FEDERAL RESERVE BANK OF DALLAS

DALLAS, TEXAS 75222

Circular No. 79-89
May 17, 1979

UNIFORM STATEMENT ON CLASSIFICATION OF BANK ASSETS AND APPRAISAL OF SECURITIES IN BANK EXAMINATIONS

TO ALL STATE MEMBER BANKS IN THE
ELEVENTH FEDERAL RESERVE DISTRICT:

In conjunction with the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Conference of State Bank Supervisors, the Board of Governors of the Federal Reserve System has issued a revised statement on classification of bank assets and appraisal of securities in bank examinations, including amended rules for assessing bank holdings of municipal general obligations.

Enclosed is a copy of the press release and the revised Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks. Any questions should be directed to Uzziah Anderson or Marvin C. McCoy of our Bank Supervision and Regulations Department, Ext. 6274.

Sincerely yours,

Robert H. Boykin

First Vice President

Enclosure

Joint News Release

Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
CONFERENCE OF STATE BANK SUPERVISORS

For immediate release May 7, 1979

A revised statement on classification of bank assets and appraisal of securities in bank examinations, including amended rules for assessing bank holdings of municipal general obligations, was issued today by State and Federal bank supervisors.

The statement is a revision of the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks issued in 1938 and revised in 1949. The statement was issued jointly by the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve Board and the Conference of State Bank Supervisors.

The revision clarifies definitions and eliminates practices duplicated elsewhere. It provides expanded definitions of "Substandard," "Doubtful" and "Loss" categories used for criticizing bank assets.

The revised Agreement sets forth guidelines for examiners to follow in distinguishing investment quality from sub-investment quality securities in bank portfolios, and restates guidelines for examiners to use in computing a bank's net sound capital.

The revised Uniform Agreement provides an exception to the general rules for appraisal and classification of municipal general obligation securities in bank portfolios (obligations of states, cities, counties or

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other political divisions that have general taxing authority). The revised Agreement establishes these rules:

--When municipal general obligations are not in default, but are regarded as being of sub-investment quality, they are to be classified as substandard assets of the bank.

--In the event of a default of a municipal general obligation, the book value of the securities in default are to be classified as doubtful until the issuer has taken budgetary, tax or other actions to cure the default or until the market for the defaulted securities has stabilized. The regulators will review the market for the defaulted securities periodically. Upon determination that a functioning market has been re-established, the book value of the securities in excess of market value will be classified as a loss to the holder.

Previously, any excess of book value above market value of a defaulted municipal general obligation was recognized as a loss at the time of the default and was eliminated from the bank's reported assets. Experience has shown, however, that general obligation municipal securities have generally not been disavowed and principal amounts have ultimately been paid.

The revised Uniform Agreement is attached.

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UNIFORM AGREEMENT ON THE CLASSIFICATION OF ASSETS AND APPRAISAL OF SECURITIES HELD BY BANKS 1/

Joint Statement of the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Conference of State Bank Supervisors

THE CLASSIFICATION OF ASSETS IN BANK EXAMINATIONS

Classification units are designated as "Substandard," "Doubtful," and "Loss." A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Fifty percent of the total of "Doubtful" and all of "Loss" will be deducted in computing the net sound capital of the bank. Amounts classified "Loss" should be promptly charged off.

THE APPRAISAL OF SECURITIES IN BANK EXAMINATIONS

Investment quality securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group generally includes investment securities in the four highest rating grades and unrated securities of equivalent quality. Neither market appreciation nor depreciation in these securities will be taken into account in figuring net sound capital of the bank. This policy is intended to apply to recognized sound investment practices of banks and not to those situations where the portfolio requires special treatment by a supervisory agency.

Sub-investment quality securities are those in which the investment characteristics are distinctly or predominantly speculative. This group generally includes securities in grades below the four highest grades and unrated securities of equivalent quality, defaulted securities and sub-investment quality stocks.

Securities in grades below the four highest rating grades and unrated securities of equivalent value will be valued at market price and the depreciation will be classified Doubtful; remaining book value will be classified Substandard. Depreciation in defaulted securities and sub-investment quality stocks will generally be classified Loss; remaining book value will be classified Substandard.

1/ Revises examination procedures established in 1938 and revised July 15, 1949.

An exception to the above will be made in the case of municipal general obligations which are backed by the credit and taxing power of the issuer. The entire book value of sub-investment quality municipal general obligations, which are not in default, will be classified Substandard.[1/] In the event of a default of a municipal general obligation, a period of time is usually necessary to permit the market for these defaulted securities to stabilize or for the issuer to put in place budgetary, tax or other actions that may eliminate the default, or otherwise improve the post-default value of the securities. The market for the defaulted securities will be periodically reviewed by the regulatory authorities. Upon a determination that a functioning market has been reestablished, depreciation on defaulted municipal general obligations will be classified as Loss. During such interim, the book value of all defaulted municipal general obligation securities will be classified Doubtful.[2/]

1/and 2/ The above exceptions will not apply in those instances where the supervisory authorities determine that there is no likelihood that the municipality will be able ultimately to repay or satisfactorily restructure its obligations.