Office of Thrift Supervision
Department of the Treasury
1700 G Street, N.W., Washington, D.C. 20552

Director

October 29, 1996

MEMORANDUM FOR: Chief Executive Officers

FROM: Nicolas P. Retsinas Nicolas P. Retsinas
Director

SUBJECT: Expanded Lending Authority for Federal Thrifts

When the President asked me to serve as Director of OTS on an interim basis, I was honored to accept because I believe thrifts are playing a vital role in providing credit to individuals, small businesses, and farms across America. My background is in housing and housing finance. I am currently Assistant Secretary for Housing — Federal Housing Commissioner at the Department of Housing and Urban Development (HUD). Prior to my appointment at HUD, I served as Director of Policy for the Governor of Rhode Island and as Executive Director of the Rhode Island Housing and Mortgage Finance Corporation.

Thus, I have witnessed firsthand dramatic changes in the markets for housing credit and other financial services, and understand the importance of providing thrifts with flexibility to respond to change. Many thrifts have expressed an interest in expanding their consumer, small business, and agricultural lending to better meet the needs of their communities. The OTS has supported, and during my tenure will continue to support, initiatives that provide thrifts with greater operating flexibility, consistent with safety and soundness.

In this regard, there are several significant legislative and regulatory developments to report. A brief summary of these important changes is presented here. More detail is provided in the attached staff paper.

Bad Debt Recapture Repeal. In August, Congress enacted the Small Business Job Protection Act of 1996. The Act revokes the authority of thrifts to use the reserve method of accounting for bad debts for tax years beginning after December 31, 1995. It also provides for gradual recapture of reserves that were established after January 1, 1988, while requiring no recapture for pre-1988 reserves, subject to certain exceptions and qualifications.

This legislation has advantages and disadvantages for thrifts. On the one hand, thrifts may no longer use the favorable reserve method of accounting for bad debts. On the other hand, to use this method of accounting and to avoid bad debt recapture, thrifts had to qualify as "domestic building and loan associations" by satisfying certain tax code lending restrictions. Although institutions should consult their own tax advisors, it appears that, with the repeal of the thrift bad debt provisions, the vast majority of thrifts will no longer have any significant tax or other regulatory reason to qualify as domestic building and loan associations. (A few exceptions are described in the attached OTS staff paper.) This will give thrifts substantially greater flexibility in structuring their asset portfolios because they now need only comply with the investment restrictions of the Home Owners' Loan Act (HOLA) and the qualified thrift lender (QTL) test. As noted below, these restrictions have also been significantly reduced.

HOLA Lending Reform. In September, Congress enacted the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The Act amends the investment restrictions that appear in § 5 of the HOLA and the QTL test that appears in § 10 of the HOLA. Now federal thrifts can originate credit card and educational loans without investment restriction or any adverse QTL consequences. Federal thrifts are also authorized to invest an additional 10% of their assets in loans to small businesses and farms, again without any adverse QTL consequences. This new authority is in addition to federal thrifts' existing authority to invest up to 10% of assets in commercial loans generally and up to 400% of capital in loans secured by commercial real estate.

To expedite implementation of these HOLA reforms, OTS plans to issue an interim final regulation before the end of November. At that time, thrifts will be able to utilize these new authorities.

Regulatory Reform. On September 30, 1996, the OTS published a final rule amending its lending regulations to reduce regulatory burden. Among other things, the final rule provides that the commercial loans of service corporations will no longer be aggregated with those of the parent thrift for purposes of computing the HOLA's commercial lending limits (described above).

Taken together, these statutory and regulatory changes enhance the lending flexibility of federal thrifts. As the attached staff paper explains, federal thrifts can now invest in consumer, small business, agricultural, and other business loans in amounts that are at least comparable (measured as a percentage of total assets) to the actual investments of most commercial banks in those loans. Federal thrifts that wish to operate more like community banks will be able to adjust their business to do so.

This does not mean that differences between banks and thrifts have been eliminated. The practical effect of the amended QTL test is to ensure that thrifts hold a significant percentage of their portfolio in consumer, small business, and mortgage loans. Banks are not subject to a QTL requirement. However, federal thrifts retain options not available to banks, such as broader powers for their holding companies and service corporations, more expansive branching, a single regulator at both the holding company and depository institution level, and broader federal preemption.

Institutions that expand their consumer, small business, agricultural, or other business lending must do so in a safe and sound manner. Once implementing regulations are in place, institutions planning any significant increase in these types of loans should prepare thorough business plans and acquire the necessary personnel and expertise. The OTS will monitor changes in lending activity, utilizing off-site surveillance and the on-site examination process.

The OTS is committed to ensuring that thrift institutions have the regulatory information they need to accurately assess their business options. Please do not hesitate to contact us if we can provide additional information.

We also remain committed to working with the Administration and Congress to further modernize federal depository institution charters so that all institutions can better meet the needs of their communities. As you know, the Economic Growth Act anticipates the merger of the bank and thrift deposit insurance funds in 1999 if no savings associations exist at that time. But the 1999 date in the Economic Growth Act is *not* a sunset date for the savings association charter. Unless further legislation is passed, the federal thrift charter will continue to exist indefinitely.

Given the unique operating flexibility provided by the federal thrift charter, especially now that federal thrifts have broader lending authority, we believe thrifts will continue to serve an important function in providing credit to families, farms, and small businesses. The OTS will strive to ensure that any reform legislation puts both thrifts and banks in a better position than they are today.

Staff Paper

The Federal Thrift Charter Going Forward

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Introduction

Many thrifts have expressed an interest in expanding their consumer, small business, and agricultural lending to better meet the needs of their communities. The goal of these thrifts is to provide the full range of services normally associated with community banks.[1] The OTS supports thrifts' efforts to meet community needs, provided such efforts are conducted safely and soundly and in accordance with applicable law.

As a result of the recent legislative and regulatory changes described below, federal thrifts that wish to function like community banks will be better able to do so, without giving up the favorable features of the federal thrift charter.

Traditionally, the consumer, small business, agricultural, and other commercial lending flexibility of federal thrifts has been constrained by three provisions of law: (i) the tax code "domestic building and loan association" ("DBLA") test that institutions had to meet to use the reserve method of accounting for bad debts and to avoid bad debt recapture; (ii) the qualified thrift lender (QTL) test; and (iii) the investment limits of § 5 of the Home Owners' Loan Act (HOLA).

The thrift bad debt provisions of the tax code were repealed in August with enactment of the Small Business Job Protection Act of 1996. The QTL test and HOLA § 5(c) were significantly amended in September with enactment of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 ("EGRPR Act"), which was part of the continuing resolution passed by Congress for fiscal 1997. In addition, in September OTS issued its final rulemaking streamlining its lending regulations. Taken together, these legislative and regulatory changes give federal thrifts substantial additional consumer, small business, and agricultural lending authority.

I. DBLA Test

For many thrifts, the DBLA test has been the most difficult of the three sets of investment requirements to meet. For example, the DBLA test gives no credit for mortgage loans that are originated and sold into the secondary market, whereas the QTL test does to a limited extent. Moreover, under the DBLA test, no subsidiaries may be consolidated with the parent thrift (even those that would have a positive impact on the computation), whereas thrifts are allowed to selectively consolidate subsidiaries for QTL purposes. In addition, under the DBLA test, at least 75% of a thrift's income must be derived from interest on loans. The QTL test contains no income test. Finally, under

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1 The OTS often receives inquiries regarding permissible corporate titles for federal thrifts. Many thrifts wish to promote greater community awareness of the broad range of services they offer by using the term "bank" in their corporate title. This is permissible. Moreover, federal thrifts are not required to use the terms "FSA," "FSB," "federal," or "savings." 12 C.F.R. § 543.1.

the DBLA test, consumer loans (except for education loans) are not qualifying assets. Consumer loans have always counted to a limited extent for purposes of the QTL test, even before the recent statutory amendments. As a result of these and other differences, many institutions have found the DBLA test more difficult to meet.

In the past, the primary incentive for thrifts to qualify as a DBLA was to use the favorable reserve method of accounting for bad debts and to avoid bad debt recapture. HOLA § 5(r) gave many thrifts another reason to meet the DBLA test.[2] Until enactment of the EGRPR Act, § 5(r) prohibited federal thrifts from branching interstate unless they either: (i) met the DBLA test in each state in which they branched and as a whole; or (ii) qualified for one of the exceptions listed in the statute. However, the EGRPR Act amended § 5(r) to give thrifts the option of meeting the QTL test in lieu of the DBLA test.[3] This change, combined with repeal of the special thrift bad debt provisions of the tax code, has rendered the DBLA test irrelevant for most thrifts. There are three exceptions.

First, under certain circumstances, a unitary holding company whose subsidiary thrift falls out of QTL compliance is permitted to continue the activities the holding company was engaged in on March 5, 1987, provided the subsidiary thrift continues to qualify as a DBLA and meets certain other requirements.[4] Very few, if any, holding companies are currently affected by this provision.

Second, the branching rights of federal thrifts that were acquired by bank holding companies in government-assisted transactions remain, under some circumstances, dependent upon meeting the DBLA test.[5]

Third, some tax code provisions still make reference to the DBLA test. Although none of these remaining provisions appear to provide a significant incentive for thrifts to elect to comply with the DBLA test, each institution should consult its own tax advisor.

Except where one of the foregoing exceptions applies, federal thrifts now need only look to the QTL test and to HOLA § 5(c), as amended, when developing their investment strategies.

II. QTL Test

Under the QTL test,[6] thrifts must hold "qualified thrift investments" equal to at least 65% of their "portfolio assets." Portfolio assets are defined by statute as total assets minus intangible assets, liquid assets, investments in office premises, and goodwill. For the typical thrift, portfolio assets constitute about 90% of total assets.

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2 12 U.S.C. § 1464(r).

3 EGRPR Act § 2303(f).

4 12 U.S.C. § 1467a(c)(6)(B) and (C). This provision applies to very few holding companies because, within a year of QTL failure, a thrift holding company is required to register as a bank holding company. Moreover, it is unlikely that a thrift that fails the QTL test will continue to qualify as a DBLA.

5 12 U.S.C. § 1823(k)(4).

6 12 U.S.C. § 1467a(m); and 12 C.F.R. §§ 563.50 - 563.52.

Before enactment of the EGRPR Act, "qualified thrift investments" (QTI) were defined in a manner that required every thrift to hold a substantial percentage of its portfolio assets in mortgage loans and mortgage-related securities. However, the EGRPR Act expanded the definition of QTI.[7] The key reforms are as follows:

- Small business loans (and loans to farms that qualify as small businesses) now count as QTI without restriction, to the extent such loans can be originated under HOLA § 5 or the state law equivalent.[8] Previously, small business loans counted as QTI only if originated in areas where the credit needs of low- and moderate-income persons were not being met.
- Credit card loans now count as QTI without restriction. Previously, all consumer loans (including credit cards) counted as QTI only in an amount up to 10% of portfolio assets.
- Education loans now count as QTI without restriction. Previously, these loans were grouped with consumer loans and subject to the 10% cap.
- Consumer loans (other than credit cards and education loans) now count as QTI in an amount up to 20% of portfolio assets. The previous limit, as indicated above, was 10% of portfolio assets.[9]

As a result of the foregoing reforms, savings associations will now be able to engage in substantial small business, agricultural, credit card, educational, and other consumer lending without having an adverse impact on QTL compliance.

III. HOLA § 5(c) Investment Limits

When structuring their portfolios, federal thrifts must also take account of the investment limits imposed by HOLA § 5 and its implementing regulations. Again, however, the EGRPR Act amended HOLA § 5 to give federal thrifts substantial additional lending flexibility. OTS also recently amended its lending regulations to remove regulatory impediments to lending flexibility.[10]

A. *Consumer Lending*

The EGRPR Act amended HOLA § 5 to clarify and confirm that federal thrifts are authorized to engage in credit card lending without investment restriction.[11] The Act authorizes the OTS to define the term "credit card" by regulation. The Act also amended the HOLA to permit education loans to be made without investment

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7 EGRPR Act § 2303.

8 As discussed below, HOLA § 5 now imposes a 20%-of-assets cap on small business loans.

9 When computing this 20% cap, consumer loans must still be aggregated with certain other categories of loans and investments that are also subject to the 20% cap, e.g., loans for the purchase of community service facilities, home loans sold into the secondary market, Fannie Mae and Freddie Mac stock, and so forth. 12 U.S.C. § 1467a(m)(4)(C)(iii) and (iv).

10 61 Fed. Reg. 50951, 50971 (September 30, 1996) (to be codified at 12 C.F.R. Part 560).

11 EGRPR Act § 2303.

restriction.[12] Previously, education loans were limited to 5% of total assets. Finally, federal thrifts are also authorized to make other consumer loans in an amount up to 35% of total assets.[13] Credit card loans and education loans do not count against this 35% cap.

As the tables in Appendices A and B indicate, the amount of consumer lending now permitted under HOLA § 5 compares quite favorably to the actual percentage of assets that most commercial banks invest in consumer loans.

B. *Small Business, Agricultural, and Other Commercial Lending*

The EGRPR Act also amended HOLA § 5 to expand the small business and agricultural lending authority of federal thrifts.[14] Federal thrifts have long been authorized to make loans secured by business or agricultural real estate in amounts up to 400% of capital,[15] and to make additional loans to businesses and farms (which may, but need not, be secured by real estate) in amounts up to 10% of total assets.[16] The EGRPR Act left the 400% real estate lending cap intact, but increased the 10% cap to 20%. However, all loans in excess of the 10% cap must be made to small businesses and farms that qualify as small businesses. The EGRPR Act authorizes the OTS to define the term "small business" by regulation.

In addition, OTS recently amended its lending regulations to facilitate additional small business, agricultural, and other commercial lending by thrift service corporations. Federal thrifts have long been authorized to invest up to 2% of their assets in service corporations, plus an additional 1% in service corporations engaged in community development.[17] Only the book value of the parent thrift's investment in the service corporation (including any guarantees or nonconforming loans[18] from the parent) counts against the 2% investment limit, regardless how large the service corporation might grow over time by reinvesting its profits and leveraging its capital. Pursuant to the final lending rule that was recently issued by OTS and will become effective October 30, 1996, commercial loans made by service corporations will no

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12 Id.

13 12 U.S.C. § 1464(c)(2)(D). For these purposes, consumer loans are aggregated with investments in commercial paper and corporate debt securities. In other words, consumer loans, commercial paper, and corporate debt securities, in the aggregate, cannot exceed 35% of assets.

14 EGRPR Act § 2303.

15 12 U.S.C. § 1464(c)(2)(B). Loans secured by a combination of farm residences and farmland are classified as residential real estate and, thus, are not subject to the 400% limit. Loans secured by farmland without any residences are subject to the 400% limit. 12 C.F.R. § 541.23.

16 12 U.S.C. § 1464(c)(2)(A). OTS regulations provide that, when an investment qualifies under more than one investment provision, a thrift may choose under which provision the investment is made. For example, a loan secured by commercial real estate could be made under either the commercial real estate lending provision, HOLA § 5(c)(2)(B), or the general commercial lending provision, HOLA § 5(c)(2)(A).

17 12 U.S.C. § 1464(c)(4)(B); and 12 C.F.R. § 545.74.

18 Conforming loans do not count against the 2% to 3% limit, but do count against the 20% commercial lending limit. 61 Fed. Reg. 29976, 29980-29981 and 29982 (June 13, 1996).

longer count against the commercial investment limits of the parent thrift.[19] In other words, commercial loans made by service corporations will not count against the 20%-of-assets and 400%-of-capital limits described above.

Finally, under the HOLA, federal thrifts are also permitted to hold loans fully guaranteed by a federal government agency without investment restriction.[20] Thus, when originating or investing in loans guaranteed by the Small Business Administration or the Farmers Home Administration, only the unguaranteed portion of those loans counts against a federal thrift's limits on business and agricultural lending.

As the tables in Appendices A and B indicate, the amount of small business, agricultural, and other commercial loans permitted under the foregoing authorities compares quite favorably to the actual percentage of assets that most commercial banks invest in commercial loans of all types.

IV. Overview of Key Regulatory Parameters for the Federal Thrift Charter

- **Lending.** Thrifts must comply with the HOLA and QTL lending restrictions described above. However, as recently amended, those restrictions do not prevent federal thrifts from investing in consumer, small business, agricultural, and other business loans in amounts that are at least comparable (measured as a percentage of total assets) to the actual investments of most commercial banks. Thus, as a practical matter, the primary difference between thrifts and banks is that thrifts, by virtue of the QTL test, must hold a substantial portion of their portfolio in mortgage, consumer, and small business loans, whereas banks have greater leeway to invest in other assets. In other words, thrifts are required by law to function as community banks, reinvesting a substantial portion of their funds in loans to individuals and small businesses.
- **Holding company powers.** Thrifts can generally affiliate with holding companies engaged in any line of business, including insurance sales and underwriting, securities brokerage and underwriting, real estate brokerage and development, and other commercial enterprises.
- **Service corporation powers.** Federal thrift service corporations are authorized to engage in any activity OTS deems reasonably related to the business of thrifts. For example, thrift service corporations can engage in real estate development, provided appropriate capital reserves are established. In addition, thrift service corporations can sell insurance without being subject to the town-of-5,000 limitation applicable to banks. However, thrift service corporations are subject to any state laws prohibiting insurance sales by depository institutions.

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19 See 61 Fed. Reg. 50951, 50957-58 (September 30, 1996). However, loans of a service corporation are aggregated with those of the parent for purposes of determining compliance with the loan-to-one borrower (LTOB) limits. Thus, the aggregate amount of loans that a thrift and all of its subsidiaries make to a single borrower cannot exceed the LTOB limits. 12 U.S.C. § 1464(u).

20 12 U.S.C. § 1464(c)(1)(C) and (F).

- **Branching.** Federal thrifts are authorized to branch both interstate and intrastate free from state law restrictions. As indicated above, when branching interstate, a thrift generally must either comply with the QTL test in each state and as a whole or qualify for one of the statutory exceptions.[21]
- **Single Regulator.** Federal thrifts and their holding companies are both regulated by a single regulator, the OTS.
- **Federal Preemption.** In key areas such as lending, federal thrifts are subject to less state regulation than commercial banks.[22]

In contrast, the powers of bank holding companies and bank service corporations are more limited, and while national banks have a greater ability to branch interstate than in the past, they are still subject to state restrictions on a number of branching issues.[23]

For additional information contact: Kevin Petrasic, Counsel, (202) 906-6452, or Dorene Rosenthal, Counsel, (202) 906-7268.

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21 12 U.S.C. § 1464(r), as amended by § 2303(f) of the EGRPR Act.

22 For example, compare 12 C.F.R. § 560.2, as set forth at 61 Fed. Reg. 50951, 50972 (September 30, 1996) (federal thrift lending preemption), to 12 C.F.R. § 34.2 (national bank lending preemption).

23 For example, effective June 1, 1997, national banks will be able to branch interstate via merger acquisitions, but not in states that opt out of the Interstate Branching and Banking Efficiency Act of 1994 (IBBEA). Moreover, the IBBEA does not apply to interstate de novo branching or to any type of intrastate branching. Thus, national banks are still subject to state restrictions on intrastate branching and interstate de novo branching.

FEDERAL THRIFT CONSUMER AND COMMERCIAL LENDING

Type of Loan	HOLA Investment Limits	Average Commercial Bank Investment
Federal thrift consumer lending:		
Credit cards	No limit	12.2% of assets
Education loans	No limit	
Other consumer loans	35% of assets	
Federal thrift agricultural, small business and other commercial lending:		
Loans secured by business or agricultural real estate	400% of capital	6.5% of assets
Guaranteed portion of SBA and FmHA loans	No limit	15.6% of assets [2]
Other business and agricultural loans	20% of assets, provided any over 10% are to small businesses, plus 2% to 3% in service corporations. [1]	

1/ Only the book value of the parent thrift's investment in the service corporation (plus any guarantees and nonconforming loans from the parent) count against the 2% to 3% service corporation investment limit, regardless how large the service corporation might grow over time by reinvesting its profits and leveraging its capital. Thus, the actual amount of business and agricultural loans originated by a service corporation could significantly exceed 2% to 3% of the parent thrift's assets.

2/ Approximately 35% of commercial bank assets are invested in consumer and commercial loans of all types. Under the QTL test, as amended, federal thrifts could invest 35% or more of their assets in consumer and commercial loans while maintaining QTL compliance.

COMMERCIAL BANK LENDING BY HOLA CATEGORY

FDIC-Insured Comercial Banks by Asset Size

	All FDIC-insured commercial banks	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Over $10 billion
Number of institutions	9,689	6,469	2,816	331	73
Total assets ($B)	4,397	290	681	1,001	2,425
Commercial loans ($B)	685	28	73	139	446
Percent of assets	15.6%	9.5%	10.8%	13.9%	18.4%
Commercial real estate loans ($B)	286	25	81	83	98
Percent of assets	6.5%	8.5%	11.9%	8.3%	4.0
Loans to individuals ($B)	538	26	76	188	248
Percent of assets	12.2%	8.9%	11.1%	18.7%	10.2%
Total residential mortgages ($B)	672	50	135	174	313
Percent of assets	15.3%	17.4%	19.8%	17.3%	12.9%

Source: Quarterly Banking Profile, 1996:Q2, pages 6-7.

Commercial real estate loans = total commercial real estate loans - commercial real estate loans not secured by real estate.

THRIFT LENDING BY HOLA CATEGORY

FDIC-Insured Thrifts by Asset Size

	All FDIC-insured thrifts	Less than $100 million	$100 million to $1 billion	$1 billion to $10 billion	Over $10 billion
Number of institutions	1,981	881	943	120	37
Total assets ($B)	1,023	46	277	245	455
Commercial loans ($B)	13	1	4	5	4
Percent of assets	1.3%	1.3%	1.6%	1.9%	0.9%
Commercial real estate loans ($B)	50	2	18	15	15
Percent of assets	4.9%	5.0%	6.4%	6.2%	3.3%
Loans to individuals ($B)	42	2	11	12	18
Percent of assets	4.1%	4.2%	3.8%	5.0%	3.9%
Total residential mortgages ($B)	546	25	142	119	259
Percent of assets	53.3%	54.9%	51.3%	48.6%	57.0%

Source: Quarterly Banking Profile, 1996:Q2, pages 12, 14.