The loans must be secured by agricultural commodities over a wide geographic area. A Farmer Mac loan pool may not contain:

- Two or more loans to related borrowers,
- Any one loan that exceeds 3.5 percent of the aggregate principal amount of the loans in the pool, or
- Any loan larger than $2.5 million, unless it is secured by 1,000 acres or less.

When the pool has been assembled, the pooler issues and sells securities that represent interests in or obligations backed by the pool. To qualify for the Farmer Mac guarantee, the pooler must establish a reserve of at least 10 percent of the outstanding principal amount of the loans in the pool. The pooler must also comply with all statutory requirements and any other conditions that Farmer Mac considers appropriate.

The reserve must be held as a cash reserve invested in United States government securities or as subordinated participation interests in each loan in the pool. The pooler and the originators of the loans in the pool may contribute to the cash reserve or hold the retained subordinated participation interests. The institutions that fund the reserve absorb the first dollars of losses arising from the loans in the pool. The Farmer Mac guarantee does not support the poolers, the loan originators, or any other institutions that fund the reserve.

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PART I - ACCOUNTING, CAPITAL, AND LENDING LIMIT TREATMENTS

This section presents the specific regulatory accounting, regulatory capital, and legal lending limit treatments that apply to three methods by which a national bank may sell a loan into a Farmer Mac pool. The methods differ in the way the bank participates in establishing the reserve. The treatments described in this section are derived from preexisting and long-standing requirements that apply to asset sales by national banks.

LOAN SALE WITHOUT RECOURSE

The originating bank sells a whole loan to the pooler without recourse and without acquiring any direct or indirect subordinated interest in the resulting pool. The bank makes no contribution to the reserve and is not responsible for any losses that may arise from its own sold loan or from the pool.

Regulatory Accounting - This transaction is an asset sale without recourse. The entire loan is removed from the Report of Condition ("Call Report") balance sheet and no off-balance sheet item is reported.

Regulatory Capital - Under current and risk-based capital requirements effective December 31, 1990, the sold loan requires no capital support.

Legal Lending Limit - The entire amount of the sold loan is removed from the bank's calculation of total loans or extensions of credit outstanding to the borrower under 12 U.S.C. § 84.

LOAN SALE WITH RETAINED SUBORDINATED PARTICIPATION INTEREST

The originating bank sells a loan to the pooler and retains a subordinated participation interest in that loan. The subordinated participation interest is the bank's contribution to the reserve. The bank is obligated to absorb all of the losses arising from the sold loan, up to the amount of the bank's retained subordinated participation interest.

Regulatory Accounting - This transaction is reported as an asset sale with recourse in the Call Report using generally accepted accounting principles ("GAAP"). The retained subordinated participation interest is reported on the balance sheet and the principal portion sold is reported as an off- balance sheet item (on schedule RC-L, line 9.c.(1)). See Appendix I for additional guidance.

Regulatory Capital - Under current capital requirements, the bank must hold capital against the value of the retained subordinated interest. The portion of the loan that is sold is removed from the balance sheet and does not require capital support.

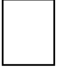
Under the risk-based capital guidelines effective December 31, 1990, the bank must hold capital against the value of the retained subordinated interest and the value of the sold portion of the loan. The on-balance sheet subordinated interest is risk-weighted according to the nature of the obligation. The off-balance sheet recourse amount (reported on schedule RC-L) is converted to an asset equivalent using a 100 percent conversion factor and then risk-weighted according to the nature of the obligation. See Appendix II for additional information and an example.

Legal Lending Limit - The entire amount of the sold loan plus the retained subordinated interest is included in the bank's legal lending limit calculation under 12 U.S.C. § 84. The OCC's regulation at 12 C.F.R. § 32.107 provides that, for the selling bank to be permitted to remove the sold portion of a loan participation from its lending limit, the sale must result in a pro rata sharing of credit risk between the originating and participating lenders.

When a national bank sells a loan and retains a subordinated interest in it, the bank retains a disproportionate amount of the credit risk in the whole loan. The subordinated participation absorbs the first losses on the whole loan and is in an inferior or secondary position with regard to collection in the event of default. Accordingly, if a national bank retains a subordinated interest in a loan sold into the Farmer Mac program, the full amount of the loan is included when calculating the amount of credit outstanding to the borrower.

LOAN SALE WITH PURCHASE OF SUBORDINATED SECURITY

The originating bank sells a loan to the pooler and acquires a subordinated security that represents an undivided, subordinated interest in the resulting pool. The subordinated security is the bank's contribution to the reserve. Any such subordinated security would not be guaranteed by Farmer Mac and would be junior in all respects, including payment and access to collateral, to the Farmer Mac-guaranteed securities (the senior securities) issued by the pool and sold to investors. The originating bank would be obligated to absorb up to the same dollar amount of loss as if it held a direct subordinated interest in its own loan, but any losses realized would arise from the pool as a whole.



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The OCC has determined that, under the express language of 12 U.S.C. § 24(Seventh), national banks are authorized to purchase subordinated securities that represent undivided, subordinated interests in Farmer Mac loan pools. Such purchases are subject to safety and soundness considerations and the supervisory limits stated in Part II of this circular. See Appendix III for legal analysis.

Regulatory Accounting - The loan sale and related purchase of the subordinated security are accounted for as one transaction. This transaction is reported as an asset sale with recourse in the Call Report in accordance with GAAP. The subordinated security is reported on the balance sheet and the principal portion sold less the principal amount of the subordinated security is reported as an off-balance sheet item (on schedule RC-L, line 9.c. (1)).

Generally, the credit risk associated with the pool of loans would be similar to the risk associated with the bank's own loan. The pooled loans would be provided by various sellers and must be diversified as to many factors, but all of the loans must be agricultural and must conform to the same underwriting standards. Thus, the acquisition of the subordinated security (which represents an undivided interest in the pool) would expose the selling bank to a similar credit risk as if it had retained a subordinated interest in its own loan sold. The selling bank would effectively retain recourse in the transaction.

Even if the pooled loans did not have similar characteristics to the bank's loan, the subordinated security would effectively constitute recourse on the sale of the bank's loan because the subordinated security holders, as a group, would provide recourse to the holders of the senior securities. The subordinated security holders must absorb the first dollars of losses arising from the pool. The selling bank would have the same dollar amount of exposure through the subordinated security as if it had retained a subordinated interest in its own loan. See Appendix I for additional guidance.

Regulatory Capital - Under current capital requirements, the bank must hold capital against the value of the subordinated security. The sold loan is removed from the balance sheet and requires no capital support.

Under the risk-based capital guidelines effective December 31, 1990, the bank must hold capital against the value of the subordinated security AND against the value of the loan sold. The subordinated security is risk-weighted according to the nature of the obligation. The off-balance sheet amount (reported on schedule RC-L) is converted using a 100 percent conversion factor

and is then risk-weighted according to the nature of the obligation. See Appendix II for additional information and an example.

Legal Lending Limit - The OCC has determined that if a national bank sells a loan into a Farmer Mac pool and purchases a subordinated security representing an undivided subordinated interest in that pool, the entire amount of the sold loan is excluded from the bank's legal lending limit calculation, and the subordinated security is not considered a loan or extension of credit to any borrower under 12 U.S.C. § 84. Cf. 12 C.F.R. § 32.111. The lending limit focuses on a bank's credit risk exposure to an individual borrower. That statute is intended to promote credit risk diversification by preventing any one borrower from borrowing an unduly large amount of a national bank's funds. See 12 C.F.R. § 32.1(b).

If a bank transfers a loan for inclusion in a Farmer Mac loan pool and purchases an undivided, subordinated interest in that pool, the bank exchanges the risk of loss arising from an individual borrower for the risk of loss arising from the diversified pool. The minimum statutory loan pool diversification requirements (see Program Description) prevent the loan of any one borrower from having more than a minimal impact on the overall performance of a loan pool. Those requirements ensure that the credit risk exposure to the underlying borrower that results from the bank's holding the subordinated security is different, for purposes of applying the lending limit, than the credit risk exposure that results from the bank's own loan to that borrower.

PART II - SUPERVISORY POLICY

This section sets forth important supervisory restrictions that apply to all national banks that sell loans into the Farmer Mac program. The supervisory policies relating to national banks acting as poolers have not been determined.

SAFETY AND SOUNDNESS

Banks that participate as loan originators in the Farmer Mac program can expect to benefit from increased liquidity and the ability to transfer interest rate risk and a portion of their catastrophic credit risk to investors and Farmer Mac. However, a national bank that sells loans into a Farmer Mac pool and retains a subordinated interest in those loans or acquires a subordinated security that represents an undivided, subordinated interest in the resulting pool, retains significant credit risk associated with the loans or the pool.

Subordinated credits, whether in the form of subordinated loan participations or subordinated securities, are significantly more vulnerable to economic reversals than other types of credits. Therefore, the OCC has established safety and soundness limitations that apply to a national bank's holdings of subordinated agricultural credits acquired in connection with the sale of loans for inclusion in Farmer Mac pools.

- A national bank may acquire a subordinated security representing a subordinated, undivided interest in a Farmer Mac pool only in connection with the bank's sale of its own loans for inclusion in that pool.

- A national bank may not acquire direct subordinated participation interests in individual agricultural loans sold for inclusion in Farmer Mac pools by other agricultural lenders.

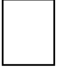
- A national bank may hold subordinated credits acquired through participation in the Farmer Mac program, in the form of subordinated loan participations or subordinated securities, equal in total to no more than 25 percent of the bank's regulatory capital. In calculating this limit, until December 31, 1990, a bank's regulatory capital is its primary capital as defined in 12 C.F.R. § 3.2(c). Thereafter, a bank's regulatory capital for this purpose is its Tier 1 capital as defined in Appendix A to 12 C.F.R. Part 3, Section 2(a).

ADEQUACY OF ALLOWANCE FOR LOAN AND LEASE LOSSES

A national bank that sells loans to a Farmer Mac-certified pooler must evaluate the adequacy of its allowance for loan and lease losses and other specific reserves after the sale. This evaluation should consider the collectibility and inherent risks of any subordinated assets retained or acquired.

CAPITAL ADEQUACY

The current and risk-based capital ratios are minimums primarily designed to protect banks against credit risk exposure. A capital level at or near the regulatory minimum is acceptable only for a bank with excellent control systems, high asset quality, and well managed on- and off-balance sheet activities. Most banks will be expected to maintain more capital than the regulatory minimum. See Appendix II.



BANKING ISSUANCE

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If a bank reduces its risks by participating in the Farmer Mac program, the amount by which its capital is expected to exceed the regulatory minimum will be reduced. However, if a bank significantly increases the riskiness of its portfolio through participation in the Farmer Mac program, it will be expected to maintain correspondingly more capital than the regulatory minimum.

ORIGINATING OFFICES

General questions may be referred to the Chief National Bank Examiner's Office, (202874-5190. Accounting questions may be referred to the Chief Accountant's Office, (202) 874-5180. Legal questions may be referred to the Legal Advisory Services Division, (202) 874-5200.

Donald G. Coonley
Chief National Bank Examiner

Attachments:
- Appendix I
- Appendix II
- Appendix III

APPENDIX I

ACCOUNTING GUIDANCE FOR LOAN SALES WITH RECOURSE

If a bank sells a loan to a Farmer Mac-certified pooler and either retains a subordinated interest in the loan sold or acquires a subordinated security backed by the resulting pool, the transaction is considered an asset sale with recourse. Statement of Financial Accounting Standards Board No. 77 ("FASB 77") and FASB Emerging Issues Task Force Issue 88-11 ("EITF 88- 11") give accounting guidance on the transfer of receivables with recourse. FASB 77 sets forth the conditions that must be met if a sale is to be recorded.

<u>Loan Sale with Retained Subordinated Participation Interest</u>

In this transaction, the profit or loss the bank reports is based on calculating the cost of the portions sold and retained. The retained subordinated portion bears more of the risk on the whole loan than the senior portion sold into the Farmer Mac program. Therefore, a simple pro rata allocation of the carrying value of the loan is inappropriate. Under EITF 88- 11, which provides guidance on the partial sale of a loan when a portion is retained, the cost attributable to the portions sold and retained must be based upon the relative fair value of each.

Valuation is done as of the date of sale, using established market values if available. If established market values are not available, fair values should be established using discounted cash flows. When computing the present value of cash flows, the interest rates used must reflect the credit risk associated with each portion -- that is, each should be the rate an independent purchaser would demand. The fair value determined for each portion should not exceed the value that would be realized in an arm's-length sale.

Gain or loss on the sale should be recognized immediately. Any gain recognized may not exceed the gain that would be recognized if the entire loan were sold.

<u>Loan Sale with Purchase of Subordinated Security</u>

The specific accounting treatment for this transaction will vary depending upon the similarity of the pooled loans and the loan sold by the bank.

If the subordinated security is backed by a pool of loans with characteristics similar to the loan sold, the guidance in EITF 88-11 on the partial sale of loans with an interest retained applies. The recorded investment in the loan sold is allocated between the portion sold and the subordinated security acquired based on the relative fair value of each. The fair values determined for the subordinated security and the portion sold should not exceed the value that would be realized in an arm's- length transaction.

If the bank obtains a subordinated security backed by a pool of loans that are not similar to the loan sold, the transaction should be accounted for at fair market value. The recorded investment in the loan sold is eliminated from the balance sheet and the subordinated security and any other proceeds received are recorded at fair value. Gain or loss is based on the difference between the recorded investment in the loan sold and the fair value of the total proceeds received.

In either situation, fair values should equal established market values, if available. If such values are not available, fair values should be established using discounted cash flows. When discounting cash flows, banks must use interest rates that reflect the credit risk associated with each portion -- that is, rates an independent purchaser would demand for such assets. If the fair value of the subordinated security cannot be reasonably determined, gain should not be recognized on the portion sold.

APPENDIX II

OVERVIEW OF CURRENT AND RISK-BASED CAPITAL REQUIREMENTS

Under the OCC's current capital requirements, national banks must maintain primary capital equal to 5.5 percent of adjusted total assets and total capital equal to 6 percent of adjusted total assets. Adjusted total assets are determined by reference to a bank's on-balance sheet assets reported in the Call Report. If an asset transfer is treated as a sale, the asset is removed from the balance sheet and does not enter into the computation of adjusted total assets. Accordingly, to the extent that a loan sold into the Farmer Mac program is removed from the bank's balance sheet, it does not require capital support under current minimum capital standards. The OCC's risk-based capital guidelines become effective on December 31, 1990. Those guidelines require national banks to hold Tier 1 and Tier 2 capital equal to at least 7.25 percent of risk-weighted assets until December 31, 1992 and equal to at least 8 percent of risk-weighted assets thereafter. Unlike the current capital requirements, those standards will require a bank to hold capital to protect it from risks from its off- balance sheet activities, including assets sold with recourse.

In calculating risk-based minimum capital, off-balance sheet activities are converted to asset equivalent amounts by multiplying the face value of the off-balance sheet item by the appropriate conversion factor as specified in the guidelines. The asset equivalent amount is then risk-weighted according to the nature of the obligation. The resulting risk-weighted asset is included when computing the bank's overall risk-weighted assets. Assets sold with recourse that are removed from the balance sheet for Call Report purposes are converted to asset equivalents at 100 percent of their face value.

Risk-based Capital Treatment of Loans Sold with Recourse

The following are examples of the risk-based capital treatment when a national bank sells a loan to a Farmer Mac-certified pooler and either retains a subordinated interest in the loan sold or acquires a subordinated security that represents an undivided, subordinated interest in the resulting pool.

A bank has a qualified loan with an outstanding principal balance of $200 that meets the requirements for the 50 percent risk-weight on residential mortgages in the risk-based capital guidelines. The bank's other assets and off-balance sheet activities result in additional risk-weighted assets ("RWA") of $9,900. Therefore, the bank's total RWA equal $10,000 [($200 x .50) + $9,900 = $10,000]. The bank has total capital, as defined in the risk-based capital guidelines, of $1,000. The bank's risk-based capital ratio is 1,000/10,000, or 10 percent.

Then the bank:

- Sells 90 percent of the principal portion of the loan to a Farmer Mac-certified pooler for $180 in cash and retains a 10 percent subordinated participation interest in the loan (face amount of $20), or

- Sells 100 percent of the principal portion of the loan for $200 and pays $20 for a subordinated security backed by the resulting pool.

The bank's subordinated asset, whether held as a subordinated participation interest or a subordinated security, is appropriately valued at $10. In both cases, the bank records $180 in cash, a $10 asset on its balance sheet, a $10 loss on the sale of the loan, and $180 in assets with recourse (on schedule RC-L line 9.c.(1)).

The bank's total capital has been reduced by $10 (from $1,000 to $990) by the loss on the sale of the loan. Assuming for the subordinated security that the loans in the pool qualify for the 50 percent risk-weight, the bank's total RWA is:

		$9,900	Other risk-weighted assets
+ ($180 x 0.0)	=	0	Cash on the balance sheet
+ ($10 x .50)	=	$5	The subordinated participation interest or subordinated security risk-weighted at 50 percent
+ ($180 x 1.0 x .50)	=	$90	The off-balance sheet recourse, converted at 100 percent and risk-weighted at 50 percent
Total	=	$9,995.	

The bank's risk-based capital ratio is 990/9,995 or 9.9 percent.

APPENDIX III

AUTHORITY OF NATIONAL BANKS TO PURCHASE SUBORDINATED SECURITIES REPRESENTING UNDIVIDED INTERESTS IN FARMER MAC POOLS

The OCC has determined that a national bank is authorized to purchase a subordinated security that represents an undivided, subordinated interest in a Farmer Mac pool. Although Section 16 of the Glass-Steagall Act, 12 U.S.C. § 24 (seventh), restricts, among other things, a national bank's power to purchase securities for its own account, this restriction does not apply to "obligations issued under authority of the Federal Farm Loan Act, as amended . . . ."

The Federal Farm Loan Act was repealed by section 5.26(a) of the Farm Credit Act of 1971, Pub. L. No. 92-181, 85 Stat. 583, 625. The Farm Credit Act of 1971 provided, however, that "[a]ll references in other legislation, State or Federal, . . . to the Acts repealed hereby, shall be deemed to refer to comparable provisions of this Act." 12 U.S.C. § 2001 note. Thus, the reference in 12 U.S.C. § 24(Seventh) to the "Federal Farm Loan Act, as amended" should now be read as the "Farm Credit Act of 1971, as amended." The statute which created Farmer Mac, Title VII of the Agricultural Credit Act of 1987, was an amendment to the Farm Credit Act of 1971. Accordingly, "obligations issued under authority" of the statute that created Farmer Mac are legally authorized for purchase by national banks under 12 U.S.C. § 24(Seventh).

A subordinated security representing an undivided, subordinated interest in a Farmer Mac loan pool would be an "obligation", i.e., a participation in, or obligation backed by, a pool of mortgage loans. A Farmer Mac pooler's issuance of such a subordinated security in connection with meeting its statutory obligation of establishing reserves or retaining subordinated participation interests to absorb at least the first 10 percent of losses from the pool would be made "under authority" of the Farm Credit Act of 1971, as amended by Title VII of the Agricultural Credit Act of 1987.

Therefore, the subordinated securities would literally meet the terms of the exception stated in 12 U.S.C. § 24(Seventh) for obligations issued under the authority of the Federal Farm Loan Act, as amended. National banks are authorized to purchase these obligations subject to safety and soundness considerations and the specific supervisory limits stated in Part II of Banking Circular 248.