Dated at Washington, DC, this 24th day of March, 1992.

Federal Deposit Insurance Corporation.

Hoyle L. Robinson,

Executive Secretary.

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FEDERAL HOUSING FINANCE BOARD

12 CFR Part 934

[Docket No. 92-185.2]

Examinations of the Federal Home Loan Banks

AGENCY: Federal Housing Board.

ACTION: Proposed rule.

SUMMARY: The Federal Housing Finance Board (Finance Board) is issuing a regulation that establishes a system for the classification of assets of the Federal Home Loan Banks (FHLBanks) pursuant to examinations of the FHLBanks. The asset classification system created here will be consistent with that used by the other Federal financial regulatory agencies, namely: the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC) and the Office of the Thrift Supervision (OTS).

This regulation also requires that the FHLBanks establish general or specific reserves for assets classified under this system, allowing the FHLBanks to accurately report in their financial statements any losses caused by such assests.

DATES: Comments must be submitted by May 1, 1992.

ADDRESSES: Comments may be mailed to Elaine L. Baker, Executive Secretary, Federal Housing Finance Board, 1777 F Street, NW., Washington, DC 20006.

FOR FURTHER INFORMATION CONTACT: Gary B. Townsent, Deputy Director For Examinations, District Banks Directorate, (202) 408-2540, Charles Szlenker, Attorney, Office of General Counsel, (202) 408-2554, Federal Housing Finance Board, 1777 F Street, NW., Washington, DC 20006.

SUPPLEMENTARY INFORMATION:

1. General

The Finance Board is an independent financial regulatory agency responsible for the regulation and supervision of the FHLBanks. 12 U.S.C 1422a(a) (Supp. I 1989). It is specifically charged with ensuring the FHLBanks System's safe and sound financial operations and ensuring that each FHLBanks is adequately capitalized. *Id.* at 1422(a)(3)(C) and (D). In large part, it accomplishes this task through periodic regulatory examinations of the FHLBanks performed by its examination staff. *See id.* at 1440.

Pursuant to its statutory responsibility to examine the FHLBanks periodically and to inspect and evaluate their assets, the Finance Board has implied authority to require reporting of FHLBanks assest, as well as the authority to develop the policies and procedures prescribing the treatement of such assets for regulatory purposes.

Such policies and procedures are not strictly governed by general accounting principles or standards, because a regulatory examination of an institution differs significantly from an accounting audit of financial statements. Audit reports are usually publicly available, whereas examination reports are exempt from public disclosure under the Freedom of Information Act. Unlike an audit, the underlying purpose of an examination is to aid the regulator in determining whether it is fulfilling its statutory duty. See e.g. In re: Franklin Nat. Bank Sec. Litig., 445 F. Supp. 723, 730-31 (E.D.N.Y. 1978).

Any important aspect of a regulatory examination is an assessment of asset quality. Any procedures or system for identification of impaired or distressed assets involves judgement and a need for flexiblity on the part of the examiner. There is no mathematical or quantitative formula readily adaptable to asset classification. by its very nature, it involves a qualitative analysis of accounting data, economic factors and policy. While virtually all asserts are subject to some risk of loss, not all such risk requires classification. The decision to classify an asset is a function of its actual degree of exposure to a risk of loss and the risk inherent to that type of asset.

The Finance Board's system for the classification of FHLBank assets being established by this regulation is modeled in part on the revised "Uniform Agreement on the Classification of Assets and Appraisal of Securities held by Banks" issued as joint statement by the OCC, Federal Reserve, FDIC and the Conference of State Bank Supervisor on May 7, 1979. This system also was adopted by the OTS for its supervision of federally chartered thrifts.

Adoption of this asset classification system benefits both the Finance Board and the FHLBank System. This asset classification system has an established, proven record of sucess with the aforementioned financial regulatory agencies, and provides appropriate flexibility to the Finance Board's examination staff. Moreover, these agencies have issued helpful guidelines and interpretive opinions on the classification of assets in accordance with this system that are available for Fianance Board use and adaptation. It also is helpful that the senior staff at the FHLBanks are familiar with this classification system. Prior to 1989, the FHLBanks served a dual rule as a central credit banking system to federally insured thrifts and as regulators of the thrift industry on behalf of the former Federal Home Loan Bank Board.

The classification system contained in this regulation will apply to all FHLBank assets. However, the risk characteristics of assets differ somewhat when the total range of a FHLBank's various assets are considered. In practice, asset classification for the FHLBanks likely will be primarily focused on a FHLBank's advances and its investment assets. A FHLBank's advances and investment portofolio comprise the bulk of its assets, and such assets are also the type of assets most susceptible to impairment.

This regulation comprises only one aspect of the general scheme of regulatory supervision of the FHLBanks to be undertaken by the examination staff. The Finance Board's Deputy Director for Examinations, District Banks Directorate ("Deputy Director"), may issue periodic guidelines and interpretive memoranda on the asset classification system and other regulatory examination procedures. The Deputy Director also will compile an Examination Manual for use by Finance Board examination staff.

This regulation also will require FHLBanks to establish adequate reserves for losses on classified assets. The authority to compel a FHLBank to establish reserve and/or make such charge-offs as required, is contained in Bank Act section 16 (12 U.S.C. 1436 Supp. I 1989)).

As required by section 20 of the Bank Act, the regulation specifies that each FHLBank will be examined at least once a year. *Id.* at 1440). It also requires to Office of Finance, as a joint office of the FHLBank System, to be likewise examined. In addition, it permits other examinations of a FHLBank or the Office of Finance at the direction of the Finance Board. It detailes the duties of the Deputy Director with regard to the examination of the FHLBank System, and confirms the Deputy Direcotor's role as the agency's chief examiner of the FHLBanks.

The Bank Act vests the Finance Board's examiners with the same powers and privileges as examiners of Federal Reserve Banks and national ›ks. (*ID.*). Accordingly, the powers and privileges of examiners contained herein are based on applicable provisions in both the Federal Reserve Act (12 U.S.C. 221 *et seq.*.) and the National Bank Act (12 U.S.C. 21 *et seq.*).

2. Analysis of Classification of Assets Regulation

General

This regulation describes the four classifications that will be used to classify a FHLBank asset when the examiner determines that it (1) is impaired or is potentially weak, and (2) could have an adverse impact on the earnings or equity of a FHLBank. Through analysis and determination, an examiner will classify each such asset into one of the four described classifications in accordance with the system prescribed by the Finance Board.

FHLBank Assets Affected

In the course of a FHLBank examination, the Finance Board's examination staff will review the FHLBank's advances-related assets, vestment-related assets and other sets to determine whether any have ecome impaired. If so, the examiner will determine whether the FHLBank has similarly identified them as impaired. The examiner will further determine whether such impairment adversely impacts earnings and/or equity.

If a Finance Board examiner determines that a FHLBank has failed to identify impaired assets or failed to recognize the effect of an impairment on its financial condition, the examiner will bring this to the attention of the FHLBank, will identify the asset and will note the proper amount of the allowance, reserve or write-down to be established, if any.

Classification Objectives

The system of classification of FHLBank assets, being adopted here, will provide the Finance Board's examination staff an orderly means to achieve three objectives in the course of an examination of a FHLBank:

1. Identification of Adversely Classified Assets

To first evaluate the assets of a FHLBank and then to identify whether any such assets are impaired assets or potentially weak assets, using the classification designations established herein;

2. Determination of Degree of Impact

To first determine the extent of probable loss to a FHLBank on these impaired or weak assets; and then to evalute the adequacy of such FPHLBank's current allowances and reserves for loss, to cover any such probable loss.

3. Evaluation of Financial Impact on FHLBank

To determine the actual or potential impact of impaired assets on the FHLBank's financial condition and operations in order to take necessary corrective steps, usually an increase in current reserves or the establishment of reserves or the taking of a write-off of an impaired asset. Examiners are not bound by issues of materiality in determining the necessity of supplementing a current reserve or establishing a new reserve.

3. Effect of Classification

The classification system contained in this regulation will permit the Finance Board's examination staff to split a particular FHLBank asset among the classifications, and will permit the flexibility to classify a part of an impaired asset while not classifying the entire asset.

The Deputy Director, as the agency's chief examiner, is empowered to determine the particular mode of allowance or reserve that may be needed to protect the operations of a FHLBank against the risk of loss associated with an impaired asset. This may include establishing specific reserves or establishing or enlarging a general "loss reserve."

4. Regulatory Flexibility Act

In accordance with section 605(b) of title 5, United States Code, the Board of Directors hereby certifies that this proposed regulation will not have a significant impact on a substantial number of small entities. The Finance Board reaches this conclusion because this regulation affects only the FHLBank System consisting of 12 FHLBanks. The Small Business Administration defines a small financial institution as a commercial bank or thrift with assets not exceeding $100 million. 13 CFR 121.13(a). The FHLBanks are neither of such institutions and their assets exceed that threshold.

List of Subjects in 12 CFR part 934

Federal home loan banks, Securities, Surety bonds.

SUBCHAPER B—FEDERAL HOME LOAN BANK SYSTEM

Accordingly, the Finance Board hereby amends part 934 of subchapter B of chapter IX, title 12, Code of Federal Regulations, as follows:

PART 934—OPERATIONS OF THE BANKS

1. The authority citation for part 934 is revised to read as follows:

Authority: Sec. 2B, 103 Stat. 414, as amended (12 U.S.C. 1422b); section 16, 103 Stat. 412, as amended (12 U.S.C. 1436); sec. 20, 103 Stat. 415, as amended (12 U.S.C. 1440); sec. 22, 103 Stat. 422, as amended (12 U.S.C. 1442).

2. Part 934 is amended by designating §§ 934.1 through 934.15 as Subpart A—General Operations, and adding a new subpart B consisting of §§ 934.30 through 934.33 to read as follows:

Subpart B—Examination Policies and Procedures

Sec.

Subpart B—Examination Policies and Procedures

§ 934.30 Classification of assets.

(a) *Scope*. The classification system described in paragraph (c) of this section applies to all assets or portions thereof held by a Bank. Assets subject to this classification requirement may fall within one or more classifications, and a portion of any asset that is subject to this classification requirement may remain unclassified.

(b) *Purpose*. The classification system described in paragraph (c) of this section shall be utilized by the examination staff of the Board for the purpose of analyzing the assets of a Bank pursuant to a regulatory examination of such Bank. The Banks shall accept and adhere to the categories of such system.

(c) *Categories of classification*—(1) *Other Assets Especially Mentioned (OAEM) assets*. (i) Assets classified as OAEM are such assets as are determined to be currently protected from loss, but are potentially weak. To be classified in this category, assets must constitute an undue and unwarranted risk to the Bank, but must not have deteriorated to the point justifying classification as a Substandard asset. OAEM assets are deemed to have potential weaknesses which may, if not corrected, weaken the set or inadequately protect the Bank's position at some future date.

(ii) Assets detailed in this classification category may include Bank advances against which:

(A) The quality of the collateral securing the advance is not reasonably determinable;

(B) Physical possession of the collateral has not been taken when conditions warrant such action; or

(C) Collateral margins are potentially inadequate based on trends in interest rates, which may affect the market value of underlying collateral and collateral quality.

(2) *Substandard assets.* Assets classified as Substandard assets are characterized by the distinct possibility that the Bank will sustain some loss if deficiencies are not corrected. Generally, such loss potential should be evident in the aggregate amount of Bank assets classified as Substandard assets, but need not be specifically evident in each individual asset being classified as a Substandard asset.

(i) Assets classified as Substandard assets are such Bank assets as are determined to be inadequately protected by:

(A) Current sound worth, payment capacity, or collateral in cases where the asset is an advance to a member; or

(B) Projected cash flow and earnings if the asset is an investment or other asset of the Bank.

(ii) Assets classified as Substandard assets must have a well-defined weakness, or well-defined weaknesses, that jeopardize:

(A) The liquidation of an advance; or

(B) Cash flow and earnings expectations of an investment or other earning asset.

(iii) Assets classified as Substandard assets may exhibit one or more of the following characteristics:

(A) Collateral which is not subject to adequate inspection and verification;

(B) There is no primary source of repayment and reliance is upon the secondary source;

(C) A loss does not seem likely, but sufficient problems have arisen to require that the Bank take additional and abnormal measures to protect its position in order to maintain a high probability of repayment;

(D) Deterioration in collateral; or

(E) Flaws in documentation, with the effect that the Bank is in a subordinated or unsecured position.

(iv) The presence of one of these factors does not require an asset to be classified substandard if the examiner determines that the presence of such factor does not indicate a well-defined weakness jeopardizing the timely liquidation of the asset, or realization of its book value.

(3) *Doubtful assets.* (i) An asset classified as Doubtful has all the weaknesses inherent in an asset classified as a Substandard asset, with the added characteristic that the weaknesses make collection, liquidation in full, or realization of book value improbable on the basis of currently existing facts, conditions, and values. The probability of loss is high, but because of certain important and reasonably specific pending factors that may work to strengthen the asset, its classification as an estimated loss is deferred until more information is available.

(ii) An examiner may determine a reasonable carrying value for an asset classified as Doubtful and may request that the Bank establish additional specific reserves and/or make charge-offs as are required. Such a determination shall be based on tangible facts recorded in the Bank's files and other documents, and Bank officers shall give assurance to the examiner that such reserve or charge-off will be established or made.

(iii) An entire asset should not be classified as a Doubtful asset when collection of a specific portion appears highly probable. Doubtful classifications are generally transitory, pending receipt of additional information.

(4) *Loss asset.* An asset or a portion of an asset classified as Loss is one in which its book value is considered unrealizable or of such little value that its continuance as a bookable asset is not warranted. Such classification does not mean that the asset has no recovery value.

(d) *Effect of classification.* (1) When, pursuant to this subpart, an examiner has classified one or more assets, or portions thereof, as Substandard or Doubtful assets, and/or has determined that existing valuation allowances are inadequate, the Bank shall establish allowances for losses in an appropriate amount as determined by the examiner, subject to the approval of the Board's Deputy Director for Examinations, District Banks Directorate (Deputy Director).

(2) When, pursuant to this subpart, an examiner has classified one or more assets or portions thereof as a Loss, the Bank shall charge off an amount equal to 100 percent of the asset, or portion thereof, classified as a Loss.

(3) Allowances provided on classified assets should be in amounts consistent with Generally Accepted Accounting Principles. For the purpose of determining a proper allowance, the asset evaluation methods (and corresponding allowances) that are consistent with the practice of the Financial Regulatory Agencies (as defined in § 934.15(a)(3) of this part) may be used.

(e) *Implementation of classification system.* (1) In connection with a regular, special or other examination of a Bank, the Board's examination staff shall have authority to review all assets whatsoever of a Bank and to identify and to classify such asset in accordance with the classification system described in paragraph (c) of this section and to calculate the amount of necessary reserves.

(2) Each Bank shall, on a regular basis, classify its assets in accordance with the classification system described in paragraph (c) of this section and shall make such classification analysis available to the Board's examination staff upon request. Nothwithstanding any other remedy or supervisory measure available to the Board under applicable statutes or regulations, a Bank's failure to adequately measure or monitor the risk to its asset portfolio through self-classification of its assets, may be a factor considered by the Board's examination staff in determining the amount of reserves necessary to be established as a result of the classification of an asset pursuant to an examination.

(f) *Delegations.* (1) The Deputy Director is authorized to approve, disapprove or modify any classification of assets made pursuant to paragraph (c) of this section and to approve, disapprove or modify any amounts or types of allowances or reserves or write-offs required by the classification of assets pursuant to paragraph (d) of this section.

(2) In the event the Board or Bank requires an appraisal in connection with the re-evaluation or re-classification of a Bank asset, such appraisal must meet recognized industry and appraisal standards.

§ 934.31 Manual and interpretations.

The Deputy Director shall:

(a) Compile a Federal Home Loan Bank System Examination Manual that will:

(1) Be a compilation of the agency's formalized policies and procedures to be followed by the examination staff in all regulatory examinations of the Bank System; and

(2) Provide guidance and aid to the Board's examination staff in the conduct of on-site inspections of Bank operations and assets.

(b) Issue, from time to time, interpretative letters, memoranda, guidance or other informative material regarding the Board's examination of Banks.

§ 934.32 Examination schedule.

(a) *Regular.* The Deputy Director shall schedule and conduct an examination of each Bank at least annually.

(b) *Follow-up.* The Deputy Director may conduct additional unscheduled examinations of a Bank, when, in the judgment of the Deputy Director, it is necessary as a follow-up to a regular annual examination.

(c) *Special.* The Deputy Director shall conduct a special, unscheduled examination of any Bank when directed to do so by resolution or order of the Board.

(d) *Office of Finance.* Examinations of the Office of Finance shall be scheduled and conducted by the Deputy Director in the same manner as examinations of the Banks.

§ 934.33 Powers of examiners.

In conjunction with the examination of a Bank pursuant to section 20 of the Act (12 U.S.C. 1440), the Deputy Director, and each Board examiner, is empowered to:

(a) Access all records, data, information, and assets of each Bank wherever situated as are, in the judgment of the Deputy Director, reasonably necessary to effect a thorough examination of the Bank;

(b) Administer oaths;

(c) Examine and interrogate the directors, officers, employees and agents of any Bank under oath on any subject or matter reasonable calculated to disclose information necessary to effect thorough examination of the Bank.

By the Federal Housing Finance Board.

Dated March 24, 1992.

Daniel F. Evans, Jr.,

Chairman.

[FR Doc. 92–7412 Filed 3–31–92; 8:45 am]

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FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

12 CFR Part 1102

[Docket No. AS92–3]

Appraisal Subcommittee; Appraisal Regulation; Privacy Act Implementation

AGENCY: Appraisal Subcommittee, Federal Financial Institutions Examination Council.

ACTION: Proposed rulemaking.

SUMMARY: The Appraisal Subcommittee ("ASC") of the Federal Financial Institutions Examination Council ("FFIEC") today announced the proposal of 12 CFR part 1102, subpart C ("subpart" or "subpart C"), which sets out the ASC's procedures pertaining to the privacy of individuals and systems of records maintained by the ASC.

DATES: Comments must be received on or before June 1, 1992.

ADDRESSES: Persons wishing to submit written comments should file them with Edwin W. Baker, Executive Director, Appraisal Subcommittee, 2100 Pennsylvania Avenue, NW., Suite 200, Washington, DC 20037. All comment letters should refer to Docket No. AS92–3. All comments received will be available for public inspection and copying at the above location.

FOR FURTHER INFORMATION CONTACT: Edwin W. Baker, Executive Director, or Marc L. Weinberg, General Counsel, at (202) 634–6520, Appraisal Subcommittee, 2100 Pennsylvania Avenue, NW., Suite 200, Washington, DC 20037.

SUPPLEMENTARY INFORMATION:

I. Introduction and Background

On August 9, 1989, Congress adopted Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 [1] ("FIRREA"), including section 1102 [2] of Title XI, which established the ASC and placed it within the FFIEC. The ASC consists of representatives appointed by the Heads of the Federal Financial Institutions Regulatory Agencies ("Regulatory Agencies") [3] and the Department of Housing and Urban Development. Congress intended Title XI of FIRREA and the ASC, the Regulatory Agencies and the Resolution Trust Corporation ("RTC") to protect federal financial and public policy interests [4] in real estate-related financial transactions [5] requiring the services of an appraiser.[6]

The ASC has several statutory duties under Title XI. First, it must monitor the appraisal regulations adopted by the Regulatory Agencies and the RTC (collectively, "Agencies"). Those regulations set out appraisal standards for federally related transactions [7] and defined those federally related transactions requiring the services of a State certified or State licensed appraiser. Second, the ASC must monitor and review the practices, procedures, activities, and organizational structure of the Appraisal Foundation. Third, the ASC must monitor the certification and licensing programs for real estate appraisers in each State, territory, commonwealth, and the District of Columbia ("States") [8] and must review the State's compliance with the requirements of Title XI. It also is authorized by Title XI to take action against non-complying States.[9]

Under sections 1103(a)(3) and 1109(a) of Title XI,[10] each State with an appraiser certifying and licensing agency is responsible for transmitting to the ASC a roster of State certified and licensed appraisers who are eligible to perform appraisals in federally related transactions, along with an annual registry fee, and the ASC must maintain a national registry of these appraisers. The ASC currently is in the process of implementing this registry. The information in the registry clearly is protected by the Privacy Act because some data elements pertain to individuals, and it can be accessed by individual identifiers.[11]

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[1] Pub. L. 101–73, 103 Stat. 511 (1989), as amended by Pub. L. 102–233, 105 Stat. 1761 (1991) and Pub. L. 102–242, 105 Stat. 2236 (1991).

[2] 12 U.S.C. 3310 (1990).

[3] The Regulatory Agencies are the Board of Governors of the Federal Reserve System ("FRS"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), the Office of Thrift Supervision ("OTS"), and the National Credit Union Administration ("NCUA"). See section 1122(6) of Title XI, 12 U.S.C. 3350(6) (1990).

[4] Title XI's general purpose is "to provide that Federal financial and public policy interests * * * will be protected by requiring that (certain) real estate appraisals are performed in writing, in accordance with uniform standards, by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision." Section 1101 of Title XI, 12 U.S.C. 3331 (1990).

[5] *See* section 1121(5) of Title XI, U.S.C. 3350(5) (1990), for the definition of "real estate-related financial transaction."

[6] The Regulatory Agencies and the RTC have adopted appraisal regulations that, among other things, clarify the phrase "requires the services of an appraiser." *See* 12 CFR part 34 (OCC); part 225, subpart G (FRS); part 323 (FDIC); part 564 (OTS); part 722 (NCUA); and part 1608 (1991) (RTC).

[7] See section 1121(4) of Title XI, 12 U.S.C. 3350(4)(1190), which defines a "federally related transaction."

[8] The ASC is required to "monitor State appraiser certifying and licensing agencies for the purpose of determining whether the * * * agency's policies, practices, and procedures are consistent with (Title XI)." Section 1118(a) of Title XI, 12 U.S.C. 3347(a) (1990). *See, also,* section 1103(a)(1) of Title XI, 12 U.S.C. 3332(a)(1)(1990).

[9] *See* section 1118 of Title XI, 12 U.S.C. 3347 (1990).

[10] 12 U.S.C. 3332(a)(1) and 3338(a) (1990), respectively.

[11] The ASC expects to publish soon in the Federal Register a notice establishing the registry as a "system of records" under the Privacy Act of 1974.