FEDERAL RESERVE BANK
OF NEW YORK

At Circ. No 8484

December 29, 1978

TREATMENT OF DEFAULTED STATE OR LOCAL GOVERNMENT OBLIGATIONS

To the Chief Executive Officer of Each State Member Bank
in the Second Federal Reserve District:

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System on its own behalf and on behalf of the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation establishing new procedures dealing with the treatment by bank examiners of defaulted State or local government obligations held by banks:

In light of the default on payment of municipal securities by the city of Cleveland, Ohio, the Federal bank regulatory agencies issued the following statement—

It is not possible to anticipate the extent to which a default on a municipal general obligation may affect the ultimate payment of such an obligation, due to the fact that such obligations are backed by the full faith and credit of an issuing State, city or other political subdivision which has general taxing authority. In view of these uncertainties, the bank regulators recently reviewed the bank examination procedures that apply to defaulted securities and decided to allow for a market stabilization period in order that a more accurate estimate of the value of the securities may be made.

Under the new procedures applying to defaulted municipal general obligation securities, a period of time will be provided 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 market value of the securities.

The Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation have agreed on the following treatment by bank examiners of defaulted State or local general obligations held by banks:

1. After a default has occurred, holdings of the defaulted issue will be listed in examination reports for appropriate treatment.
2. Depreciation in the defaulted municipal general obligation will not be classified as a loss for the purposes of a bank examination while a market is in the process of being re-established for the defaulted security or other steps are being taken that will improve the quality of the security.
3. Adjustments to a bank's capital position will be required when reasonable estimates of value can be determined.
4. The default of a general obligation of a municipal issuer will not be viewed by the supervisory authorities as an overriding factor in the appraisal of other obligations of the same issuer, nor will it preclude the purchase by banks of other obligations of the same issuer.

The above procedures represent interim adjustments by Federal banking agencies in a Uniform Agreement (written in 1938) on the treatment of investment securities held by banks. That agreement, currently being studied for appropriate revision, provides that examiners would classify immediately as a loss the net market depreciation of securities in default.

Any questions regarding this matter may be directed to our Bank Examinations Department (Tel. No. 212-791-6835).

PAUL A. VOLCKER,
President.