



FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

September 30, 1996

DALLAS, TEXAS
75265-5906

Notice 96-92

TO: The Chief Executive Officer of each member bank and others concerned in the Eleventh Federal Reserve District

SUBJECT

Adoption of Final Interagency Guidelines on Safety and Soundness Standards

DETAILS

The Board of Governors of the Federal Reserve System, along with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, have issued final interagency guidelines prescribing safety and soundness standards for asset quality and earnings. The guidelines are effective October 1, 1996.

The guidelines prescribe that insured depository institutions establish and maintain systems that are commensurate with the institution's size and the nature and scope of its operations to

- identify problem assets and prevent deterioration in those assets and
- evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves.

ATTACHMENT

A copy of the Board's notice as it appears on pages 43948-52, Vol. 61, No. 167, of the *Federal Register* dated August 27, 1996, is attached.

MORE INFORMATION

For more information, please contact Basil Asaro at (214) 922-6066. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

For additional copies, bankers and others are encouraged to use one of the following toll-free numbers in contacting the Federal Reserve Bank of Dallas: Dallas Office (800) 333-4460; El Paso Branch *Intrastate* (800) 592-1631, *Interstate* (800) 351-1012; Houston Branch *Intrastate* (800) 392-4162, *Interstate* (800) 221-0363; San Antonio Branch *Intrastate* (800) 292-5810.

DEPARTMENT OF THE TREASURY**Office of the Comptroller of the Currency****12 CFR Part 30**

[Docket No. 96-19]

RIN 1557-AB17

FEDERAL RESERVE SYSTEM**12 CFR Part 208**

[Docket No. R-0766]

FEDERAL DEPOSIT INSURANCE CORPORATION**12 CFR Part 364**

RIN 3064-AB13

DEPARTMENT OF THE TREASURY**Office of Thrift Supervision****12 CFR Part 570**

[No. 96-53]

RIN 1550-AA97

Interagency Guidelines Establishing Standards for Safety and Soundness

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Final guidelines.

SUMMARY: The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board of Governors), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are amending the Interagency Guidelines Establishing Standards for Safety and Soundness (Guidelines) to include asset quality and earnings standards. The Guidelines were adopted pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act).

EFFECTIVE DATE: October 1, 1996.

FOR FURTHER INFORMATION CONTACT:

OCC: Emily R. McNaughton, National

Bank Examiner (202/874-5170), Office of the Chief National Bank Examiner; David Thede, Senior Attorney (202/874-5210), Securities and Corporate Practices Division; or Mark Tenhundfeld, Senior Attorney (202/874-5090), Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

Board of Governors: David Wright, Project Manager (202/728-5854), Division of Banking Supervision and Regulation; Gregory A. Baer, Managing Senior Counsel (202/452-3236), Legal Division, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544), Board of Governors of the Federal Reserve System, 20th and C Streets, NW, Washington, DC 20551.

FDIC: Robert W. Walsh, Manager, Planning and Program Development (202/898-6911) or Michael D. Jenkins, Examination Specialist (202/898-6896), Division of Supervision; or Susan vandenToorn, Counsel (202/898-8707), or Nancy L. Alper, Counsel (202/736-0828), Legal Division, Federal Deposit Insurance Corporation, 550 17th Street, NW, Washington, DC 20429.

OTS: William Magrini, Senior Project Manager (202/906-5744), Supervision Policy; or Kevin Corcoran, Assistant Chief Counsel (202/906-6962), or Teri M. Valocchi, Counsel (Banking and Finance) (202/906-7299), Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

SUPPLEMENTARY INFORMATION:**I. Background****A. Statutory Framework**

Section 132 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), Pub. L. 102-242, amended the Federal Deposit Insurance Act (FDI Act) by adding a new section (section 39, codified at 12 U.S.C. 1831p-1) that requires each Federal banking agency to establish by regulation certain safety and soundness standards for the insured depository institutions and depository institution holding companies for which it is the primary Federal regulator. As enacted in FDICIA, section 39(b) of the FDI Act required the agencies to establish standards by regulation specifying a maximum ratio of classified assets to capital and minimum earnings sufficient to absorb losses without impairing capital.

Section 318(a) of the Riegle Community Development and Regulatory Improvement Act of 1994

(CDRIA), Pub. L. 103-325, which was enacted on September 23, 1994, eliminated the application of section 39 to depository institution holding companies and replaced the requirement that the agencies "specify" quantitative asset quality and earnings standards with a requirement that the agencies prescribe standards, by regulation or by guideline, relating to asset quality and earnings that the agencies determine to be appropriate.

B. Agencies' Proposals

The agencies published a joint notice of proposed rulemaking in the **Federal Register** on November 18, 1993 (59 FR 60802) that solicited comment on specific standards that would govern numerous facets of a depository institution's operations, including quantitative standards governing a depository institution's asset quality and earnings. On July 10, 1995 (60 FR 35674), the agencies adopted: (1) final guidelines in all areas except asset quality and earnings; and (2) a final rule establishing deadlines for submission and review of safety and soundness compliance plans which may be required for failure to meet one or more of the safety and soundness standards adopted in the Guidelines.¹ On the same day (60 FR 35688), the agencies also proposed revised guidelines concerning asset quality and earnings standards to address problems noted by many commenters with the quantitative standards. The primary concern of these commenters was that it was impossible to design quantitative standards that would be appropriate for every regulated institution. Because the CDRIA clarified that quantitative standards were not required, the agencies proposed to replace the quantitative standards with more comprehensive qualitative standards that emphasize monitoring, reporting, and preventive or corrective action appropriate to the size of the institution and the nature and scope of its activities.

The proposed asset quality standards required an institution to identify problem assets and estimate inherent losses. The proposal also required an institution to: (1) consider the size and potential risks of material concentrations of credit risk; (2) compare the level of problem assets to the level of capital and establish reserves sufficient to absorb anticipated

losses on those and other assets; (3) take appropriate corrective action to resolve problem assets; and (4) provide periodic asset quality reports to the board of directors to assess the level of asset risk. The proposal noted that the complexity and sophistication of an institution's monitoring, reporting systems, and corrective actions should be commensurate with the size, nature, and scope of the institution's operations.

The agencies proposed earnings standards requiring monitoring and reporting systems similar to those required in the standards for asset quality. The proposed earnings standards were intended to enhance early identification and resolution of problems. The standards required an institution to compare its earnings trends, relative to equity, assets, and other common benchmarks, with its historical experience and with the earnings trends of its peers. The proposed standards also provided that an institution should: (1) evaluate the adequacy of earnings given the institution's size, and complexity, and the risk profile of the institution's assets and operations; (2) assess the source, volatility, and sustainability of earnings; (3) evaluate the effect of nonrecurring or extraordinary income or expense; (4) take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering asset quality and the institution's rate of growth; and (5) provide periodic reports with adequate information for management and the board of directors to assess earnings performance.

II. Discussion of Comments

The agencies received a total of 31² comments, some of which were sent to more than one agency. Commenters were overwhelmingly supportive of the proposal, particularly its reliance on qualitative and flexible standards in lieu of the quantitative standards originally proposed. Commenters noted that the more flexible guidelines embodied in the second proposed rule built upon a depository institution's own procedures for monitoring, reporting, and taking action with respect to asset quality and earnings conditions. Commenters agreed that well run institutions would not have to alter their practices in order to comply with the proposed standards.

Some commenters suggested amendments to the proposal. One commenter asked the agencies to clarify how the proposed standards interact with the examination process and the

determination of CAMEL ratings. Another commenter emphasized that institutions need flexibility in determining earnings benchmarks and defining the appropriate peer group. A third commenter suggested that the agencies eliminate the earnings standard directing each institution to evaluate the effect of nonrecurring or extraordinary income or expense. This commenter believed such an evaluation was effectively required by the separate standard requiring the institution to assess the source, volatility, and sustainability of earnings. Finally, one commenter asked that institutions be given the option of complying with quantitative standards.

III. Final Guidelines

The agencies are adopting the asset quality and earnings standards substantially as proposed. These qualitative standards are sufficiently flexible to permit an institution to adopt practices that are consistent with safe and sound banking practices and that are appropriate for the institution. Moreover, the standards are designed to prompt a depository institution to take steps that will help identify emerging problems in the institution.

The final rule makes two minor changes to the asset quality standards. First, the order of the steps a depository institution is to take is rearranged to reflect more accurately the appropriate sequence of these steps. Second, the final rule deletes the word "quality" in the standard requiring periodic asset reports (asset quality standard 6 in the final guidelines). This change was made to emphasize that the report is to address each of the asset quality standards, as appropriate, and not focus solely on problem assets. In response to the comment about the redundant earnings standards, the final rule combines the two standards concerning the nonrecurring income and sustainability of income. The agencies agree that these standards need not be listed separately, given the significant overlap in what they address. A discussion of the remaining comments follows.

Impact on examinations and ratings. The guidelines will not change the examination process or the determination of CAMEL ratings. These guidelines represent the agencies' longstanding expectation regarding an institution's management of asset quality and earnings, and, as such, will not require a change in the agencies' examination procedures or the determination of an institution's rating.

Definition of peer group. The agencies recognize that defining a peer group

¹ For the OCC, these Guidelines appear as Appendix A to part 30; for the Board of Governors, these Guidelines appear as Appendix D to part 208; for the FDIC, these Guidelines appear as Appendix A to part 364; and for the OTS, these Guidelines appear as Appendix A to part 570.

² The Board of Governors received 14 comments, while the OCC, FDIC, and OTS received 8, 6, and 3, respectively.

necessarily entails making decisions about which criteria to use. The guidelines identify equity and asset data as two commonly used benchmarks in defining a peer group and expressly state that an institution may use other commonly used benchmarks. The agencies will be flexible in permitting institutions to select criteria reasonably designed to provide a meaningful peer group comparison.

Quantitative standards. The agencies have decided against returning to quantitative standards in lieu of, or in addition to, the standards proposed. The agencies believe the standards contained in the final guidelines will encourage the adoption of practices that are consistent with safe and sound banking practices and that are appropriate for a given institution. Moreover, the agencies believe that these standards will be more effective than quantitative standards would be in helping identify emerging problems in a financial institution. However, even though the agencies are not adopting quantitative standards, the agencies will continue to analyze asset quality ratios and earnings levels, and trends thereof, in assessing an institution.

IV. Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act, 5 U.S.C. 605(b), the agencies hereby certify that these guidelines will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. As is explained more fully in the preamble to these guidelines, the guidelines are designed to illustrate what the agencies consider to be steps that are consistent with safe and sound banking practices while preserving flexibility for an institution to adopt a system that is appropriate for its circumstances.

V. Executive Order 12866

The OCC and OTS have determined that these final guidelines are not significant regulatory actions for purposes of Executive Order 12866.

VI. OCC and OTS: Unfunded Mandates Reform Act of 1995 Statement

Section 202 of the Unfunded Mandates Reform Act of 1995, Pub. L. 104-4 (Unfunded Mandates Act) requires that an agency prepare a budgetary impact statement before promulgating any rule likely to result in a Federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector of \$100 million or more in any one year. If a budgetary impact

statement is required, section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule. The OCC and OTS have determined that the final guidelines will not result in expenditures by State, local, and tribal governments, or by the private sector, of \$100 million or more in any one year. Accordingly, the OCC and the OTS have not prepared a budgetary impact statement or specifically addressed any regulatory alternatives. As discussed in the preamble, the final guidelines represent the standards applied by the agencies in examining insured depository institutions, and, therefore, represent no change in the agencies' policies and impose minimal new Federal requirements.

List of Subjects

12 CFR Part 30

Administrative practice and procedure, National banks, Reporting and recordkeeping requirements, Safety and soundness.

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Safety and soundness, Securities.

12 CFR Part 364

Administrative practice and procedure, Bank deposit insurance, Banks, banking, Reporting and recordkeeping requirements, Safety and soundness.

12 CFR Part 570

Accounting, Administrative practices and procedures, Bank deposit insurance, Holding companies, Reporting and recordkeeping requirements, Savings associations, Safety and soundness.

Office of the Comptroller of the Currency

12 CFR CHAPTER I

Authority and Issuance

For the reasons set forth in the joint preamble, part 30 of chapter I of title 12 of the Code of Federal Regulations is amended as follows:

PART 30—SAFETY AND SOUNDNESS STANDARDS

1. The authority citation for part 30 is revised to read as follows:

Authority: 12 U.S.C. 93a, 1831p-1.

2. The table of contents of appendix A to part 30 is amended by adding

entries for II.G. and II.H. to read as follows:

Appendix A to Part 30—Interagency Guidelines Establishing Standards for Safety and Soundness

Table of Contents

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II. * * *

G. Asset quality.

H. Earnings.

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3. Item II of appendix A to part 30 is amended by adding paragraphs G and H to read as follows:

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II. Operational and Managerial Standards

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G. *Asset quality.* An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should:

1. Conduct periodic asset quality reviews to identify problem assets;
2. Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;
3. Compare problem asset totals to capital;
4. Take appropriate corrective action to resolve problem assets;
5. Consider the size and potential risks of material asset concentrations; and
6. Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

H. *Earnings.* An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves. The institution should:

1. Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;
2. Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;
3. Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expense;
4. Take steps to ensure that earnings are sufficient to maintain adequate

capital and reserves after considering the institution's asset quality and growth rate; and

5. Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

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Dated: May 21, 1996.

Eugene A. Ludwig,
Comptroller of the Currency.

Federal Reserve System

12 CFR CHAPTER II

Authority and Issuance

For the reasons set forth in the joint preamble, part 208 of chapter II of title 12 of the Code of Federal Regulations is amended as follows:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for part 208 continues to read as follows:

Authority: 12 U.S.C. 36, 248 (a) and (c), 321-338, 461, 481, 486, 601, 611, 1814, 1823(j), 1831o, 1831p-1, 3906, 3909, 3310, 3331-3351, 15 U.S.C. 78b, 78o-4(c)(5), 78q, 78q-1, 78w, 781(b), 781(i), and 1781(g).

2. The table of contents of appendix D to part 208 is amended by adding entries for II.G. and II.H. to read as follows:

Appendix D to Part 208—Interagency Guidelines Establishing Standards for Safety and Soundness

Table of Contents

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II. * * *
G. Asset quality.
H. Earnings.

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3. Item II of appendix D to part 208 is amended by adding paragraphs G and H to read as follows:

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II. Operational and Managerial Standards

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G. Asset quality. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should:

1. Conduct periodic asset quality reviews to identify problem assets;
2. Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;

3. Compare problem asset totals to capital;

4. Take appropriate corrective action to resolve problem assets;

5. Consider the size and potential risks of material asset concentrations; and

6. Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

H. Earnings. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves. The institution should:

1. Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;

2. Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;

3. Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expense;

4. Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering the institution's asset quality and growth rate; and

5. Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

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By order of the Board of Governors of the Federal Reserve System, June 14th, 1996.

William W. Wiles,
Secretary of the Board.

Federal Deposit Insurance Corporation

12 CFR CHAPTER III

Authority and Issuance

For the reasons set forth in the joint preamble, part 364 of chapter III of title 12 of the Code of Federal Regulations is amended as follows:

PART 364—STANDARDS FOR SAFETY AND SOUNDNESS

1. The authority citation for part 364 continues to read as follows:

Authority: 12 U.S.C. 1819 (Tenth), 1831p-1.

2. The table of contents of appendix A to part 364 is amended by adding entries for II.G. and II.H. to read as follows:

Appendix A to Part 364—Interagency Guidelines Establishing Standards for Safety and Soundness

Table of Contents

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II. * * *
G. Asset quality.
H. Earnings.

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3. Item II of appendix A to part 364 is amended by adding paragraphs G and H to read as follows:

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II. Operational and Managerial Standards

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G. Asset quality. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should:

1. Conduct periodic asset quality reviews to identify problem assets;

2. Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;

3. Compare problem asset totals to capital;

4. Take appropriate corrective action to resolve problem assets;

5. Consider the size and potential risks of material asset concentrations; and

6. Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

H. Earnings. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves. The institution should:

1. Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;

2. Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;

3. Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expense;

4. Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering the institution's asset quality and growth rate; and

5. Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

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By order of the Board of Directors.

Dated at Washington, D.C. this 13th day of August 1996.

Federal Deposit Insurance Corporation.

Jerry L. Langley,
Executive Secretary.

Office of Thrift Supervision

12 CFR CHAPTER V

Authority and Issuance

For the reasons set forth in the joint preamble, part 570 of chapter V of title 12 of the Code of Federal Regulations is amended as follows:

PART 570—SUBMISSION AND REVIEW OF SAFETY AND SOUNDNESS COMPLIANCE PLANS AND ISSUANCE OF ORDERS TO CORRECT SAFETY AND SOUNDNESS DEFICIENCIES

1. The authority citation for part 570 continues to read as follows:

Authority: 12 U.S.C. 1831p-1.

2. The table of contents of appendix A to part 570 is amended by adding entries for II.G. and II.H. to read as follows:

Appendix A to Part 570—Interagency Guidelines Establishing Standards for Safety and Soundness

Table of Contents

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II. * * *

G. Asset quality.

H. Earnings.

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3. Item II of appendix A to part 570 is amended by adding paragraphs G and H to read as follows:

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II. Operational and Managerial Standards

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G. *Asset quality.* An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should:

1. Conduct periodic asset quality reviews to identify problem assets;
2. Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;
3. Compare problem asset totals to capital;
4. Take appropriate corrective action to resolve problem assets;

5. Consider the size and potential risks of material asset concentrations; and

6. Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

H. *Earnings.* An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to evaluate and monitor earnings and ensure that earnings are sufficient to maintain adequate capital and reserves. The institution should:

1. Compare recent earnings trends relative to equity, assets, or other commonly used benchmarks to the institution's historical results and those of its peers;
2. Evaluate the adequacy of earnings given the size, complexity, and risk profile of the institution's assets and operations;
3. Assess the source, volatility, and sustainability of earnings, including the effect of nonrecurring or extraordinary income or expense;
4. Take steps to ensure that earnings are sufficient to maintain adequate capital and reserves after considering the institution's asset quality and growth rate; and
5. Provide periodic earnings reports with adequate information for management and the board of directors to assess earnings performance.

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Dated: June 3, 1996.

John F. Downey,

Executive Director, Supervision.

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