

Department of the Treasury

Regulatory Bulletin

RB 32-13



Handbook: **Thrift Activities**
Subject: **Various Sections**

Thrift Activities Regulatory Handbook Update

Summary: This bulletin provides updates for the following Thrift Activities Regulatory Handbook sections: 045, Regulatory Action Data System; 219, Leasing Activities; and 230, Equity Investments. Please replace the existing handbook sections with the enclosed revised sections. We provide a summary of changes for each section below.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: www.ots.treas.gov. If you wish to purchase a handbook and a subscription to the updates, please contact the OTS Order Department at (301) 645-6264.

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SUMMARY OF CHANGES

OTS is issuing updates to the following Thrift Activities Handbook Sections. We provide a summary of all substantive changes to the Handbook Sections in the listing below. These handbook sections are in plain language to comply with the President's June 1, 1998, memorandum "Plain Language in Government Writing."

045 Regulatory Action Data System (RAD)

This section reflects changes to the RAD system. It specifically addresses problem areas involving improper coding of actions, lack of coordination between supervision and enforcement, and lack of timely updates of data.

Introduction: Deletes outdated reference to Supervisory Action Control System (SACS).

Accuracy and Timeliness: Renames section formerly titled Overview to change emphasis. Deletes reference to reports discontinued with implementation of the Thrift Information Management (TIM) system. Inserts reference to the RAD data used to prepare congressionally mandated reports on enforcement activity. Emphasizes the need for timely data entry to facilitate accurate monthly reporting. Adds procedures to review RAD reports and to update records during examinations and monitoring. Addresses the types of action closings.

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NATS Interface: Removes as inappropriate detail.

Closing Codes: New section.

Enforcement Action Codes: Updates list. Adds three action types: F03D Notice of Prohibition, S04 Mortgage Derivative Product/Swap Restriction, and S06 Growth Restriction. Directs staff to include Safety and Soundness Determination, Notification, and Requests with S02 Supervisory Directives.

Reason Codes: Deletes lengthy descriptions of reasons and incorporates cross reference to the RAD user guide. Updates list of reason codes.

Actions Against Others (Not Thrifts): Renames section formerly titled Actions Against Individuals to correct a common misunderstanding. Includes discussion of need for regional staff to monitor open actions coded by inactive thrift docket numbers.

Actions Involving Holding Companies: Incorporates new procedures requiring actions against holding companies to be coded under holding company docket numbers.

Amended or Initial Actions: Renames section formerly titled Active/Inactive Actions and provides the reason for the change.

Civil Money Penalties and Restitutions: New paragraph clarifies that regional staff must report payments to the OTS Controller's staff for posting to RAD. Directs regional staff to close zero balance actions or explain why they are open.

219 Leasing

We reorganized this section to improve the presentation of information.

Introduction: Includes a definition of general leasing.

Finance Leasing: Reorganizes the discussion on the requirements of a finance lease.

Underwriting and Portfolio Maintenance Considerations: New section.

Servicers: New section.

Documentation: New section.

Lending Limitations: New section.

Leveraged Leases: Clarifies the definition of leveraged lease. Provides an example of a leveraged lease.

Consumer Leasing: New section relating to new disclosure laws for consumer leases.

Strategies to Mitigate Risks Associated with Leasing: New section.

Accounting Considerations: Includes definitions of capital lease, sales type of lease, and direct financing lease. Also includes a brief discussion of sale/leaseback transactions.

References: Revises the 12 CFR references.

Program: Adds a new bullet to No. 11 to determine whether the leasing operation rejected any leases.

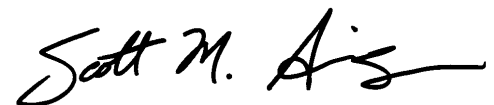
General Questionnaire: Adds new questions 3, 4, 5, 7, 8, 9, 13, 16, 17, 18, 19, and 22 through 28.

230 Equity Investments

Reorganizes the Section by type of equity investment and adds detail on supervisory considerations and regulatory requirements. Revises text to reflect provisions in the OTS Subsidiary and Equity Investment Rule, effective January 1, 1997, and other regulatory changes. Supplements guidance on real estate equity investments with information contained in former Handbook Section 253, Real Estate Held for Investment.

Adds discussion of thrifts' pass-through investment authority codified at 12 CFR § 560.32, permissible community development-related real estate investments authorized in § 5(c)(3)(A) of the HOLA and de minimis investment authority codified at 12 CFR § 560.36. Updates discussion of capital and OTS reporting standards and replaces detail with cross-references to appropriate Handbook Sections and OTS issuances.

Incorporates references to revised accounting procedures for thrifts' securities that are subject to standards in SFAS No. 115. Removes references to obsolete grandfathering/divestiture regulatory provisions. Deletes Appendix A, Service Corporation Investment Limitation. See Handbook Section 730, Subordinate Organizations, for this information.



—Scott M. Albinson
Managing Director, Supervision

INTRODUCTION

This Handbook Section provides guidance to you as the examiner or other supervision staff assigned to work with enforcement actions or the Regulatory Action Data (RAD) system. RAD is the automated record of OTS enforcement activities initiated against institutions and individuals or other entities. It is the source of various internal and external reports on enforcement actions. You must record certain enforcement related information in the RAD system to allow the following actions to occur:

- Regional staff to actively and effectively manage caseloads and fulfill management reporting requirements.
- Washington staff to monitor selected cases and effectively perform oversight functions.
- The Enforcement division of the Office of Chief Counsel to prepare accurate enforcement activity reports, including monthly reports to the public.
- The Press Relations division of the Office of External Affairs to prepare accurate enforcement activity press releases.
- Applications staff to identify actions against individuals or companies with applications currently under review.
- Other OTS staff members to prepare or review reports on enforcement actions as needed.

The RAD System User Guidelines provides detailed instructions for use of the RAD system. Regulatory action data collected in the system includes significant informal enforcement actions and all formal enforcement actions.

Accuracy and Timeliness

Accurate and timely entry of enforcement action data in the RAD System is critical to the integrity of congressionally mandated monthly reporting of

enforcement activity and to OTS monitoring and administration of such activity. Supervision and Enforcement staff must cooperate in reviewing monthly activity reports to ascertain that RAD data is up to date at each month end. The Thrift Information Monitoring System (TIM) provides a variety of reporting options to monitor and test RAD data.

Opening an Action

When OTS takes an enforcement action, you must enter the action into the RAD system and include the following information:

- Thrift or holding company docket number.
- An action code.
- Reason codes.
- *Initiated* date.
- Enforcement order number.
- Docket number of related entity, such as an affiliated thrift or holding company, if applicable.
- Designate whether the action is against a thrift or other entity.
- Comments identifying the target individual or entity and a description of the action.
- Enter the *effective* date of the action once the action takes effect.

Monitoring an Action

Examination and monitoring are a vital source of RAD data. During full scope examinations, you should review an Action History report (TIM EE AH) of all open actions for the docket. During the examination, you must check for compliance. You should note in RAD whether the target of the

action is in compliance with the terms of the action, the date of your review, and any explanatory comments.

Closing an Action

As the activity associated with the action concludes, enter the close code, the close date, and concluding comments. You must enter all dates and supporting information within five working days of the actual event, and the information should be up to date by month end to facilitate accurate reporting. Some actions against individuals such as Part 513, Removal and/or Prohibition, Cease and Desist Order, Enforcement of Orders in U.S. District Court, or Injunctive Action, generally are not successfully closed before the death of the target of the action.

Close Codes

You may close actions with any of the following five close codes in the RAD system:

- AS – successful – when we find the deficiency or problem that it addresses resolved.
- AC – canceled – when we decide not to pursue it.
- AT – transferred – when a change in charter transfers responsibility for the action out of OTS jurisdiction.
- AM – merged – when the thrift disappears due to a merger.
- AD – opened-in-error.

Enforcement Action Codes

An enforcement action is OTS’s response to violations of law, regulation, agreement, OTS-imposed conditions, or unsafe and unsound practices. The RAD System User Guidelines and Thrift Activities Regulatory Handbook Section 370, Enforcement Actions, provide more information on enforcement actions. Here is a list of codes for all enforcement action types within the RAD system.

- F01 Formal Investigation
- F02 Capital Directive

- F03A Suspension of Individuals Charged with Felonies
- F03B Immediate Suspension
- F03C Part 513 Action (suspension of practice before the OTS)
- F03D Notice of Prohibition
- F04 Temporary Cease and Desist Order
- F05 Removal and/or Prohibition Order
- F06 Cease and Desist Order
- F07 Civil Money Penalty
- F08 Enforcement of Orders in U.S. Court
- F09 Injunctive Action
- F10 Restitution
- F11 PCA Directive
- S02 Supervisory Directive (includes §570.2 Determination, Notification, Request)
- S03 Director's Resolution
- S04 Mortgage Derivative Products and Mortgage Swaps Restrictions
- S06 Growth Restriction
- S07 Capital Plan
- S08 Capital Plan Termination Notice or Modification Request
- S10 Exempt Capital Directive
- S11 Individual Minimum Capital Requirement Directive
- S12A Commitment Letter
- S12B Memorandum of Understanding
- S15 Capital Maintenance Agreement
- S17 Supervisory Agreement
- S19 Request For Voluntary Management Changes
- S20 Marketing Agreement
- S21 Consent Merger Agreement
- S23 Formal Enforcement Action Waiver
- S99 Other Supervisory Action

Reason Codes

You must assign reason codes to identify the types of problems or deficiencies that the action addresses. Reason codes relate actions to examination types. RAD accepts multiple reasons for one action. The TIM system has a reporting option of listing actions limited to one select reason code,

such as actions with a holding company reason code.

Reason Codes:

- Asset Quality
- Capital Adequacy
- Compliance
- Criminal Action Response Under 12 USC § 1829
- Discretionary
- Dismissal
- Earnings
- EDP (Information Systems)
- Historical
- Holding Company
- Increase Capital Above Minimum Capital Requirement (IMCR)
- Liquidity
- Management
- Other
- Presumed
- Sensitivity to Market Risk
- Trust
- Y2K

You can find a more detailed description of these codes in the RAD User Guidelines.

Actions Against Others (Not Thrifts)

OTS may initiate enforcement actions against an institution or an individual or other entity, such as a holding company or affiliate. You must code all actions against any entity that is not a thrift as against an other party and identify the party in the comments. This includes actions against persons, affiliates, holding companies, and subsidiaries. Always code actions against a thrift board of directors as actions against the thrift. Always code actions against individual directors as against others and enter a separate action for each individual. RAD automatically labels all Part 513, Removal or Prohibition, Suspension of Individuals Charged with Felonies, Immediate Suspensions, and Re-

quests for Voluntary Management Change as actions against others.

For all actions against other parties, you must name the individual or entity in the comments. This allows you to use a word search to locate all actions against the specific individual or entity.

Actions against other entities can remain in effect for years after a thrift has disappeared (for example: investigations, restitutions, and civil money penalties). These actions remain the responsibility of supervision and enforcement staff as long as they are open. You may list inactive docket numbers in a TIM docket file for easy retrieval of RAD data on open actions filed under inactive docket numbers.

Actions Involving Holding Companies

Always code actions involving holding companies under the holding company's docket number, with the holding company reason code, and as against an other entity. Before 1998, RAD listed actions involving holding companies under a subsidiary thrift's docket number. Because holding companies change names and their relationships with thrifts, holding company actions coded under a thrift docket number (before 1998) identified the holding company by name and docket number in the comments. Therefore, you can locate all actions against a holding company by searching for the holding company docket number in a report of actions with the holding company reason code.

Amended or Initial Actions

RAD automatically designates new actions as "Initial." When you modify an action, you must manually designate the action as "Amended" to provide for correct monthly public disclosure of modifications of orders and agreements.

Civil Money Penalties and Restitution

You must report all payments on civil money penalties and restitutions to the OTS Controller. The staff of the Controller's office enters these transactions into RAD to maintain a correct record of outstanding balances. When the balance reaches zero, you should close the action with the

“AS” code for Action Successful. If certain considerations require the action to remain in effect, you should enter the reason in the comments.

REFERENCES

Office of Thrift Supervision

Regulatory Action Data System User's Guide

Regulatory Bulletin Series

RB 18 series Enforcement Policy

United State Code (12 USC)

Federal Deposit Insurance Act

§ 1818(u)(1)(C) Public Disclosure of Final Orders and Agreements

INTRODUCTION

A lease is a contract between the owner of a property, the lessor, and a person or company authorized by the lease contract, the lessee, to use the property. The lease contract specifies the lease term, the amount and frequency of lease payments, and who is responsible for insurance, property maintenance and repairs. Leasing allows the lessee to use the property without making a large cash outlay or incurring additional debt.

There are two types of leases:

- Operating or general leases – short-term leases; the lessor is often responsible for the maintenance of the property.
- Financing leases – also called capital leases; longer-term leases that the lessee uses as a means of financing his or her acquisition of a property.

With operating leases, the lessor often leases property to several different lessees over the property's economic life. Examples of this type of leasing often include: leasing of computer systems and heavy equipment.

Financing leases often cover much of the economic life of the leased property. They are very similar to purchase financing. Examples of a financing lease include: an airline using a long-term lease to acquire its fleet of aircraft and ground support equipment; and companies and consumers using automobile leases to acquire their vehicles.

Savings associations typically structure lease contracts so that the association realizes return on the investment from three sources:

- Contractual payments from the lessee.
- Disposition of the asset at the termination of the lease.

- Income tax deferral benefits from depreciating the property.

If properly managed, leasing activities may enhance a thrift's asset diversification and product mix, improve its ability to compete in its market, and provide a favorable return on the investment. While leasing can provide benefits to both the lessor and lessee, leasing can be quite complicated and risky. Prior to engaging in any leasing activities, the institution must determine if it has adequate staff and capital resources to conduct such activities safely and profitably. It must also identify, measure, monitor, and control the risks.

In this section we discuss four topics:

- Regulatory considerations, including a discussion of investment authority and restrictions for both general leasing and finance leasing.
- Underwriting and portfolio management considerations.
- Tax considerations, including the Internal Revenue Service (IRS) requirements for determining if lease payments are fully deductible as expenses.
- Accounting considerations, including a brief discussion of the methods for recording leases.

REGULATORY CONSIDERATIONS

Federally chartered savings associations may engage in both operating leasing (referred to in OTS regulations as general leasing) and finance leasing. Each are allowable under different statutory lending and investment authority.

General Leasing

The Home Owners' Loan Act of 1933 (HOLA) §1464 authorizes federal thrifts to invest up to 10 percent of their assets in tangible personal property

acquired for the purpose of rental or sale. Personal property includes items such as vehicles, manufactured homes, machinery, equipment, and furniture. Section 560.41(d) of the regulations specifically allows general leasing activities within this investment authority.

Within the general leasing authority, savings associations can make several different types of leases with different purposes and duration. Service leases (or operating leases) are a type of general lease. These typically provide for financing and maintenance services, include an option to cancel, and often are relatively short-term. Savings associations commonly make service leases for computer systems and other equipment.

Businesses often prefer general leasing to financing leasing because, in terms of structure, it is less restrictive. An institution may enhance its profitability and product offering by providing businesses a flexible instrument such as a general lease. However, the lack of standard requirements can expose the institution to substantial risk resulting from the following circumstances:

- Lack of demand for the re-inventoried property.
- Inadequate contracts.
- Unexpected depreciation in asset values.
- Asset obsolescence.
- Abuse of property by the lessee.
- A poor resale market.
- Lack of staff expertise in purchasing and disposing of leased property.

Under the general leasing authority, institutions may grant leases for consumer or business purposes, but do not have to aggregate such leases with other commercial or consumer loans for the purpose of determining the institution's compliance with investment limits. Instead, general leases are grouped together and limited to 10 percent of assets.

Successful general leasing requires extensive expertise. The board of directors should adopt

prudent policies and procedures in accordance with OTS regulations and policy guidance, and management should closely monitor the institution's compliance with such policies. Institution personnel should follow prudent credit underwriting practices and have extensive knowledge of assets purchased for leasing.

Leasing staff should also be familiar with the accounting and tax issues and be able to structure leases to minimize risks and ensure adequate pricing to cover all costs and provide an adequate profit. Management should also stay current with changes in tax law, accounting standards, customer demand, and other economic factors that may significantly affect its leasing program.

Finance Leasing

OTS may consider certain lease arrangements to be the functional equivalent of loans. Because the authorization for financing leases comes from HOLA's lending authority, federal savings associations that want to make financing leases under such authority must structure them as the functional equivalent of loans. Institutions must aggregate finance leases with loans for the purpose of determining compliance with the HOLA investment limits. Finance leases are not, however, aggregated with general leases for determining the 10 percent of assets limit.

As with general leases, institutions may make finance leases for tangible personal property such as vehicles, airplanes, manufactured homes, machinery, equipment, and furniture. Institutions may make a finance lease for consumer or commercial purposes. OTS regulation 12 CFR §560.41(c) specifies several requirements that must be met for a lease to qualify as a financing lease. To consider a lease the functional equivalent of a loan, the institution must structure it to meet the following requirements:

- The lease must be a net, full pay-out lease, that the lessee cannot cancel, notwithstanding the possible early termination of the lease.

A "full pay-out lease" is a lease on which the institution:

- receives full payment of amounts it invests in the leased property, plus a reasonable return on the investment over the term of the lease; and
- does not depend on the sale of the property at the end of the lease term for more than 25 percent of the original cost of the property.
- Realization of the lessor's investment must primarily depend on the creditworthiness of the lessee, not the estimated sales price (residual value) of the leased property. "Realization of the investment" means the institution can reasonably expect to get back its full investment in the property, plus financing costs during the lease term from lease payments, tax benefits, and the sale of the property at lease end. The estimate of the sales price of the property at lease end must be reasonable.
- At the termination of the lease, the institution must liquidate or re-lease the property as soon as practical. The institution must reevaluate and record at the lower of fair market value or book value any property held in anticipation of re-leasing.

In addition to being the functional equivalent of a loan, to qualify as a financing lease, the institution cannot have direct or indirect involvement in the operation of the property over the lease term and it cannot provide any of the following services during the lease term:

- Servicing, repair, or maintenance of the property.
- Purchasing parts or accessories, unless included in the full pay-out requirement.
- Lending replacement or substitute property while the leased property is serviced.
- Purchasing insurance for the lessee (except where the lessee failed to discharge a contractual obligation to do so).
- Renewing any license, registration, or filing fee for the property unless necessary to protect the institution's interest as an owner or financier of the property.

The characteristics of finance leasing eliminate some of the risk associated with short-term, general leases. The institution, however, is still subject to credit risks, risks associated with estimating residual values at lease end, and the risk of repossession. We discuss in the following section the steps institutions should take in underwriting and servicing leases.

Underwriting and Portfolio Maintenance Considerations

Historically, institutions focused more on finance leasing than on operating leases. This is due in large part to the characteristics of finance leasing which limit an institution's responsibility for the leased equipment and pass such costs on to the lessee. Lease financing expanded in recent years with the involvement of brokers/servicers who pool leases and offer institutions shares in these pools. Moreover, due to market demands for automobile financing, institutions are making shorter-term leases that often do not meet OTS or accounting requirements for financing leases, yet allow lessees to acquire and use the leased vehicles. Thus, institutions may need to underwrite and structure such operating leases similar to financing leases.

Regardless of how the institution structures the lease, the underwriting considerations the institution should apply in leasing are basic to the administration of any credit portfolio and are just as important in lease financing. The institution must know the borrower (lessee). This includes evaluating the lessee's character and credit history as evidence of their willingness to repay the lease obligation as agreed. The institution should evaluate the lessee's income and financial resources to demonstrate their ability to meet the lease obligation according to the terms established. The institution should also carefully review the collateralization and workout covenants (which are often unique) to ensure contracts are written to reduce its risks.

The leasing staff's ability to realistically estimate the value of the leased property at the end of the lease is second only to credit underwriting in importance with respect to the success of any leasing program. Staff may obtain estimates from various industry pricing guides, such as Kelly Blue Book and the National Automobile Dealer's Association (NADA), which look at trends in used car prices and project future retail and wholesale prices for various vehicle makes and models. It is important that the institution use conservative estimates based on wholesale, rather than retail values. This is because the institution will likely sell the leased property at wholesale to a wholesaler or retailer at lease end.

Finally, an institution should obtain a clear title to the leased equipment to enable its repossession and liquidation in the event of the lessee's default.

While thrift management and examiners should be aware of the various lease underwriting and portfolio maintenance issues (see the General Questionnaire at the end of this Section), a few areas merit particular attention.

Documentation

Institutions must be thoroughly familiar with the documentation evidencing the lease financing and its operation. Lease financing documentation is similar to the documentation for any secured financing and includes the following documents:

- A lease financing agreement evidencing the lease obligation, including payment amounts and the lease term.
- A security agreement that establishes the lessor's right to the leased property in event of default.
- A financing statement filed under the Uniform Commercial Code (UCC) that perfects the lessor's right in the property.
- An assignment from the original lessor, passing rights under the financing arrangement to the institution (only if it purchases the lease from a broker or invests in a pool of leases).

Management must understand the documentation regardless of the structure of the transaction. Legal counsel familiar with leasing and answerable to the institution should thoroughly review the documentation. There should be clear recourse to the collateral in the event of a default by the lessee.

Regardless of whether it is originating the financing leases directly, or purchasing them through a third party or in a pooled arrangement, the institution should have control of the documentation. Not only can the institution readily monitor the documents; but, in certain situations, possessing the actual lease can provide a distinct advantage in the perfection and recovery of collateral and the ability to take control of cash flow from leases.

The board and management should have an effective working knowledge of the leasing operation, backed up by thorough, institution-specific policies and procedures.

Servicers

Servicers of lease pools have been known to make arrangements to replace delinquent leases with performing leases, or to advance payments to cover delinquent leases. Both of these situations have led to complacency on the part of thrifts investing in the lease pools and lack of attention to the quality and performance of leases accepted. Regardless of any take-out arrangements that may exist, the thrift must be aware of the composition and performance of its lease portfolio. This is crucial if the servicer fails and the thrift assumes control of the pools.

Lending Limitations

Both general and financing leases are considered loans or extensions of credit for purposes of 12 CFR §§ 560.93, 563.41, 563.42, and 563.43. Thus, the amount of funds advanced on behalf of the lessee/borrower, together with any other extensions of credit, must be aggregated and meet OTS's loans to one borrower, transactions with affiliates, and insider lending rules.

With respect to the loans to one borrower rule, if an institution uses its general leasing authority to lease property it already owns, such as its previously leased or repossessed property, the limitations of 12 CFR § 560.93 may not apply. This is because

such extensions of credit are excluded from the definition of a loan. (See the Office of the Comptroller of the Currency's (OCC's) definition in 12 CFR § 32.2(j)(iii).)

Loans to a third party to finance their leases, especially pools, can exhibit characteristics that result in the credits being considered loans to the originating or brokering company, rather than loans to the individual lessees. This can result in a violation of the regulatory limitations for loans to one borrower.

Section 32.3(b)(10) of the OCC's regulations (12 CFR § 560.93 applies to thrifts) sets forth criteria that the institution must meet for OTS to treat a loan to a leasing company as separate loans to underlying lessees. These criteria include:

- Institution evaluation of the creditworthiness of the lessee on a lease-by-lease-basis.
- The loan to the leasing corporation is without recourse.
- The institution has a valid security interest in the leased equipment.

Any institution engaging in a leasing program must be able to document how and why the lease financing conforms to the lending limitation regulations.

The provision, by a thrift, of a lease financing or credit line to a leasing company in no way lessens the need to secure, understand, and retain information and analyses on the underlying lessees, as noted above.

Leveraged Leases

Leveraged leasing is a three-party arrangement involving:

- The lessee, who leases the property and makes lease payments, thus providing cash flow.
- The lessor, who purchases the property for the lessee and provides some equity funding (commonly called the equity participant).

- The lender (long-term creditor), who provides funding for the purchase of the property.

In a leveraged lease, the lessor purchases the asset by providing only a percentage (usually 20 to 40 percent) of the capital needed. The lender provides the balance of the purchase price to the lessor. The security provided to the lender includes a first lien on the equipment and an assignment of the lease and lease payments.

If the asset purchase price is very large, there may be several equity owners (lessors) and debt holders. In this case, an owner trustee may be named to hold title to the asset and to represent the equity owners.

The lessor, as the owner, can depreciate the property for income tax purposes, based on the total cost of the asset, not just the invested amount. The lessor will also receive the portion of the rental payments attributable to the difference the lessor charges for the lease and the rate he or she pays the lender.

For example, an airline leases an aircraft costing \$100 million for 15 years at \$12.5 million each year (representing a 9 percent lease rate). The lessor obtains a 15-year bank loan for \$80 million at an interest rate of 7.5 percent with payments of \$9.06 million. At the end of the lease, the lessor expects to sell the aircraft for \$20 million. The airline is responsible for all operating expenses, maintenance, and insurance. If everything goes as planned, the cash flows to the lessor will be as follows:

<u>Year 1</u>	
Lessor's down payment:	-\$20.00 million
<u>Years 1-15</u>	
Lease income:	\$12.50 million
Loan payment:	-\$ 9.06 million
Yearly net cash flow:	\$ 3.44 million

Lessor's annual depreciation expense:
 $\$80 \text{ million} / 15 \text{ years} = \$ 5.33 \text{ million}$
 (This will cover the lease income and result in excess depreciation of \$2.11 million that can offset the lessor's other income.)

Year 15

Sale price at end of lease: \$20 million
(The lessor receives the amount of the initial investment.)

If realized, the above cash flows result in a 35 percent return to the lessor. However, leveraging cuts both ways. The early termination of the lease and forced liquidation of the property can result in equally large losses.

Leveraged lease financing provides lessors with the ability to leverage their capital into a larger lease(s) than they could fund with their capital alone — hence the name “leveraged leasing.” Savings associations can participate in leveraged leases either as the lessor or as the financing institution. They can do so either directly or through a subsidiary. However, such activities are highly risky and the institution must control such risks. Failure to control such risks will subject the institution to criticism and possible supervisory action.

One of the risks of leveraged lease transactions is their complexity, stemming from the large dollar amounts and number of parties involved, and the unique relationship between the parties. Legal expenses and administrative costs associated with leveraged leasing generally limit its use to financing for large capital investments.

Because of the complexity, institutions should have qualified staff with a current working knowledge of all aspects of leasing, including the risks involved, applicable laws and regulations, and tax consequences. Moreover, when structuring leveraged leases, institutions should consider all relevant aspects of how the leasing activities will affect the institution, including capital requirements, estimated future cost of funds, and cash flows. The return on the institution's investment in leveraged leases depends largely on these factors, and even a slight change in the variables can affect profitability.

As with financing and operating/general leases, the residual value of the property at lease-end is a major element of the return on the investment. The institution should carefully estimate and support the value. Because leveraged leases generally in-

volve the financing of very costly property, institutions should periodically inspect properties for condition and possible misuse to prevent rapid deterioration of the value of the property before the lease term expires. Institutions should also monitor properties for obsolescence or market value decline, to assist in structuring profitable lease programs in the future.

Institutions should carefully scrutinize the financial capacity of all parties involved in the lease. Should the lessee default, the lessor will have to repay the loan if they want to recapture at least a part of their investment. Thus, an institution should not enter into a leveraged lease as the lender unless the lessor has the capacity to maintain the lease for a time in the event the lessee defaults.

Consumer Leasing

A large part of the leasing done by thrifts is consumer leasing of vehicles and other personal property. This type of leasing creates a homogeneous portfolio of leases that, if underwritten properly, may involve less credit risk than business use leasing. Underwriting consumer leases is very similar to underwriting consumer loans, with three major exceptions:

- The lease terms are often shorter and may not provide for the full pay-out of the acquisition cost of the leased property.
- Down payments (capital reduction costs) and monthly lease payments are typically lower than loan purchase payments, so there is no equity build-up.
- Profitability is dependent on the lessor receiving proceeds from the sale of the leased property. Actual proceeds may be much less than proceeds estimated at the beginning of the lease.

Originating leases to consumers requires adherence to the Federal Reserve Board's Regulation M (12 CFR Part 213). This regulation requires comprehensive disclosures for leases of personal property with a contractual obligation of up to \$25,000 and a term of more than four months. These may be general or financing leases. Regulation M provides a model disclosure form. Thrifts engaging in con-

sumer leasing must thoroughly understand and comply with Regulation M.

Strategies to Mitigate Risks Associated with Leasing

As mentioned previously, leasing activities may involve considerable risks. Such risks may stem from the failure of the lessee to meet the terms of the lease contract or the inability of the institution to accurately estimate cash flows from the lease, such as tax advantages or the residual value of the property at lease-end.

With each lease transaction, the institution should compute the internal rate of return, considering lease payments, estimated tax benefits, the estimated residual value at expiration of the lease, and the cost of funds. (The Thrift Activities Regulatory Handbook Section 440, Present Value Analysis, discusses lease calculations.) Any change in variables during the lease term will affect the rate of return.

Each lease agreement should clearly state the type of lease structure and identify the specific characteristics that qualify the lease for the designated tax and accounting classifications.

To effectively minimize these risks, the leasing department should exhibit several key characteristics:

- Comprehensive and prudent written policies, procedures, and internal controls.
- Expert knowledge of the assets acquired for leasing (specifically in the areas of market demand, purchasing, disposition, market value depreciation over time, and appraisal techniques).
- Expertise and experience with structuring lease contracts and perfecting security interests in the leased property.
- Procedures for the periodic reviews of policies to determine consistency with changes in the tax laws, accounting requirements, and market conditions.

TAX CONSIDERATIONS

Tax benefits to the lessee generally stem from the lessor's ability to depreciate the property over a shorter time than the property's economic life. This results in a tax deferral, not the elimination of tax liability. The deferred taxes must be paid when the property is either sold or taken out of service. Therefore, such benefits are more pronounced with long-term leases than with short-term leases.

The lessee also has tax benefits. The full amount of the annual lease payments as well as the cost of operating the property is a deductible business expense for income tax purposes if the Internal Revenue Service (IRS) agrees that a particular contract is a genuine lease and not simply an installment sale called a lease. This makes it important that a lease contract be written in a form acceptable to the IRS. The IRS considers the inclusion of the following components to meet the requirements of a bona fide lease transaction:

- The term should be less than the useful life of the property; otherwise, the lease may be regarded as a form of sale.
- The rent should provide a reasonable return to the lessor.
- The renewal option should be bona fide. This requirement may be met by giving the lessee the first option to meet an equal bona fide outside offer.
- Any purchase option should not be less than fair market value.

IRS requirements may change periodically; therefore, the institution should continually monitor tax law changes.

ACCOUNTING CONSIDERATIONS

Generally Accepted Accounting Principles (GAAP) regarding lease accounting are very extensive. The institution should refer to GAAP specifically for a detailed understanding of the accounting and reporting requirements of lease transactions. SFAS

No. 13 discusses the accounting for capital¹ leases and operating leases from the perspective of the lessor and the lessee.

You should ascertain that the institution is using proper accounting treatment and appropriately recording lease transactions. In certain cases, institutions have accepted leases that purport to be straight financing leases of new equipment but, in actuality, are the sale and leaseback by the lessee of the lessee's current machinery and/or equipment. You should carefully review sale/leaseback transactions. Often, failing businesses use sale/leasebacks to generate cash flow.

Lease classification is generally dependent upon six criteria for lessors and four criteria for lessees. If any one of the following four common criteria for both lessors and lessees are met, the lease may qualify as a capital lease:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains a bargain purchase option.
- The lease is equal to 75 percent or more of the estimated life of the leased property. This criterion is not used for purposes of classifying the lease if the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property, including earlier years of use.
- The present value at the beginning of the minimum lease term of the lease payments equals 90 percent or more of the fair value of the leased property.

Lessors must meet two additional criteria:

- The collectibility of the minimum lease payments is reasonably predictable.
- No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

¹ The accounting definition of capital leases is very

Lessor

If, at inception, a lease meets any one of the first four criteria and both of the last two criteria, the lessor typically classifies the lease as a direct financing lease. Thus, the lessor records as assets the present value of total lease receivables (aggregate rentals due under the lease) and the residual value. The lessor records the excess of these combined assets over the actual cost of the leased asset as unearned income. Subsequently the lessor amortizes the unearned income over the life of the lease on the level yield basis. Lease rental payments received reduce the recorded asset.

If none of the first four criteria are met or at least one of the last two criteria is not met, the lessor records the lease as an operating lease. Thus, the lessor records the cost of the leased asset on the balance sheet and depreciates the asset using the lessor's normal depreciation policy. Lease payments received are recorded in income as rent over the lease term.

Lessee

If, at inception, a lease meets any one of the first four criteria, the lessee classifies the lease as a capital lease. The lessee records an asset and a liability equal to the present value of the minimum lease payments exclusive of any executionary costs the lessor will pay.

If none of the first four criteria is met, the lessee records the lease as an operating lease. The lessee records the lease payment as accrued expense on a regular basis.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act of 1933

- §1464 (c)(2)(C) Investments in Personal Property
- §1464 (c)(2)(D) Consumer Loans and Certain Securities

similar to OTS's financing leases.

Code of Federal Regulations (12 CFR)

§559.4 What activities are pre-approved
for service corporations?
§560.30 General Lending and Investment
Powers
§560.41 Leasing

§560.93 Lending Limitations
§563.41 Transactions with Affiliates (TWA)
§563.42 Additional TWA Standards
§563.43 Loans to Insiders

**Financial Accounting Standards Board, State-
ment of Financial Accounting
Standards**

No. 13 Accounting for Leases
No. 27 Accounting for Sales with Leasebacks
No. 98 Accounting for Leases

Leasing Activities Program

Examination Objectives

To determine if the policies, procedures, and controls regarding leasing activities adequately ensure safety and soundness, profitability, and compliance with laws, regulations, and established guidelines.

To determine the quality of the assets through an analysis of underwriting and lease production, including: creditworthiness, collectability, collateral sufficiency, lease terms and other variables.

To determine if the institution employs qualified officers and employees that can adequately perform their duties and responsibilities associated with leasing.

To determine if financial records and management reports provide accurate and necessary performance and asset quality information to management and the board of directors.

To determine if any contingent liabilities exist with regard to the institution's leasing activities and whether they affect its overall soundness.

To initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note violations of laws or regulations.

Examination Procedures

Wkp.Ref.

Level I

1. Review scoping materials related to leasing, including the following reports and schedules:
 - Lease trial balance listings.
 - Delinquent leases.
 - Classified leases.
 - An itemization of repossessed and returned leased property.
 - A report of the disposition of repossessed and returned property.
 - Leases in which payments are not collected in accordance with the terms of the lease.
 - Leases whose terms have been modified by reduction on interest rate or principal, or by other restructuring of repayment terms.
 - Leases sold since preceding examination.

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Leasing Activities Program

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- Lease commitments and contingent liabilities.
- Extensions of lease credit to affiliated persons.
- Miscellaneous lease debit and credit suspense accounts.
- The current interest rate structure.
- The minutes of appropriate committees.
- Reports on leasing activities furnished to the board of directors.
- The current status of leases classified during the previous examination.
- A listing of rebooked charged-off leases.
- The nature and extent of leases serviced for others.
- Month-end lease account balance and total delinquency since the previous examination.

2. Evaluate the institution's policies and procedures through review of policy statements, underwriting guidelines and manuals, interviews with management, and review or recaps of board minutes.

- Determine if accounting and tax issues are adequately addressed in policies and procedures.
- Determine whether objectives and related policies are reviewed periodically and any changes communicated to the appropriate personnel.

3. Review management reports, especially exception reports, related to this area. Assess the adequacy and accuracy of the reported information.

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4. Review the qualifications, capabilities, and expertise of leasing officers in relation to their responsibilities.

5. Determine whether the institution corrected deficiencies mentioned in prior examination reports.

6. Complete the General Questionnaire.

7. Review the Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

Level II

8. Review the reconciliation of the subsidiary ledgers for leasing to the general ledger. Investigate any large reconciling items.

9. Select leases for review using an appropriate sampling technique. (For details on sampling, refer to Section 209 of the Thrift Activities Regulatory Handbook.) Include all of the following in your review:

- A sample of leases per Handbook Section 209.
- Lease accounts of employees, officers, directors, major stockholders, and their interests.
- Lease accounts of officers and directors of other institutions.
- Lease accounts related to significant borrowers.

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- Lease accounts in excess of their credit limits.
-

10. Analyze a sample of credit files for lessees for credit quality (earnings, indebtedness, credit history, collateral, loan modifications) and compliance with the credit policy.

11. Review lease repossessions and charge-offs.

- Determine if the institution performs charge-offs in accordance with its policies and regulatory requirements. Review the current past-due account report and test for accuracy. Review and discuss with management individual accounts not charged-off in accordance with regulatory requirements.
 - Determine if collection practices are proper and conform to policy. Review written collection procedures and test check customer contact records.
 - Review listings of charged-off leases and recoveries and prepare or update the carry forward work paper showing charge-offs and recoveries as a percentage of outstanding leases.
 - Determine and discuss with management causes of any adverse trends or significant fluctuations. Excessive lease losses are the product of weak lending and collection policies and provide a good indication of the soundness of the lease department's operations.
 - Determine if the leasing operation has rejected leases offered by brokers or third parties, or if the leasing operation accepts into portfolio all leases offered. An absence of rejected leases can be an indicator of weak credit policies and procedures.
-

12. Ensure that the examination meets the *Objectives* of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

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Leasing Activities Program

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Level III

13. Review any leveraged leases the institution has undertaken as lessor lender. Determine if the institution structured the lease in a safe and sound manner and that it complies with all OTS's loans to one borrower, transaction with affiliates, and insider lending rules.

14. Determine if the institution has adequate inventory controls over property held for leasing.

15. Inspect large lease properties for which the leases are past due.

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Leasing Activities Questionnaire

General Questionnaire		Yes	No			Yes	No
1. Does the institution have objectives, policies, procedures, and controls specific to the leasing activity and are they adequate regarding:				10. Are lease financing and general leasing identified separately and distinctly, with accounting and tax criteria clearly identified? ...			
<ul style="list-style-type: none"> • Accounting designation of financial and operating leases? • Credit and accounting analysis? • Tax considerations for both lessees and lessors? • Collection and lease service record keeping? 			11. Does the institution have an adequate procedure for financial analysis? (The institution should obtain financial information on lessees and lease servicers; and require regular updates as warranted, particularly for commercial accounts.)				
2. Does the institution's board of directors review and approve these objectives, policies, procedures, and controls?				12. Does the institution have proper controls for the maintenance of leasing records?			
3. Has the board set limits for the leasing activity?				13. Does the institution retain on thrift premises or under the thrift's control lease files, including the original lease and security agreements?			
4. Does the board receive periodic reports on the performance and quality of the leasing portfolio?				14. Does the institution issue lease commitments in writing?			
5. Has counsel for the thrift, with expertise in leasing, reviewed the leasing activity? (In particular, counsel should closely scrutinize security agreements/ assignments, participation agreements and servicing contracts.)				15. Does management monitor and report to the board of directors delinquent lease payments?			
6. Does the institution have adequate expertise in the individual leasing areas?				16. Does the institution take appropriate collection action on delinquent lease accounts?			
7. Does the institution refrain from undue reliance upon broker/seller/servicers to answer questions on lease pools?				17. Does the institution place delinquent lease accounts in non-accrual status as required in the TFR instructions and GAAP?			
8. Are seller/servicers making payments on lease pools, potentially masking problems? .				18. Does the institution appropriately note, value, book, and control repossessions?			
9. Does the institution retain written documentation of initial underwriting and ongoing analysis?				19. Do qualified thrift personnel complete valuation reports on repossessed property from an independent party or source?			
				20. Does the institution ensure the control, inspection, maintenance, and insurance of lease property?			
				21. Does the institution use reliable techniques to estimate the value of the property at the end of the lease term? Does the institution adequately support the estimate?			

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INTRODUCTION

The term equity investment covers a wide range of investments. Many of these investments are not permissible for federal savings associations because of their inherent risk. Equity investments are riskier than loans and other permissible investments because all creditors are paid in full before investors' claims are paid. The return on equity often requires a sale, rather than amortization from known cash flow streams. Because of the greater risk of loss, savings associations should be extraordinarily cautious when making equity investments. Sound internal policies and procedures and effective diversification of equity investments by individual savings associations is extremely important to limit overall portfolio risk. Certain equity investments will not require the same level of review that is necessary for equity investments that possess higher risk factors. An equity investment of moderate risk has the following characteristics:

- The savings association is a passive investor in an entity engaged in permissible savings association activities.
- The savings association's liability does not exceed its investment.

The Home Owners' Loan Act (HOLA) and Office of Thrift Supervision (OTS) regulations substantially limit a federal savings association's direct equity investment authority. Permissible equity investments nevertheless can present substantial risk to the savings association. Your review should reflect the level of risk involved. You should consider the following items when determining the scope of your review:

- The adequacy of oversight by the board of directors.
- Compliance with sound internal policies and procedures for the acquisition, management, and monitoring of equity investments.
- Composition of the equity investment portfolio.

- Regulatory capital levels.
- Equity investment/loan concentrations.

This Section provides an overview of the following areas:

- Equity investments authorized for federal savings associations.
- Types of equity investments and applicable limitations.
- Potential safety and soundness concerns associated with these investments.

PERMISSIBLE EQUITY INVESTMENTS

Unless stated otherwise, this Section specifically refers to a federal savings association's authority to make equity investments. State-chartered savings associations must consult applicable state laws and regulations to determine whether similar authority exists. The Federal Deposit Insurance Act (FDIA) at 12 USC §1831e(c) limits state savings associations' equity investment authority to the type and amount permissible for federal savings associations. Federal law pre-empts state laws permitting extensive equity investments by state-chartered savings associations. In the event that states have equity investment regulations that are more restrictive than OTS regulations, state savings associations must adhere to the more stringent standard.

HOLA §5(c)(1) contains a list of investments, which include securities of certain government sponsored entities, that are permissible for federal savings associations.

This list substantially limits a federal savings association's authority to purchase an equity

interest (for example, common or preferred stock) in a corporation that is not a subordinate organization. As discussed further below, the association can make certain de minimis community development-related investments as well as pass-through investments. The association can also acquire personal property for sale or lease and make certain real estate investments.

Notwithstanding the limited scope of allowable equity investments, such investments could present substantial risk to the investing savings association. In addition to establishing the association's authority to make the investment, consider the following:

- Adequacy of internal policies, procedures, and controls for the acquisition, management, and monitoring of equity investments.
- Accuracy of the accounting treatment for, and valuation of, equity investments.
- Compliance with OTS's capital standards, savings association financial reporting requirements, and asset classification policy.
- Whether a significant concentration of assets exists, including equity investments in, and loans to, related entities. For example, limited partnerships that share a common third-party investor or joint ventures that derive cash flow from a single project.

Congress grandfathered some equity investments of federal savings associations chartered before October 15, 1982, or that converted from a mutual savings bank charter before August 9, 1989. See 12 USC §1464(i)(4). Federal savings associations, however, must file notice with the Federal Deposit Insurance Corporation (FDIC) regarding grandfathered equity investments. Notwithstanding available grandfathered status under §1464(i)(4), §1828(m)(3) of the FDIA may prohibit or limit the grandfathered authority.

A federal savings association may have the FDIC's approval consistent with 12 CFR §303.13(d) to retain an impermissible investment that a former state-chartered savings association held on August 8, 1989. In such cases, the savings association

should provide access to records documenting such approval or an acceptable divestiture plan.

TYPES OF EQUITY INVESTMENTS

Equity Securities

For OTS regulatory purposes, equity securities can include corporate stock, investments in joint ventures, profit-sharing arrangements and loans having profit-sharing features. Federal thrifts may invest in the following types of equity securities consistent with applicable statutory and regulatory standards. (Also, see discussion of subordinate organizations and pass-through investment authority.)

- Securities of U.S. government-sponsored corporations. (12 USC §1464(c)(1)). Federal thrifts may invest in the securities of the following government-sponsored corporations without investment limit:
 - Federal National Mortgage Association (Fannie Mae)
 - Government National Mortgage Association (Ginnie Mae)
 - Federal Home Loan Mortgage Corporation (Freddie Mac)
 - Student Loan Marketing Association (Sallie Mae)
 - Federal Home Loan Bank

Federal thrifts may also invest in Federal Agricultural Mortgage Corporation (Farmer Mac) common stock in nominal amounts necessary to enable them to sell agricultural loans to Farmer Mac and participants in Farmer Mac's secondary market program.

- National Housing Partnership Corporations and related partnerships and joint ventures. (12 USC §1464(c)(1)(N))
- Business development credit corporations up to the lesser of 0.5 percent of total outstanding loans or \$250,000. (12 USC § 1464(c)(4)(A))

- Shares of an open-ended management investment company that is registered with the SEC under the Investment Company Act of 1940. (12 USC §1464(c)(4)(D)). *Note:* The portfolio of the open-ended investment company must consist only of investments that a federal savings association by law or regulation, without limitation as to percentage of assets, may invest in, sell, redeem, hold, or otherwise deal in.
- Shares in minority enterprise small business investment companies established for the purpose of aiding the members of a Federal Home Loan Bank. The thrift's investment must not exceed one percent of its assets. (12 USC §1464(c)(4)(D))
- Shares in bankers' banks or their holding companies that have depository institutions or depository institution holding companies as investors in an amount up to 10 percent of the federal thrift's capital stock and unimpaired surplus. (12 USC §1464(c)(4)(E))

SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, requires that the association report most equity securities at fair value (available-for-sale), rather than at amortized cost. Refer to the Thrift Financial Report (TFR) Instruction manual for guidance on reporting such investments.

For a detailed discussion of savings association investment policies and procedures, refer to the Investment Securities handbook section. Also, Handbook Section 410, Financial Records and Reports, addresses accounting considerations for determining the accuracy of savings association financial reporting.

De Minimis Investments

Section 560.36 authorizes a federal savings association to invest in community development investments of a type permitted for a national bank under 12 CFR Part 24. Savings associations may invest in such community development projects up to the greater of one-fourth of one percent of total capital or \$100,000. Generally, these would be investments that primarily benefit the following groups or areas:

- Low- and moderate-income individuals.
- Low- and moderate-income areas.
- Areas targeted for redevelopment by local, state, tribal, or federal government. This includes federal enterprise communities and federal empowerment zones.

These investments provide or support one or more of the following activities:

- Affordable housing, community services, or permanent jobs for low- and moderate-income individuals.
- Equity or debt financing for small businesses.
- Area revitalization or stabilization.
- Other activities, services, or facilities that primarily promote the public welfare.

Under § 560.36, there are no restrictions as to control, geographic location, ownership, or organizational structure.

Given the limited investment authority, these investments should not have a significant effect on the parent federal savings association's financial condition.

Personal Property Acquired for Sale or Lease

Typically, federal savings associations acquire personal property for lease at the request of a customer wanting lease financing, usually for very expensive items such as mainframe computers, earth-moving equipment, and fleets of vehicles. Handbook Section 219, Leasing Activities, further discusses personal property acquired for sale or lease.

Pass-Through Investments

Federal savings associations, in accordance with §560.32, may make limited investments, on a pass-through basis, in certain preapproved entities that hold only assets or engage in activities permissible for federal savings associations. Pass-through investment authority enables federal savings associations to join with others to engage in an

activity. Joint participation has the potential to reduce capital outlays and operating costs and enhance profitability, or serve other bona fide business objectives without jeopardizing safety and soundness. A federal savings association that meets all of the following conditions may make pass-through investments without prior notice to OTS:

- The federal savings association invests no more than 15 percent of total capital in any one entity.
- The book value of the aggregate pass-through investments does not exceed 50 percent of total capital after making the investments.
- The investment would not give the association direct or indirect control of the company. See the definition of control in 12 CFR §362.2(e).
- The federal savings association's liability does not exceed the amount of the investment.
- The company falls into one of the following categories:
 - Limited partnership. A limited partnership classifies its members as either general or limited partners. Under this structure, the general partner is personally liable for the partnership's obligations, whereas the limited partner enjoys limited liability as long as it does not materially participate in the business of the partnership.
 - Open-end mutual fund. These are investment vehicles registered with the SEC under the Investment Company Act of 1940. The investment company must restrict its portfolio by its investment policy. The company's investment policy may only change if authorized by shareholder vote. The investment company's portfolio must consist solely of investments that a federal savings association can make directly.
 - Closed-end investment trust. A closed-end trust differs from an open-end fund in that it typically has a fixed number of shares, but is like an open-end fund in that it trades on a stock exchange.

- Limited liability company (LLC). LLCs are neither corporations nor partnerships yet they combine the limited liability of a corporation with the tax benefits of a partnership. A key advantage of the LLC is that it provides limited liability to all of its members and managers, regardless of their level of participation in the entity's business activities. The members are the owners of the LLC and may be individuals, corporations, general or limited partnerships, LLCs, trusts estates or other entities.
- Entity that a federal savings association would invest in primarily to use the company's services (for example, data processing). A federal savings association may invest in a jointly owned corporation established to provide services for several users. The objective of such an investment is the receipt of services rather than engagement in a speculative investment through stock investment.

When making a pass-through investment, a federal association must comply with all the statutes and regulations that would apply if it were engaging in the activity directly. For regulatory reporting purposes, to calculate a federal association's lending and investment limits, the association should aggregate a proportionate share of the entity's assets with the assets the association holds directly. Loans that a savings association makes to the entity are subject to the LTOB rule in the same manner as loans by a savings association to any third party.

To make pass-through investments that do not meet the standards in §560.32, a federal savings association must provide OTS with 30 days advance notice. During the 30-day review process, OTS may require the association to file an application to obtain written approval prior to making the investment.

Subordinate Organizations

Part 559 of OTS regulations deals with savings associations' authority to establish and operate subordinate organizations, for example, operating subsidiaries, service corporations and their lower-

tier entities. For various business reasons, for example, tax considerations or efforts to limit potential liability, a savings association may prefer to make permissible investments through a subordinate organization in accordance with 12 CFR Part 559. Operating subsidiaries must limit their assets and activities to those authorized for federal savings associations. A service corporation can engage in additional lines of business specified in §559.4 not otherwise allowed at the savings association level.

Handbook Section 730 contains detailed examination guidance for reviewing such investments. The guidance addresses the following primary considerations in the review of a subordinate organization's operations:

- The potential effect of the subordinate organization's operations on the parent savings association.
- Compliance with OTS notification or, if applicable, application process.
- Compliance with applicable investment restrictions detailed in 12 CFR Part 559.
- Maintenance of separate corporate identities.
- Any indications of insider abuse.

Accounting for a savings association's investment in a subordinate organization should follow GAAP as set forth in Statement of Financial Accounting Standards (SFAS) No. 94 and Accounting Principles Board (APB) Opinion No. 18. Under GAAP, a savings association may account for investments in subordinate organizations by one of three methods:

- Consolidation
- Equity method
- Cost method.

Accurate accounting for investments in subordinate organizations is important to ensure that the books of the parent adequately reflect the carrying value of the entities. See Handbook Section 430, Appendix C, to assess whether the savings association has followed OTS savings association

financial reporting standards for investments in majority-owned or unconsolidated subordinate organizations. OTS's capital rule generally refers to a majority-owned subordinate organization as a subsidiary. (See also the TFR Instructions.)

Equity Interest in Real Estate Investments (REI)

Real estate investments include ownership interests in raw land, residential or commercial development projects, or established rental properties. GAAP rules also include in REI loans with equity characteristics. Such lending includes certain project lending that in essence constitutes investments. An element characteristic of an investment is that the lender shares in profits. Although certain types of REI may qualify as loans under §1464(c), they remain REI for reporting purposes. However, REI does not include interests in real estate acquired for the savings association's own use, such as office facilities, and other reasonable business purposes as authorized in 12 CFR §560.77. Also, REI does not generally include real estate owned (REO) obtained in the settlement of debts previously contracted. The savings association should classify as REI real estate acquired in settlement of debts, if they intend to hold the real estate for investment purposes or if the savings association will not dispose of the real estate within five years (or a longer period as approved by OTS). A detailed discussion of real estate development activities is beyond the scope of this Section. Handbook Section 740, Real Estate Development, however, contains guidance on this subject. Also, Section 212, Real Estate Mortgage Lending, Section 208, Real Estate Appraisal, Section 260, Classification of Assets, and Section 251, Real Estate Owned and Other Repossessed Assets, provides relevant guidance.

REI Authorized in HOLA §5(c)(3)(A)

HOLA §5(c)(3)(A) limits REI investments of federal savings associations to those that are community-development related and certain investments preapproved for service corporations.

Federal savings associations may invest up to two percent of assets in REI to further community development pursuant to HOLA §5(c)(3)(A). Federal savings associations must aggregate these REI in-

vestments with loans allowed under HOLA §5(c)(3)(A) to determine compliance with a statutory five percent of assets limit. To be permissible for investment, real estate must be located in areas receiving concentrated development assistance under Title I of The Housing and Community Development Act of 1974 (HCDA), or subject to an OTS no-action letter. Savings associations can make the investments in the following ways:

- Directly.
- As de minimus investments (see §560.36).
- Through investment vehicles authorized for federal savings associations that include subordinate organizations (as defined in §559.2).
- On a pass-through basis using investments authorized in §560.32 (for example, limited partnerships).

Indirect investments in real estate projects are subject to the same investment limits that apply to any direct REI. Include indirect investments in real estate projects in determining compliance with the overall five percent of assets statutory investment or loan limit. When making real estate investments through an entity, the savings association should obtain a written commitment that the entity will comply with applicable OTS standards for such investments, and routinely monitor compliance.

A common investment vehicle for making a community-development related REI is an investment in a Low Income Housing Tax Credit (LIHTC) limited partnership. In making such investments, savings associations generally rely on the authority in HOLA §5(c)(3)(A) to invest on a pass-through basis.

Therefore, such investment must meet the standards in §560.32 (Pass-Through Investments) including the individual and aggregate investment limits.

The Tax Reform Act of 1986 authorized LIHTC programs. LIHTCs are a popular mechanism to provide equity to affordable multi-family housing projects. Most LIHTC projects use a limited partnership structure. The partnership raises equity in the project by selling limited partnership interests

and uses the proceeds to support development or rehabilitation of affordable multifamily housing. The tax credits, as well as any profits or losses from the property, flow through to the limited partners.

To minimize the risk of tax credit recapture or project failure, a savings association can participate in a LIHTC fund that diversifies investments among several LIHTC projects. Of course, the underlying REI must be permissible pursuant to HOLA 5(c)(3)(A). Diversification among several projects, however, does not eliminate a savings association's risk. In reviewing such investments, you should determine whether the savings association has other relationships that are dependent upon the success of a particular LIHTC-related project. This may be an indication of a savings association's asset concentration in a particular project. Extensions of credit to the project or guarantee of third-party loans to the project by the savings association are indications of project concentration.

REI Authorized for Service Corporations

Through service corporations, federal savings associations can engage in additional activities not permissible for federal savings associations to perform directly. Service corporation activities are either preapproved by regulation or OTS determines the activities to be reasonably related to the business of financial institutions. Section 12 CFR §559.4 lists the preapproved service corporation real estate activities and includes the following:

- Acquiring real estate in accordance with a prudent program of property development for:
 - prompt development or subdivision
 - construction of improvements
 - resale or leasing to others
 - construction
 - use as manufactured home sites.
- Acquiring improved real estate or manufactured homes for:
 - rental or resale
 - remodeling
 - renovating or demolishing

- rebuilding for sale or rental
- offices and related facilities of a stockholder of the service corporation.

Therefore, in addition to certain REI authorized in HOLA 5(c)(3)(A), a savings association can make permissible REI in an amount up to its service corporation investment limit. Generally, the service corporation investment limit is three percent of assets provided any amount over two percent relates to community development activities.

As noted above, investments in service corporations must comply with the standards in Part 559, including applicable investment limits. Service corporations, for example, are subject to various ownership and geographic restrictions. Such restrictions, however, do not apply to the establishment of a savings association's lower-tier entities. For monitoring compliance with applicable statutes, regulations, and OTS policy, it is important that the savings association's internal records indicate the authority for any REI. (Refer to Handbook Section 730, Subordinate Organizations, for a discussion of service corporation and lower-tier investment authority.) Also, there are regulatory capital implications for real estate service corporations. Savings associations must deduct from capital any direct investments (both debt and equity) they or subordinate organizations make in subsidiaries engaged in activities that are not permissible for national banks. Handbook Section 120, Capital Adequacy, discusses this subject.

Refer also to the OTS Guide to the Federal Laws Governing Community Development Activities of Savings Associations. Appendix D of the guide addresses capital standards for REI and lists community development related investments permissible for national banks.

Real Estate Loans with Equity Investment Characteristics

REI includes loans with equity investment characteristics because they are, in essence, equity investments in the projects being financed even though such loans are permissible under 12 USC §1464(c). REI, for example, may include the following types of loans:

- Land loans and nonresidential construction loans with loan-to-value (LTV) ratios greater than 80 percent.
- Interest capitalized as part of a real estate loan balance in accordance with GAAP.
- Loans or advances to, and guarantees issued on behalf of, partnerships or joint ventures in which a savings association holds an equity interest in real property as determined under GAAP.

You should carefully scrutinize loans with equity characteristics because they present risks similar to other types of equity investment. This supervisory oversight is necessary because such loans are permissible investments for savings associations. These loans are not equity investments under the capital rule to the extent they are permissible investments for national banks. With one exception, these loans are generally risk weighted at 100 percent instead of being deducted when computing risk-based capital. The exception pertains to land loans and nonresidential construction loans with LTV ratios greater than 80 percent. Savings associations must include in the 100 percent risk-weight category the portion of the loan that represents 80 percent of the project's value. In addition, they must deduct dollar-for-dollar from total capital the portion of the loan in excess of 80 percent LTV.

A significant type of loan that often falls within the definition of equity investment is the highly leveraged acquisition, development, and construction (ADC) loan. OTS may consider an ADC loan an equity investment if it possesses any of the following characteristics:

- The lender participates in the expected profit upon completion of the project.
- The lender supplies virtually all funds for the project, including the funds to cover loan origination fees and interest on the loan. The borrower, although having title to the project, has little or no equity investment in it.
- The only security for the loan is the ADC project itself and, therefore, the lender has no recourse to other assets of the borrower.

- The structure of the arrangement precludes default or foreclosure during the project's development because there are no requirements for interim payments. This means that the loan can never become delinquent before its maturity date.

Accounting and Reporting for REI

Beyond verifying that REI comply with rules and regulations, you should verify that the savings association's financial reports properly reflect these investments. REI include the purchase price or original cost less depreciation of all equity interests in real property as determined in accordance with GAAP. Savings associations and others must carry REI at the lower of the carrying amount or fair value less cost to sell as prescribed by SFAS No.121. The cost of the real estate should include the original purchase price plus allowable items, such as:

- Cost of construction.
- On-site and off-site improvements.
- Costs of architectural and engineering studies.
- Interest during the construction period (as required by SFAS No. 34).
- Certain pre-acquisition costs meeting the criteria specified in paragraph four of SFAS No. 67.
- Property taxes and insurance incurred during the development period prior to the property being substantially complete as addressed in paragraph six of SFAS No. 67.

Depreciation begins when a project is substantially complete and held available for occupancy. Charge all carrying costs to expense when incurred. You should consider a property substantially complete and available for occupancy no later than one year from cessation of major construction activity.

Handbook Section 251, Real Estate Owned and Other Repossessed Assets, contains guidance on accounting for sales of real estate. When the seller, for example, receives a note on a sale of real estate, it is necessary to adjust the sales price to the estimated fair value of the note. Refer to APB No.

21 for a detailed discussion of determining the appropriate sales price that will affect the gain or loss on the sale.

Internal Controls for REI

In evaluating risk, you should determine whether the savings association is prudently managing the REI portfolio. You should have access to information indicating the authority that the savings association relied on for making REI or loans with equity investment characteristics. You should assess the adequacy of internal policies and procedures for REI. There is often a direct relationship between the competence and expertise of individuals managing a project and its risk and profitability. Therefore, you should also review the savings association's real estate investment strategy and decision-making analyses (for example, risk versus return assessment, project feasibility, expertise of individuals managing the project, real estate appraisals, financing commitments). You should document all information relating to management's investment analysis consistent with the savings association's (or if applicable, its subordinate organization's) internal policies and procedures. The analysis can provide substantial insight into the level of risk involved and facilitate an assessment of performance projections against actual results.

It is the responsibility of the savings association to ensure that any investment in real estate is safe and sound. Additionally, internal procedures should address the monitoring of REI. For example, subsequent appraisal reports may be necessary as dictated by prudent management policy. Examples requiring subsequent appraisal reports include the following situations:

- The marketplace suffers a decline.
- The property remains on the market for an extended time period.
- A change in the property or circumstances affects its sale or development.

Finally, you should perform, as appropriate, the examination procedures contained in Handbook Section 740, Real Estate Development, which also

provides guidance on assessing risk associated with REI.

ADDITIONAL SUPERVISORY CONSIDERATIONS AND REGULATORY REQUIREMENTS

As discussed above, a savings association's internal policies and procedures should address prudent standards for the acquisition and monitoring of equity investments. Internal controls include the plan, procedures, and records that management uses in making decisions, maintaining reliable financial records, and safeguarding assets. Savings associations and their subordinate organizations should monitor the adequacy of internal control systems. (Refer to Handbook Section 340, Internal Controls.)

For investments in real estate, for example, internal procedures should address the pre-acquisition analysis performed to support the investment decision. This includes obtaining valid appraisals and feasibility studies. It also includes the management oversight of various phases of real estate development or property management. In addition to guidance concerning specific equity investment authority, an assessment of the following considerations may be appropriate for determining the effect of equity investments on the savings association's financial condition.

Asset Concentrations

There are substantial limitations on the levels of permissible equity investments. Nevertheless, a concentration of such assets may present safety and soundness concerns. In assessing risk associated with asset concentrations, consider both loans to and equity investments in related entities.

There is a concentration if the savings association extends a substantial level of equity investments, loans, or guarantees of debt to the following:

- An individual
- An entity
- A project
- A group of borrowers or investors.

There is also a concentration if there is a relationship of common dependency or a common risk characteristic. A savings association may make equity investments in entities that are related in some manner. They share a common third-party investor or otherwise depend on the cash flow generated by a single operation or project. Section 560.32 limits a savings association's pass-through investments in the aggregate to 50 percent of capital. However, the savings association's overall exposure may include the amount of any loans, subject to applicable loans-to-one-borrower restrictions, to these entities or to individuals investing in such entities (for example, general partner or developer). Also, while a savings association's direct REI cannot, in the aggregate, exceed two percent of assets, a service corporation may invest up to three percent of assets in the same real estate projects. This amount is in addition to any loan authority available to the savings association or subordinate organization.

Savings association management should adequately address such equity investment concentrations through policies and procedures that minimize potential risk presented to the savings association. At a minimum, management should identify, monitor, and regularly report significant concentrations to the board of directors to provide a basis for board policy. Refer to Handbook Section 211, Loans to One Borrower, for additional guidance on assessing asset concentrations.

Internal Asset Classification Systems

Savings associations must periodically evaluate their equity investments and make any appropriate adjustments to the carrying value. You should consider relevant documentation supporting such values during the examination. Also, the savings association's and its subordinate organization's assets should reflect GAAP valuation standards. Finally, equity investments are subject to classification consistent with standards in 12 CFR §560.160 and related OTS policy. For guidance in this area, refer to Handbook Section 260, Classification of Assets.

Conflicts of Interest

Conflicts of interest occur when the interests of a savings association clash with the personal interest of individuals or the business interests of entities associated with the savings association. Each savings association should develop a policy on conflicts of interest and a code of conduct for their officers and other employees. The existence of such a policy is particularly important if a strong potential for conflict exists, such as, numerous REI involving affiliates. A savings association must prohibit a person involved in a particular conflict associated with a transaction from participation in the savings association's approval process. (Refer to Handbook Section 330, Management Assessment, for guidance on identifying potential conflicts of interest.)

Transactions with Affiliate (TWA) Rules

The TWA Rules contained in §§563.41 and 563.42 place quantitative and qualitative restrictions on loans and certain other transactions entered into by the savings association or its subsidiaries with affiliates. TWA regulations may affect REI or personal property transactions involving an affiliate or insider. (See Handbook Section 380.)

OTS Capital Treatment

Handbook Section 120, Capital Adequacy, contains guidance that will help you determine the treatment of various types of equity investments under OTS's capital rule contained in Part 567. The capital treatment for equity investments, for the most part, depends on the savings association's percentage ownership interest and whether the investment is permissible for national banks. Savings associations must deduct from capital for reporting purposes equity investments that are not permissible for national banks.

The actual capital calculations for deducting non-includable investments differ among equity investments that are subsidiaries (for example, majority-owned, control exists) and those accounted for under the equity or cost accounting method. Savings associations must deduct investments in (including loans to) non-includable

subsidiaries from core capital. In addition, savings associations must deduct other non-subsidiary equity investments not permissible for national banks from total capital.

OTS Reporting Requirements

The savings association's internal controls should ensure the proper reporting of equity investments in financial reports. These reports must also be in accordance with GAAP. Under OTS TFR instructions, there are three elements that determine the appropriate reporting for equity investments:

- The investment authority that the savings association relies upon.
- The savings association's percentage ownership interest.
- Whether the investment is permissible for national banks.

For example, a savings association would report investment in a non-consolidated subordinate organization under the equity or cost method of accounting on line item SC 50 of the Statement of Condition of the TFR.

The institution should consolidate the operations of a majority-owned subordinate organization(s) with the parent savings association on a line-by-line basis. However, institutions should report other permissible equity securities, for example, common and preferred stock including Freddie Mac and Fannie Mae stock and shares of mutual funds accounted for pursuant to SFAS No. 115, on SC 140 (Equity Securities except FHLB Stock). Savings associations should report FHLB stock on SC 690 (Other Assets). A savings association should report direct investments in real estate, including those held by consolidated subsidiaries on SC 45 (Real Estate Held for Investment). The TFR instructions provide additional guidance.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§1464(c) Investment Authority

§1468(a),(b) Affiliate Transactions

Part 567 Capital

Federal Deposit Insurance Act

Accounting Principles Board (APB) Opinions

§1828(m) Activities of Savings Associations and Subsidiaries

No. 18 Equity Method of Accounting for Investments in Common Stock

§1831e(c) Equity investments

No. 21 Interest on Receivables and Payables

Code of Federal Regulations (12 CFR)

Financial Accounting Standards Board, Statement of Financial Accounting Standards (SFAS)

FDIC Rules and Regulations

§303.13 Applications and Notices by Savings Associations

No. 34 Capitalization of Interest Cost

§303.13(d) Equity investments

No. 67 Accounting for Sales of Real Estate

No. 94 Consolidation of All Majority-Owned Subsidiaries

No. 115 Accounting for Certain Investments in Debt and Equity Securities

OTS Rules and Regulations

Part 559 Subordinate Organizations
§560.30 General Lending and Investment Powers

Other References

AICPA Audit and Accounting Guide, Banks and Savings Institutions

§560.32 Pass-through Investments

§560.36 De minimis Investments

§560.37 Real Estate for Office and Related Facilities

§560.41 Leasing

§560.93 Lending Limitations

§560.121 Investment in State Housing Corporations

§560.160 Asset Classification

§560.172 Re-evaluation of Real Estate Owned

§563.41 Loans and Other Transactions with Affiliates and Subsidiaries

§563.42 Additional Standards Applicable to Transactions with Affiliates

Equity Investments Program

Examination Objectives

To determine whether the savings association is correctly categorizing and valuing equity investments.

To evaluate the quality of equity investments and their effect on the financial condition and performance of the savings association.

To determine whether the savings association makes equity investments in accordance with applicable laws and regulations.

Examination Procedures

Wkp.Ref.

Level I

1. Obtain a list of the savings association's equity investments and review related examination scoping materials. *Note:* Evaluate the savings association's investments in subordinate organizations under separate examination procedures contained in Section 730. As necessary, obtain information relevant to this program from persons reviewing subordinate organizations.

Verify that the savings association properly categorizes equity investments. Ensure that equity investments comply with applicable statutory, regulatory or policy standards (for example, investment limits, activities restrictions).

2. Identify an equity investment or any concentration of equity investments that could have a significant effect on the savings association's overall financial condition taking into consideration the adequacy of valuations and internal asset classifications.

3. Assess the adequacy of the savings association's equity investment policies with consideration given to the following areas:
 - The acquisition and monitoring of equity investments, for example, risk/return analysis and objectives, appraisal policy, due diligence performed, tracking relevant economic indicators, projections versus investment performance.
 - Establishing carrying values consistent with GAAP, the savings association internal asset classification policy, and appropriate valuation allowances.

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Wkp.Ref.

- Accounting for equity investments on savings association financial reports; approaches for identifying and controlling risk for various categories of equity investment.
- Board of director's oversight. This includes the frequency of the review of policies and procedures. Does the board of directors require approval for equity investments that represent a certain percentage of capital, involve an affiliate or insider or present a potential conflict of interest?
- Compliance with applicable statutory, regulatory or policy standards.

4. For any REI, verify that management conducted an independent and complete evaluation of the project and the reputation of individuals involved, (for example, partners, members, developers), as well as their experience, expertise, and financial capabilities. (Do partners have the capacity to meet financial and other obligations? Can personal guarantees be enforced?)

5. Assess the adequacy of management's expertise in relation to the savings association's equity investment portfolio and related goals and objectives.

6. Analyze the savings association's future equity investment plans in relation to its business plan and overall condition.

7. For pass-through investments, confirm that the savings association appropriately limits the amount of its investment. Review a savings association's obligations stated in contracts, agreements, and other legally binding arrangements to ensure that the association's potential liability is limited to the amount of its investment. Provisions in such contracts, agreements, or arrangements would include the sharing of profits and losses among investors and additional funding requirements.

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Equity Investments Program

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8. Confirm that the savings association properly reports equity investments when calculating regulatory capital. (Refer to Handbook Section 120, Capital Adequacy, and the Thrift Financial Report Instructions for guidance.)
-

9. Review Level II procedures and perform those necessary to test, support, or present conclusions derived from performance of Level I procedures.
-

Level II

10. Identify any equity investments that involve a potential conflict of interest or circumstances in which any affiliate or insider (savings association officer, director, or major shareholder) has benefited directly or indirectly from the savings association's equity investment.
-

11. If weaknesses exist within internal accounting procedures, reconcile the savings association's current reported equity investments to an audited financial statement.
-

12. If REI are material, perform any appropriate and relevant procedures detailed in Handbook Section 740, Real Estate Development.
-

13. Ensure that the examination meets the *Objectives* of this Handbook Section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages. Update the continuing examination file, if applicable.
-

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Equity Investments Questionnaire

	Yes	No		Yes	No
General Questionnaire					
1. Does the thrift's asset review and classification program cover equity investments?			11. Does the institution reconcile ledgers for the individual REI properties to the general ledger at least monthly?		
			Frequency? _____		
2. If state chartered, is the thrift complying with statutory and regulatory investment limits under state law if more restrictive than federal limits?			12. Does the thrift maintain insurance coverage on REI including liability coverage where advisable?		
3. Does the thrift's internal audit program adequately cover equity investments?			13. Does the thrift maintain adequate control over REI rental income?		
4. Does the thrift adequately monitor compliance with its equity investment policies and procedures?			14. Are agents who collect REI rents and/or manage properties bonded?		
5. Does the thrift have definitive written investment plans for each equity investment?			15. Does the thrift properly control REI security deposits?		
6. Is the thrift complying with its investment plans?			16. Does the thrift maintain adequate control over all REI disbursements?		
7. Is the association in compliance with the statutory investment limits prescribed by the HOLA and FDIA?			17. Does the thrift physically inspect all REIs at least quarterly?		
8. Does the thrift apply the consolidation method to applicable EIs of operating subsidiaries for the purpose of determining its aggregate level of investments?			18. Has the thrift imposed limitations on the securities investment authority of officers? ..		
9. Are equity investment management reports and information systems adequately providing management and directors with decision-making information and the ability to monitor compliance with established guidelines?			19. Does the thrift require dual authorization of investment security transactions?		
10. Does the institution maintain records for each equity interest in a real estate investment (REI) parcel (e.g., showing capital items, expenses, rentals)? Are such files complete?			20. Do procedures preclude the custodian of the thrift's securities from:		
			• having sole physical access to security documents?		
			• preparing release documents without the approval of authorized persons?		
			• preparing release documents not subsequently examined or tested by a second custodian?		
			• performing more than one of the following transactions:		
			— execution of trades?		

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Equity Investments Questionnaire

		Yes	No			Yes	No
— receipt or delivery of securities?				trading and recordkeeping functions receive the periodic statements?			
— receipt and disbursement of proceeds?							
21. Does the thrift physically safeguard securities to prevent loss or unauthorized removal or use?				26. Does the thrift reconcile the periodic statements to all of the thrift's accounting records?			
22. Are registered securities held only in the name (or street name) of the thrift or subordinate organization?				27. Do persons who do not have direct, physical, or accounting control of accounts balance EI subledgers at least annually to the appropriate general ledger accounts?			
23. Do thrift and subordinate organization records of investment securities show all pertinent data describing the security, its location, pledged or unpledged status, premium amortization, discount accretion, and dividends declared or interest earned, accrued, and collected?				28. Do persons who do not have direct, physical, or accounting control of the assets prepare and post EI subledgers?			
24. Do periodic statements the thrift receives from securities brokers reflect:				If not, do persons who do not have direct, physical, or accounting control of the assets test the preparation and postings?			
• trading activity for the period?				29. Does the thrift maintain supporting documents for all entries to EI accounts?.....			
• open positions at the end of the period? .				30. Does management report acquisitions and dispositions of EIs to the board of directors?			
• market value of open positions?.....				31. Does the board of directors review EI policies at least annually to determine if they are compatible with changing regulatory restrictions and market conditions?			
• unrealized gains and losses?							
• cash balances in accounts?							
25. Does someone independent of both the							

Comments

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