TB 38-4 was rescinded 1/13/95. Incorporated into TFR Instructions (Schedule CCR).

April 13, 1992

RESCINDED

Computation of Capital Deduction Requirement for Assets with General Valuation Allowances

Summary: The OTS, in computing regulatory capital, will offset general valuation allowances against the deduction requirement applicable to investments in and loans to certain subsidiaries and equity investments.

For Further Information Contact: Your Regional Office or Supervision Policy, OTS, Washington, D.C.

Thrift Bulletin 38-4

Background

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and the OTS's capital regulation require savings associations to deduct from tangible and core capital investments in and loans to subsidiaries that engage in activities impermissible for national banks. FIRREA, however, also permits associations to deduct the amount of such investments and loans on associations' books as of April 12, 1989, according to a five year phase-in schedule; the amount in excess of the April 12, 1989 amount is immediately deducted. The phase-in schedule is as follows:

— 0% deducted — 8/9/89
— 10% deducted — 7/1/90
— 25% deducted — 7/1/91
— 40% deducted — 7/1/92
— 60% deducted — 7/1/93
— 100% deducted — 7/1/94

In addition, associations must similarly deduct their equity investments in computing their risk-based capital. All equity investments are subject to the phase-in schedule.

Savings associations must also establish valuation allowances on these assets, as required by OTS policy and generally accepted accounting principles, to address exposure to loss inherent in the assets.

General Policy

It is important that institutions maintain valuation allowances at a level commensurate with the risks associated with their equity investments and investments in subsidiaries. In addition, institutions are required to hold regulatory capital against these investments. Finally, institutions must also set capital aside to comply with the capital deduction requirement.

From a safety and soundness perspective, general valuation allowances, regulatory capital, and the capital deduction requirement all serve the same purpose of protecting the institution and insurance fund from future losses. In recognition of this overlap, general valuation allowances should be included in the determination of compliance with the capital regulation. Charge offs and specific valuation allowances, however, may not be included, as they reflect amounts classified as "loss."

For example, if an association has a $100 asset (net of charge offs and specific valuation allowances, but not net of general valuation allowances) subject to the "deduction from regulatory capital" requirement, and a $10 general valuation allowance has been established against that asset, the association will be required to deduct from regulatory capital an additional $15 to fulfill the deduction requirement (currently 25%). If, in the above example, the association established a $10 specific valuation allowance against the $100 asset (rather than a $10 general valuation allowance), for regulatory capital purposes, the asset is viewed as a $90 asset, and the association would currently be required to deduct $22.50 — 25% of $90 — from capital.

Generally, the sum of the capital deduction and the general valuation allowance for an asset should not exceed 100% of the outstanding investments in and loans to the subsidiary, unless the association has

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guaranteed obligations of the subsidiary or is otherwise committed to providing financial support.

In computing their capital requirement, savings associations must also risk weight the asset value, net of charge offs, specific valuation allowances, and FIRREA capital deductions, but before reduction for general valuation allowances. Using the first example above, the association would be required to risk weight $[illegible] ($1[illegible] minus $15).

Detailed Thrift Financial Report (TFR) instructions for the computation of regulatory capital under this policy will be distributed shortly.

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