SUPPLEMENTARY INFORMATION AND ISSUES

Allowance for Loan and Lease Losses (ALLL)

A valuation allowance is a contra-asset account, established and maintained through charges against current earnings to absorb losses in a thrift's portfolio. Valuation allowances established to absorb the losses inherent in a thrift's overall loan and lease portfolio are the Allowance for Loan and Lease Losses, or ALLL. A thrift's ALLL is part of Tier 2 (supplementary) capital, up to 1.25 percent of risk-weighted assets. Thrift's may not use the ALLL to cover losses that are not credit-related or losses on other types of assets (that is, assets other than loans or leases). Valuation allowances established to absorb losses identified for specific assets are Specific Valuation Allowances, or SVAs. For capital purposes, the ALLL does not include SVAs. SVAs require a separate deduction from capital.

ALLL only covers *incurred credit-related losses* in the asset portfolio. Thrifts with higher risk activities should maintain higher capital levels to protect against unanticipated losses.

Impact of Subordinate Organizations on Capital Requirements[1]

OTS capital regulations classify a subordinate organization as either a *subsidiary* or an *investment*. Generally, subsidiaries are entities in which the parent thrift has a majority ownership interest. The regulations also distinguish whether or not a subsidiary is an *includable subsidiary*. An includable subsidiary engages only in activities that are permissible for a national bank.[2] Note that a thrift's operating subsidiary is typically an includable subsidiary. The capital treatment for a subordinate organization depends on its status as follows:

Capital Treatment for Subordinate Organizations Having Another Regulator

This section applies to most functionally regulated subsidiaries[3] as well as most subsidiary depository institutions that have a primary regulator other than OTS. In analyzing the capital of a thrift that owns these subordinate organizations, OTS deducts capital needed to meet the requirements of the primary regulator[4]. Then, OTS makes a determination as to whether the excess capital in the subsidiary (that is, capital in excess of the stated formal requirements of the subsidiary's primary regulator) is available to the entities above it in the organizational hierarchy. In these situations, OTS will review the examination reports of the subsidiary's primary regulator (and engage in discussions with the

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[1] Refer to the definitions of includable subsidiary and equity investment in 12 CFR §567.1, the requirement for deduction of nonincludable subsidiaries in §567.5(a), the preapproved activities for service corporations in §559.4, and the list of activities permissible for a national bank available on the website of the Office of Comptroller of the Currency at: www.occ.treas.gov.

[2] This refers to the activities of a national bank itself, not to the activities permissible for a national bank's subsidiary.

[3] Functionally regulated subsidiaries include: registered broker-dealers, registered investment advisors, registered investment companies, insurance companies, or entities subject to regulation by the Commodity Futures Trading Commission.

[4] A small number of thrifts have established subsidiaries to reinsure first mortgage residential loans originated by the thrift and insured with private mortgage insurance (PMI). These subsidiaries are consolidated onto the thrift's balance sheet for regulatory capital; however, the PMI reinsurance risk assumed by the subsidiary will count as part of the parent thrift's exposure on the loan for risk-based capital purposes; and where the thrift sells a loan with PMI retained, the loan is then treated as sold with recourse for risk-based capital purposes. A thrift can avoid these additional requirements on PMI reinsurance by deconsolidating and deducting its investment in the PMI subsidiary, after review and concurrence by the OTS.

subsidiary's primary regulator) in order to determine whether the subsidiary's excess capital is transferable and available to support the parent. Depending upon the outcome of this analysis, OTS decides whether to permit inclusion of the subsidiary's excess capital.

Capital Treatment for Subsidiaries

Includable Subsidiaries

For GAAP and TFR reporting purposes, the thrift ordinarily consolidates the assets of its includable subsidiary into the parent. For Tier 1 capital, the subsidiary's assets comprise part of the parent's adjusted total assets on schedule CCR. For risk-based capital, the thrift risk weights the subsidiary's assets on schedule CCR along with its own.

Nonincludable Subsidiaries

When a GAAP-consolidated subsidiary is not includable for regulatory capital purposes, the thrift must deconsolidate the subsidiary's assets and liabilities, and deduct for Tier 1 capital its investment in that subsidiary.[5] The thrift makes the deduction on Schedule CCR according to the instructions and this does not affect Schedule SC or reporting under GAAP. This deconsolidation and deduction approach means that the subsidiary will be ignored for capital purposes: its assets not included with those of the thrift, and its capital not included in the thrift's capital base. The capital deduction will include the following:

- The parent's equity investment in the subsidiary.
- The parent's loans and other advances to the subsidiary.
- Where applicable, an amount representing any guarantees by the parent of the subsidiary's debt made on behalf of a third party.

Capital Treatment for Equity Investments

When a thrift does not have majority ownership of a subordinate organization, it generally does not consolidate the assets of the subordinate organization with the parent. Instead, the thrift uses the equity method to account for its investment in that subordinate organization. In the equity method, the thrift's investment in the subordinate organization is a thrift asset for GAAP and for Schedule SC. The capital treatment, however, will generally depend upon whether or not the subordinate organization engages solely in activities permissible for a national bank.

Includable Activities Only

The thrift's investment in the subordinate organization is a component of adjusted total assets for regulatory capital purposes. When computing the risk-based capital requirement on Schedule CCR, the thrift risk weights its investment in the subordinate organization at 100 percent. The thrift does not risk

[5] There is an exception to this automatic deduction treatment. Section 12 USC 1464(t)(5) exempts from automatic deduction those subsidiary depository institutions acquired before May 1, 1989, even though they may be engaged in activities not permissible for a national bank.

weight the subordinate organization's assets, only the parent's investment in the subordinate organization.

Nonincludable Activities

If the subordinate organization engages in activities that are nonincludable, the thrift should deduct its investment in the nonincludable activity for Tier 1 capital. The capital deduction will include the following:

- The parent's equity investment in the subsidiary.
- The parent's loans and other advances to the subsidiary.
- Where applicable, an amount representing any guarantees by the parent of the subsidiary's debt made on behalf of a third party.

The use of intermediate organizations, or the legal form of organization, will not affect the deduction.

Reservation of Authority

In some instances, OTS uses its reservation of authority to require (or permit) deduction, or deconsolidation *and* deduction, of a subordinate organization that would not otherwise be so treated. Where OTS uses its reservation of authority, a simple deduction from Tier 1 capital would apply to a subordinate organization reported under the equity method of accounting per GAAP; whereas, deconsolidation *and* deduction would apply to subsidiaries consolidated under GAAP.

You may consider whether to recommend to your regional office deduction of *investment in or loans to* a subordinate organization using the reservation of authority. In some instances, a thrift requests a deduction approach. OTS reviews the request and then decides whether to approve it.

Construction Loans

Construction loans receive a 100 percent risk weight unless they meet the definition of qualifying residential construction loans (below), or the definition of qualifying mortgage loans (that is, loans to individual borrowers for the construction of their own homes that meet the definition in §567.1).

Qualifying Residential Construction Loans

Qualifying residential construction loans, also referred to as residential bridge loans, have similar credit risk to single-family residential mortgage loans. Residential construction loans must meet specific criteria in order to qualify for a 50 percent risk weight. You may review the definition of qualifying residential construction loans in §567.1.

Loans-in-Process

Many thrifts initially record a construction loan as a debit entry to loans receivable equal to the gross amount of the loan. They in turn make a credit entry to a contra-asset account called, "loans in process of disbursement" (LIP). A thrift then reduces the LIP balance with each disbursement of funds.

Therefore, the LIP represents the undisbursed portion of the loan and is off-balance- sheet. For capital purposes, the thrift needs to convert the LIP to an on-balance-sheet credit equivalent amount as described below. If a thrift does not set up a loans-in-process account, the thrift should still treat the unfunded (undisbursed) loan commitment in the same manner as an off-balance-sheet item for capital purposes. LIP or other unfunded construction loan balances will either:

- Convert at 0 percent (that is, there is no capital requirement).
- Convert at 50 percent to an on-balance-sheet credit equivalent (that is, a risk-weighted asset).

If the original maturity of the construction loan is one year or less, LIP (or the unfunded construction commitment) should generally convert at 0 percent. When the original maturity of the loan exceeds one year, the LIP (or unfunded commitment) should generally convert at 50 percent, in which case the thrift then risk weights the credit equivalent amount based on the type of loan: for example, 50 percent for qualifying residential construction loans or qualifying mortgage loans, 100 percent for most other types of loans.

Notes:

- Thrifts should not split LIP (or the unfunded commitment) on a single loan into a component that matures within one year and a component that matures after one year.
- Thrifts may apply a 0 percent conversion factor to a loan with more than a one-year term if they actively evaluate the credit relationship and structure the terms of the loan to comply with §567.6(a)(2)(iv). Specifically the thrift must have a contractual right to separately underwrite each disbursement and the thrift does so, or the thrift has a contractual right to reevaluate the lending relationship at least annually and the thrift does so.

(See also Appendix A, the subsection titled Credit Conversion Factors for Off-Balance-Sheet Items.)

Nonwithdrawable (Pledged) Deposit Accounts of Mutual Institutions

Directors or officers of mutual savings associations, or other interested individuals or organizations, may pledge personal deposits held by the institution. These deposits can count as Tier 1 capital. The individuals must formally subordinate the deposits to the institution's creditors, including the FDIC. The deposits must satisfy the same criteria as noncumulative perpetual preferred stock. The pledge must affirm that the deposits have no maturity, allow no option for withdrawal of the funds, and allow the suspension of interest payment obligations. Sections 561.31, 567.5(a)(1)(iv), and 567.9(b)(3) describe how mutual institutions may use these accounts for regulatory capital purposes. Note that this form of regulatory capital is relatively uncommon.

Preferred Stock

General limitation on preferred stock: OTS has a general policy that the majority of a thrift's equity should be common voting shares. Preferred stock should not comprise the majority of a thrift's capital base.

REIT Preferred Stock

General limitation on REIT preferred stock: OTS generally limits REIT preferred stock to 25 percent of Tier 1 capital.

REIT (real estate investment trust) preferred stock is a hybrid instrument that combines traits of both debt and equity and offers special tax treatment. REIT preferred stock pays dividends like an equity investment, but is backed by collateral similar to certain debt instruments. Under certain conditions, REIT preferred stock may receive favorable capital treatment.

In a typical REIT preferred stock transaction, a thrift or holding company establishes a separate legal entity that owns 100 percent of the entity's common stock. In most cases, the value of the common stock is nominal. After establishing the new separate legal entity, the thrift sells real-estate-related assets, usually mortgages or mortgage-back securities, to this separate entity. The new entity pays for the real estate-related assets with cash proceeds from a simultaneous preferred stock issuance to independent third parties.

If the issuing entity is a subsidiary of the thrift, the subsidiary is fully consolidated with the thrift for TFR purposes. In the consolidated statements, the thrift reports the REIT preferred stock as minority interest in includable consolidated subsidiaries, a component of Tier 1 (core) capital.

The issuing entity can also be a subsidiary of a thrift's holding company. In these situations, some or all of the cash proceeds received by the holding company is down-streamed to the thrift. This generally represents an additional investment in the thrift and counts as Tier 1 capital.

The asset-backed nature of REIT preferred stock raises supervisory concerns, especially when the thrift issues the stock through a subsidiary of the thrift. If the thrift faces operating difficulties, *all* assets of the consolidated entity should be available for the thrift's use. Therefore, *OTS requires thrift subsidiaries to include certain restrictive covenants in REIT preferred stock offerings*. OTS requires that the stock be permanent (or perpetual) and noncumulative as to dividends. Additionally, OTS requires that the terms of the REIT preferred stock allow OTS to do both of the following:

- Restrict the payment of dividends on the REIT preferred stock.
- Require the conversion of the REIT preferred stock to common stock.

These restrictive covenants must be present for a thrift to include REIT preferred stock as Tier 1 capital.

Trust Preferred Securities

Trust preferred securities (TPS) are nonperpetual cumulative preferred stock issued by a wholly owned trust subsidiary of a corporation (typically insurance companies and bank or savings and loan holding companies). Cash raised through a trust preferred issuance by a thrift holding company can be down-streamed to the thrift institution. And then, at the thrift institution level, the cash received from the holding company can count as Tier 1 capital.

For more information and guidance on TPS refer to Thrift Bulletin 73a, Investing in Complex Securities.

Tier 2 Capital Instruments

Section 567.5(b) describes the components of Tier 2 capital, including *permanent capital instruments* and *maturing capital instruments*. These groups include certain types of debt instruments that are like capital in their capacity to absorb losses.

Permanent Capital Instruments

A thrift can generally include permanent capital instruments in its Tier 2 capital. Permanent capital instruments may include: cumulative and other perpetual preferred stock,[6] mutual capital certificates, perpetual subordinated debt, and mandatory convertible subordinated debt (capital notes). Refer to the regulation for qualifications and other instruments in this group.

Maturing Capital Instruments

Maturing capital instruments include:

- Subordinated debt (excluding perpetual subordinated debt – see above).
- Intermediate-term preferred stock and any related surplus (additional paid-in capital).
- Mandatory convertible subordinated debt (commitment notes).

Refer to the regulation for additional details. The degree to which a thrift can include these instruments in Tier 2 capital decreases according to the formulas and criteria described in §567.5(b)(3).

Thrifts that issue maturing capital instruments must choose between two options for regulatory capital treatment. Once a thrift selects an option, it must use that same option for all issuances outstanding at that time and for any subsequent issuances for as long as there is a balance outstanding. Once the thrift repays all outstanding issuances, it may elect a different option for future issuances.

Limits on Pass-Through Insurance Coverage

Normally, FDIC deposit insurance coverage ($100,000 per account) passes through financial intermediaries such as employee benefit plans to each beneficial owner (for example, to each employee participant in a plan). However if a thrift falls below PCA well capitalized status, the FDIC aggregates for deposit insurance purposes, any deposit that the thrift accepts (new, rolled-over, or renewed) through an employee benefit plan. The FDIC aggregates the deposits at the plan-administrator or

[6] A thrift may not include in capital preferred stock that is, in effect, collateralized by assets of the thrift or one of its subsidiaries, or issued by a nonincludable subsidiary.

fund-manager level, and then the deposits do not qualify individually for pass-through insurance.[7] The limitation affects the following types of employee benefit accounts and plans:

- 401(k) retirement accounts
- Deferred compensation plans
- Keough plan accounts
- Corporate pension plans
- Profit-sharing plan accounts

Simplified Employee Pension plan accounts (SEPs) are not subject to the limitation.

If a thrift falls below well capitalized status, it must notify affected account holders. Management should have procedures in place to monitor capital and notify affected parties. Additional information is in Regulatory Bulletin 33a, available on the OTS website. The relevant regulation section is §330.14, especially §330.14(h).

Net Deferred Tax Assets

OTS places limits on the inclusion of deferred tax assets in a thrift's Tier 1 capital. You may find OTS policy in Thrift Bulletin No. 56. To the extent that the realization of deferred tax assets depends on a thrift's future taxable income (exclusive of reversing temporary differences and carry-forwards), or its tax-planning strategies, deferred tax assets may not exceed the lesser of:

- The amount that the thrift can realize within one year of the quarter-end report date.
- Ten percent of Tier 1 (core) capital.

[7] This general rule applies unless: the institution is at least adequately capitalized, and has either obtained a brokered deposit waiver from the FDIC or provides specific notice to the plan depositor each time a deposit is accepted. Refer to RB 33a for more detail.