INTRODUCTION

Loan portfolio diversification is a means of controlling credit risk through the allocation of loan funds among different industries, borrower groups, and locations. Diversification can protect a thrift from loss due to regional economic recession, failure of a critical industry, or any factor affecting a group of loans having similar risk characteristics. Diversification by exchange of assets, such as mortgages for securities, or by adding a new loan product, opening a new marketing territory, or otherwise expanding to new prudent lending areas may present better opportunity for profit than traditional lending. Diversification may enable a thrift to:

- Take advantage of operational and marketing synergies;
- Use staff, data processing, advertising, and other resources more efficiently;
- Open up additional profit potential in new markets (which can be especially important if the thrift is facing a saturated market); and
- Avoid the dangers of credit concentration.

CREDIT CONCENTRATIONS

In risk analysis, a concentration is a significantly large volume of assets that a thrift has advanced or committed to an individual or a group of borrowers related by a common dependency or a common risk characteristic. For example, in a concentration, borrowers may be engaged in, or dependent upon, one industry; or loans may have been originated in one geographic location, or purchased from a single source, regardless of the number of borrowers or loans. The common characteristic in a concentration may be high loan-to-value ratios or it may be similar collateral. Purchased mortgage servicing rights (PMSR) may be a concentration. In concentrations, weaknesses in a common factor can adversely affect many loans.

In addition to assets such as outstanding loans, securities, and deposits, concentrations include unfunded legally binding loan commitments and letters of credit. Such obligations, if not monitored and controlled by management, can expose the thrift to unnecessarily large risk through concentrations. Refer to the definition of *Concentration of Credit* in the glossary for additional details.

Assets with a common dependency should be recognized as a concentration if they exceed 25% of core capital and general valuation allowances (see TFR), or exceed 2% of total assets when the institution is undercapitalized. Special circumstances, such as when a concentration has an especially high risk of loss, may warrant a stricter standard, such as 1% of assets.

All concentrations are not inherently objectionable. Some credit concentrations are desirable, for example: home purchase loans when diversified by location or payment sources. Also, if they are properly controlled through underwriting standards, concentration of credit may allow a thrift to take advantage of special staff expertise or available demand.

Thrift management should identify concentrations and assess their size and individual risk so policies and plans can be adjusted accordingly. At a minimum, management should identify, monitor, and regularly report significant concentrations to the board of directors to provide a basis for board policy.

Regulators should monitor concentrations and should conduct a more in-depth periodic review of them than of diversified areas of the loan portfolio. Regulators should evaluate management's control of concentrations and use of diversification to limit or prevent excessive risk of loss. Concentrations of assets with abnormally high risk of loss should be considered for adverse classification and be considered in determining the adequacy of valuation allowances. (See Thrift Activities Handbook Section 261, Adequacy of Valuation Allowances.)

If findings merit report comments, regulators must carefully justify their analyses and conclusions. Regulators should point out to thrift management that extending or committing additional credit to a concentration of risky assets is an unsafe and unsound practice. When concentrations present an unacceptable risk, greater attention to diversification of assets should be recommended to management. For unavoidable concentrations, strict underwriting standards should be followed to limit credit risk.

Thrift Policies

Occasionally, regulators will encounter a thrift without diversification policies and plans. Under such circumstances, regulators should recommend the establishment of minimum standards for monitoring concentrations, such as monthly concentration reports to the board of directors. Diversification policies and strategies should be written and implemented when the need is shown by the monitoring reports.

The thrift's written policies should address loan portfolio diversification and concentration of credit. Diversification may also be addressed in the board of directors minutes, the thrift's lending or risk management policies, and the strategic plan.

A diversification policy should contain quantified goals and objectives wherein the composition of loan portfolio mix and limits in dollar amount or percentage of assets are established for each loan category. The policy must not be overly restrictive; it must be flexible enough to allow timely reaction to changing conditions in a thrift's asset mix, its servicing area, and local, national, and international economies.

It is essential that the policy address various types of concentrations of credit, including geographically, industrially, or economically related individuals or other groups of related borrowers. In addition, the policy should establish limits for loans with similar collateral such as office space, warehouses, shopping centers, nursing homes, apartments, and land development.

The policy should limit the total amount of purchased loans and limit loans purchased from, or serviced by, each seller or servicer. Overreliance on one source for purchased loans or servicing exposes the thrift to operations risk as well as credit risk and should be avoided.

The policy should elaborate on how quantified objectives will influence the control of credit risk. This policy should stress that underwriting standards for purchased loans and participations must be the same as for thrift-originated loans. Complacency (the purchaser's dependence on the originator for underwriting without the purchaser using audit verification for compliance with strict standards) is an unacceptable practice.

Diversification Strategy

After the thrift has set quantified goals and objectives for diversification, it must develop a written strategy to achieve these objectives. The strategy should address each loan type for the loan portfolio.

Management must monitor economic and financial conditions of geographic locations, industries, and groups of borrowers in which a thrift has invested heavily. Management must change strategies as conditions warrant. For example, changes in directorship or control, demography (the age, income, or size of a population), regulations, and the thrift's goals and objectives may affect a thrift's diversification strategy.

Often, a thrift's unique characteristics will affect diversification. For example, a thrift's location may restrict diversification in originations; the local economy may depend on one major industry or employer; the thrift may lack management expertise or adequate staffing to purchase and service out-of-territory loans and participations. Inexperienced officers or employees may limit or delay the implementation of new lending strategies. Marginal liquidity or funding may restrain diversification. A small thrift may have insufficient resources to start up a new loan product or market.

If regulations or the thrift's unique characteristics inhibit diversification in the origination of assets, the sale or exchange of assets may facilitate diversification into permissible areas. When concentrations are unavoidable, more diligence in monitoring and controlling related risk is necessary, and additional capital may be required for the safety and soundness of the thrift.

PARTICIPATIONS

Loan participating as a seller (lead) or buyer (participant) can facilitate diversification of loan portfolios. Loan participating is the buying and selling of shares of loans, usually denoted as a percentage interest in principal and interest. Participation loans are often originated with contractually committed participants. Large loans are also participated after origination and funding in order to diversify a portfolio and provide liquidity.

A participation should be covered by a detailed participation agreement. The agreement should set all terms, conditions, and understandings between and among the lead lender and participants. Participation agreements typically establish the sharing of payment proceeds, expenses, losses, and servicing responsibilities and rights.

For each participation bought or sold, each lead and each participant should be aware of contingent liabilities from both contractual and fiduciary duties and the rights and obligations of each party concerning servicing under various circumstances. For this reason, participation agreements and loan documentation should be structured with legal counsel on behalf of the interests of each participant and the lead. Additionally, § 563.170(c)(6) of the regulations requires a legal opinion on whether a participation loan is sold with or without recourse.

Until the 1980s, participations were often regarded as the best loans in a lender's portfolio. Participants often (to the consternation of regulators) accepted the word of the lead lender that the loans were of excellent quality with very low risk of loss. Lead lenders staked their considerable reputations on the quality of participations sold.

In the early 1980s this situation changed dramatically as banks and thrifts experienced extreme liquidity and earnings problems. Some lenders, in desperation (sometimes fraudulently), sold participations in weak loans and securities, sometimes using devious sales techniques. In some cases, leads sold all interests in the loans, retaining only servicing. Unwary participants had to absorb losses, which were unanticipated because of inadequate participation documents, poor loan documentation, and faulty servicing.

In many cases lead lenders, who had previously enjoyed admirable reputations, experienced capital failure, leaving the servicing and liquidation of participated loans to be decided in litigation among participants and, too often, their receivers. Inadequate participation documentation has resulted in participants being deemed by courts as unsecured creditors of an insolvent lead rather than owners of an undivided interest in a loan.

Participation lending and investing involves both credit and fiduciary risk and requires due diligence on behalf of all parties. Safety and soundness requires each lender (lead or participant) to:

- thoroughly analyze proposed participation loans for credit quality and compliance with laws and regulations;
- maintain complete and current document and credit files;
- the documentation requirements of § 563.170 of the regulations apply to both leads and participants.)
- independently assess primary and secondary sources of repayment; and
- stay aware of conditions affecting the collectibility of the loan.

Each lead must:

- fully disclose current status and pertinent findings to participants to avoid liability for fiduciary irresponsibility in the event of default;
- avoid the appearance of conflicts of interest with those of the participants; and
- scrupulously comply with all terms of the participation agreement.

Additionally, each participant should obtain and independently analyze information on the current status of the borrower, such as is provided in credit reports, and make site inspections where appropriate. When a lead or a borrower exhibits credit problems, participants should take defensive legal actions to protect their interests.

LEGAL LIMITS TO INVESTMENTS

The Home Owners' Loan Act (HOLA) at 12 USC § 1467a(m) and § 584.6 of the Regulations for Savings and Loan Holding Companies require thrifts to meet the Qualified Thrift Lender test or face specified consequences. As the result of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), effective December 19, 1991, savings associations will qualify their status as Qualified Thrift Lenders if the association's actual thrift investment percentage (ATIP) equals or exceeds 65% for 9 out of the last 12 months. The calculation of the ATIP is done by dividing the amount of a savings association's qualified thrift investment (QTI) by the association's portfolio assets. Included as a part of an association's QTI is qualifying real estate owned (REO), defined as REO that would otherwise constitute QTIs. (For additional information see Thrift Activities Handbook Section 270, Qualified Thrift Lender Test.)

The Federal Deposit Insurance Act (FDIA) at 12 USC § 1831e provides that state thrifts may not engage in activities not permitted for federal thrifts unless the state thrifts comply with the fully phased-in capital requirements of HOLA and the FDIC has determined that the activity would pose no significant risk to the deposit insurance fund. The FDIA prohibits state thrifts from acquiring or retaining equity investments not permitted for federal thrifts. Divestiture of nonconforming equity investments by all thrifts is required as quickly as can be prudently done by July 1, 1994. The FDIA at § 1831e(d) prohibits acquisition and retention of junk bonds (as defined therein) and requires divestiture as quickly as can prudently be done by July 1, 1994. The related FDIC rules and regulations are found at 12 CFR § 303.13. For more discussion of these subjects refer to Thrift Activities Handbook Section 220, Investment Securities, and Section 230, Equity Investments.

The HOLA at 12 USC § 1464(c) provides investment authorities and limits for federal thrifts. The FDIA applies the federal limits to state thrifts. The OTS has further limited some investment authorities. For example, § 545.35(b) of the regulations limits aggregate loans on nonresidential real estate to 400% of total capital (risk-based capital) and § 545.46 limits aggregate commercial-purpose loans to 10% of assets. (Note: at § 1464 Note (a) the HOLA provides that the limits of § 1464(c) do not require divestiture of nonconforming loans and investments that were lawful under § 1464(c) when made.) Refer to other sections of this Handbook related to specific asset types.

The HOLA further limits all thrift lending to one borrower at 12 USC § 1464(u). Section 545.75 includes commercial paper and corporate debt securities with loans in applying the loans-to-one-borrower limits of § 563.93.

LOANS TO ONE BORROWER LEGAL LENDING LIMITS

Section 301 of FIRREA, which added § 5(u) to the HOLA (12 USC § 1464(u)), effective August 9, 1989, provides that § 5200 of the Revised Statutes (12 USC § 84) shall apply to thrifts in the same manner and to the same extent as it applies to national banks. The limits of 12 USC § 84 are implemented by the Office of the Comptroller of the Currency (OCC) in 12 CFR § 32, which relies upon capital and surplus as defined in 12 CFR § 3.100. (Note this exception: 12 CFR § 32.7 does not apply to thrifts.) FIRREA also provides Special Rules that permit loans up to $500,000 for any purpose, and provide different limits for loans to develop domestic residential housing units.

Section 563.93 of the regulations incorporates the loan limits for national banks, providing more stringent rules where necessary. The rule provides more detailed regulatory implementation of statutory requirements for Special Rules and other provisions; it provides that a thrift's investment in the commercial paper and corporate debt securities of one issuer shall be subject to the loans-to-one-borrower (LTOB) limit, and it establishes a separate limit for investment by a thrift in certain highly rated debt obligations.

The general limit for loans to one borrower is 15% of a thrift's unimpaired capital and unimpaired surplus as calculated under national bank accounting guidelines (hereafter designated as LTOB capital and surplus). The limit for loans fully secured by readily marketable collateral (that is, actively traded securities) is an additional 10% of LTOB capital and surplus. (The use of the additional 10% assumes compliance with the 15% limit.) A thrift may also invest up to another 10% of its LTOB capital and surplus in one issuer's commercial paper (if it is rated in the highest category by at least two nationally recognized rating services) or corporate debt securities (if they are rated in the two highest categories by a nationally recognized rating service). These limits are the maximum legally permissible for thrifts; safe and sound operation may dictate that thrifts follow lower, more prudent limits.

The rule applies, in large measure, the lending limit regulations and codified interpretations of the OCC under 12 CFR §§ 32 and 3.100. The OTS will give substantial weight to the OCC's noncodified legal opinions interpreting the national bank lending limits, and will regard them as strong evidence of safe and sound banking practices, but the OTS regards these opinions as advisory only.

Section 563.93 of the regulations applies to loans and extensions of credit made by a savings association and its subsidiaries. This section does not apply to loans made by a savings association to its subsidiaries or to its affiliates. The terms subsidiary and affiliate have the same meanings as those defined in section 563.41.

In applying regulations, regulators should generally follow the principle that when a loan is legal when made, it stays legal even if it becomes nonconforming; and if illegal when made, it stays illegal, even if it becomes conforming.

Exceptions

The HOLA at 12 USC § 1464(c) specifically authorizes unlimited investment authority in specified debt and equity issues of FNMA, FHLMC and the Federal Home Loan Banks. Such specified investments are not limited by § 563.93. Section 563.93(a) exempts loans to all affiliates and subsidiaries.

Congress, in 12 USC § 84, lists 10 exceptions. The OCC further explains these exceptions in 12 CFR § 32.6. Section 32.6(e) provides that loans to or guaranteed by a federal agency are not subject to the lending limits. Section 32.102(b) provides that sales of fed funds with a maturity of one business day or sold under a continuing contract allowing cancellation without prior notice are not "loans and extensions of credit" for lending limit purposes. Neither are deposits. (Fed funds, deposits, and hedged securities are conditionally limited by § 563.96. Sales of fed funds with a maturity of more than one business day are also subject to the § 563.93 lending limits.) The OCC's regulation at § 32.108 provides that the lending limits do not apply to accrued or discounted interest.

LTOB Capital and Surplus

Because bank and thrift accounting are different, the LTOB limits cannot always be calculated from the TFRs. The rule defines "unimpaired capital and unimpaired surplus" as the definition of "capital and surplus" in 12 CFR § 3.100 and requires bank accounting standards as found in the Federal Financial Institutions Examination Council (FFIEC) bank call report instructions. The calculation of LTOB capital and surplus is done according to OCC bank reporting requirements when materially different from OTS thrift reporting requirements. The OCC's regulations define the term "capital and surplus" to generally mean GAAP capital plus general allowances for loan losses with several adjustments and limits.

The capital transition rule for intangible assets in § 3.3 applies to all intangible assets (other than PMSR) - such as core deposit intangibles, goodwill, and favorable leaseholds - only as they meet the requirements of § 3.3. A thrift must have purchased the intangible asset prior to April 15, 1985 and accounted for it in accordance with OCC guidance for banks before including the asset in its calculation of the LTOB limits. In general, OCC guidance provides that intangibles must be amortized over the estimated average life or the actual life per GAAP, provided that the amortization period cannot exceed 15 years (irrespective of thrift accounting). If these requirements are met, the intangible asset may be included in LTOB capital and surplus in an amount not to exceed 25% of the sum of items listed in § 3.100(a) and (c)(1). PMSR and other intangibles may not exceed the balances computed under OCC standards irrespective of book values. Refer to Appendices A and B of this Handbook section for additional guidance.

Under § 563.93, the amount of a thrift's LTOB capital and surplus must be calculated as of the thrift's most recent periodic report (quarterly) required to be filed with the OTS prior to the date of granting or purchasing the loan or otherwise creating the borrower's obligation to repay funds. If the level of LTOB capital and surplus has changed by a material amount, subsequent to the filing of the report, the changes must be included in a new calculation.

One Borrower

For a definition of "one borrower" the rule references the OCC's definition of the term "person" as stated in 12 CFR § 32.2(b) and includes the term "financial institution" as presently defined at § 561.19. This is "any bank or savings association" as defined in the FDIA at 12 USC § 1813.

The loans and extensions of credit to one person are attributed to other persons when the loans or extensions of credit are used for the "direct benefit" of the other persons, or when a "common enterprise" is deemed to exist between such persons per § 32.5 of the OCC regulations.

Loans to partnerships are always attributed to the general partners, but the direct benefit test or common enterprise test must be met for partnership loans to be attributed to limited partners.

Debt guaranteed by a person is attributed to the guarantor if it meets either of these tests or if the guarantor has become an obligor under the terms of the guarantee. When loans to one borrower exceed the limits due to debts attributed to the borrower as guarantor only because of default, the debts are deemed legal but nonconforming and they prevent additional legal commitments or loans from being made to the guarantor.

Recordkeeping

If a thrift or operating subsidiary makes a loan to any one borrower, of an amount more than the greater of $500,000 or five percent (5%) of capital and surplus, the records of the lender shall include documentation showing that the loan was made within the LTOB limits. For such documentation the lender may require, and may accept in good faith, a certification by the borrower identifying the persons, entities, and interests described in the definition of one borrower.

Prudent loan underwriters may wish, however, to document compliance with the legal lending limits for all significant loans, even loans for amounts less than the aforementioned thresholds. Thrifts should document and explain any adjustments made between thrift accounting and bank accounting used in computing the LTOB limits. Such documentation facilitates review by regulators as well as aiding the thrift in assuring compliance with the regulation.

Loans

The term "loans and extensions of credit" is defined as any direct or indirect advance of funds, originated or purchased, including obligations of makers and endorsers arising from the discounting of commercial paper, to a person (borrower) per 12 CFR § 32.2(a). This includes charged-off loans, but not loans rendered legally unenforceable under bankruptcy or other reasons. Under § 563.93 of the regulations, a thrift must add any loans it has made to a borrower with any corporate debt securities and commercial paper held by the thrift that were issued by the same borrower and the aggregate amount is subject to the thrift's general limits.

Commitments

Historically, a loan commitment was not deemed by the OCC to be "made" until funded. Banks encountered difficulty if they entered into a commitment within the lending limits (underline commitment) but experienced a drop in capital in the intervening period before the commitment was actually funded. Because the historical approach required that the lending limits be applied when the loan was "made," and it was not "made" until the later date of funding, the lower lending limit reflecting the capital drop would apply. Section 32.2(d) of the OCC regulations remedies this problem by permitting underline commitments to be deemed "made" when entered into. Thus, by treating such commitments as having been "made" prior to the drop in capital, the higher lending limit would apply.

The OTS views the expiration of an unfunded or partially funded loan commitment, or any restructuring of the commitment, as an opportunity for a thrift to bring the loan commitment into conformance with the thrift's current lending limit. Thus, where a thrift has entered into and funded or partially funded a loan commitment that was within the thrift's lending limit when made, and the thrift's lending limit subsequently declines, the thrift may renew that portion of the loan commitment that has been funded as a legal, although nonconforming, term loan. An unfunded loan commitment, or the unfunded portion of any loan commitment, which would exceed the thrift's lending limit if made on the date of the renewal, may not be renewed legally.

Thrifts may advance additional funds to a borrower pursuant to a legally binding loan commitment (written or unwritten) that was within the thrift's lending limit when made. It is incumbent upon the thrift to establish, either by a written agreement or by other file documentation, that a commitment represents a legally binding commitment to fund. If doubt exists as to the legally binding nature of the commitment, the thrift must have a well-reasoned opinion of counsel that firmly concludes that the commitment is legally binding.

In general, loan commitments for which the prospective borrower has paid no fee to the thrift are presumed to be not legally binding. Such agreements typically contain broad provisions permitting the lender to decline to fund on subjective grounds that, in effect, render the commitment unenforceable. This presumption may be proven wrong with convincing evidence such as a legal opinion.

When a thrift is confronted with a request for a binding commitment that may exceed the lending limit now or in the future, prudent lending practice dictates that the thrift take precautions to permit escape from such a dilemma. Such actions include a protective clause in the commitment that would release the thrift from its obligation if funding the loan would result in a loan amount in excess of the legal limit (an overline).

Section 32.2(f) created a new class of legally binding loan commitments for national banks - "qualifying commitments to lend." A qualifying commitment to lend is a binding written commitment to lend that, when combined with all other outstanding loans and qualifying commitments to the borrower, is within the bank's lending limit on the date of the commitment and that has not been disqualified. A "disqualified" commitment to lend is created in the following manner: If a bank makes a loan or extension of credit that causes the bank to exceed its lending limit when the new loan amount or extension of credit is combined with all other outstanding loans and legally binding loan commitments, the unfunded commitments become "disqualified" loan commitments. These newly "disqualified" loan commitments can only be funded if, at the time of funding, the additional loan amount, when added to the total amount of loans and qualifying loan commitments outstanding, is within the institution's LTOB limit. Thus, unlike other legally binding loan commitments, disqualifying loan commitments cannot automatically be funded at latter dates. OTS allows savings associations to use this authority providing associations include in their commitments a clause that releases them from the obligation to fund the commitment if funding would cause a LTOB violation.

Renewals

The renewal of a loan does not constitute a new loan for lending limit purposes provided no new funds are advanced by the thrift to the borrower and a new borrower is not substituted for the original obligor. The renewal of a nonconforming loan presents an opportunity to the thrift to bring the loan into conformance with the lending limits. This includes attempting to have the debtor partially repay the nonconforming loan or obtain another institution's nonrecourse participation in the loan to bring it into lending limit compliance. Thus, the thrift must make and document best efforts to bring the loan into conformance prior to renewal. If these efforts are unsuccessful, the thrift may renew, restructure, or modify the nonconforming loan, provided that there is no substitution of borrowers or additional advance of funds. Circumstances that indicate a deliberate purpose to evade the law and to extend unauthorized lines of credit are to be deemed violations of the statutory limits made applicable by FIRREA, thus exposing the directorate to liability.

Upon the expiration of a partially funded loan commitment, only the funded portion may be renewed if this amount exceeds the thrift's lending limit and only if best efforts were first made to bring it into compliance. This renewed portion shall then be treated as a legal, although nonconforming, term loan. If the borrower subsequently repays a portion of the outstanding balance owed to the thrift, new funds may not be advanced (or re-advanced) to the borrower until the outstanding balance of the loan is brought within the thrift's lending limits.

Loans to Facilitate Sales

OTS policy concerning sale financing for any assets is identical to that of the OCC. A purchase money note with no advance of funds is not a "loan" for lending limit purposes. In sales financing, only advances of new funds are "loans" subject to the limits of § 563.93. OTS does not object to sale financings that do not involve an advance of funds nor place the lender in a more risky situation, provided the sale is not to the borrower who defaulted on a loan that resulted in the thrift owning the asset in question.

Use of Salvage Powers to Exceed Loans to One Borrower Limitations

It has long been the position of the OTS and its predecessor that a federal savings association has inherent or implied authority to take whatever steps may be necessary to salvage an investment, provided: (1) the steps taken are an integral part of a reasonable and bona fide salvage plan and (2) the steps taken do not contravene a specific legal prohibition. (The OTS does not consider the LTOB limitation to be a specific legal prohibition within the meaning of the salvage powers doctrine.) State-chartered savings associations have similar authority under state law. Traditionally, salvage powers have provided the legal justification for savings associations to hold, operate (if necessary), and invest additional funds (if necessary) in property acquired as a result of, or in lieu of, foreclosure prior to resale of that property.

General Policy

A savings association may use its salvage powers to exceed the LTOB limitation provided it is able to demonstrate that its excess investments are being made pursuant to a reasonable and bona fide salvage plan. Excess investments that are not made pursuant to such a plan are illegal and could trigger enforcement action by the OTS. The plan should be expressly approved by the board of directors.

The LTOB limitation is a critical safety and soundness standard that is intended to prevent savings associations from placing themselves at risk by concentrating too great a portion of their assets in any single borrower. Given the importance of this standard for the maintenance of safe and sound operations and the unique risks presented when a savings association exceeds this standard in the context of a salvage operation, the OTS will carefully review any use of salvage powers to exceed the LTOB limit.

The OTS encourages savings associations to notify regional OTS supervisory officials before engaging in any significant salvage operation. For the reasons explained above, the need to consult with regional supervisory officials is especially great when salvage powers will be used to exceed the LTOB limitation, since safety and soundness considerations will affect whether a proposed use of salvage powers is appropriate.

Accordingly, a savings association that intends to make a salvage powers investment in excess of its LTOB limitation should first contact the appropriate OTS regional director to ensure that the regional director does not object to the association's judgment that the proposed salvage plan is appropriate prior to exceeding the LTOB limitation. This advance notice should reduce the potential for misunderstanding between the savings association and OTS as to the appropriateness of a significant salvage operation. (An association need not contact its regional director before making reasonable delinquent tax or insurance payments necessary to protect the association's security interest in the property. In such instances, an association should still document that such action is necessary and appropriate.)

Regional directors, in their review of the risks posed by proposed salvage plans, will take into consideration an institution's past history of salvage operations, the financial condition of the institution, and its ability to undertake the risks attendant to salvage operations. In general, regional directors will defer to an institution's judgment on the advisability of a specific salvage operation if the institution is well-managed and well-capitalized.

The level of scrutiny given to a salvage plan will also vary depending on the foreclosure status of the asset being salvaged, as explained below:

Assets acquired as a result of, or in lieu of, foreclosure

Once an asset has been acquired as a result of, or in lieu of, foreclosure, the LTOB limitation no longer applies directly to subsequent investments in that asset. In such situations, however, the OTS uses the LTOB limitation as a prudential standard to identify significant salvage operations that may require special scrutiny to ensure that they are being prudently conducted. This includes salvage operations on foreclosed assets held in the insured institution and those held in subsidiaries. (For purposes of measuring whether the LTOB limit has been exceeded, the OTS will aggregate all of a savings association's investments in the property in question regardless of whether those investments occurred before or after foreclosure.)

The OTS recognizes that the payment of certain operating expenses (such as taxes and insurance or expenses to prevent deterioration of the investment) may be prudent steps necessary to minimize the potential for loss pending the disposition of repossessed assets. Some capital expenditures, such as those necessary to put collateral property in final form for occupancy or sale, may also be prudent. However, the burden of demonstrating that capital expenditures are reasonable is greater than for operating expenditures, since capital expenditures are likely to be much more substantial.

When reviewing a proposed salvage plan, regional directors will, in addition to the factors identified above, consider whether the plan: (1) is necessary to enable the association to salvage its existing investment, (2) is necessary to protect the value of the foreclosed property (e.g., the additional investments will result in a more marketable property), (3) is in the best interest of the association, and (4) will reduce the risks associated with the foreclosed property.

Loans in the process of foreclosure

A loan will be deemed to be in the process of foreclosure if a savings association has begun the process necessary to foreclose or to take a deed in lieu of foreclosure and is actively pursuing that process, but has not yet acquired title to the property securing the loan.

Although regional directors will use the same standards outlined in the section above to review salvage plans that call for investments in excess of LTOB limits in loans in the process of foreclosure, they will also take account of the additional risks associated with investing funds in a property that has not yet been acquired by the association. Under these circumstances, a savings association should also demonstrate that the timing of its proposed investment (i.e., before foreclosure) is reasonable.

Troubled loans not in the process of foreclosure

Although a savings association may also use its salvage powers to invest funds in excess of its LTOB limits in a troubled loan that is not in the process of foreclosure, the burden of demonstrating that this type of salvage operation is prudent is high. Regional directors will assess whether a savings association has made a compelling showing that the standards outlined in the section titled "Assets acquired as a result of, or in lieu of, foreclosure" have been met and that the association's decision to delay or forego foreclosure is consistent with safe and sound operations.

Special Rules

A thrift may make loans to one borrower under one of two Special Rules. The first provides for loans for any purpose up to $500,000 as a minimum for the 15% and 10% general limits; the second provides for loans to develop domestic residential housing units, not to exceed the lesser of $30,000,000 or 30% of the thrift's LTOB capital and surplus. A third Special Rule in HOLA at 12 USC § 1464(u)(2)(B) is implemented by the regulation at the 15% general limit and applies to new funds advanced with the sale of REO as grouped with all other loans to the one borrower, and is of no advantage. Loans made under these Special Rules may not be made in addition to the general limit of 15% of LTOB capital and surplus.

Special Rule For Housing Development

"Residential housing unit" includes homes (including condominiums and cooperatives), combinations of homes and business property, real estate used for primarily residential purposes other than a home (but which may include homes), combinations of such real estate and business property involving only minor business use, farm residences and combinations of farm residences and commercial farm real estate, property to be improved by the construction of such structures, or leasehold interests in the above real estate.

In applying this definition, thrifts will also be required to apply the present regulatory definitions of terms included within the § 541.23 definition of "residential real estate," to include the definitions of "home" (§ 541.14), "combination of home and business property" (§ 541.3), "combination of residential real estate and business property involving only minor or incidental business use" (§ 541.4), and "single-family dwelling" (§ 541.25). The term "domestic," as used in this section, includes units located within the geographic area where OTS-regulated thrifts are chartered.

The rule defines the term "to develop" to include the various combinations of phases necessary to produce housing units as an end product. This includes: (1) acquisition, development, and construction; (2) development and construction; (3) construction; (4) rehabilitation; or (5) conversion. It is crucial that domestic residential housing units be the end product; the mere acquisition of real estate for holding or for later developing will not fulfill the purposes of this Special Rule.

Permanent financing of either individual units within a development or of a multi-unit complex is permissible under this Special Rule provided that the financing is related to any of the five combinations of construction phases.

For a thrift to avail itself of the residential housing unit Special Rule, the thrift must satisfy five prerequisites that are set forth in the statute and the regulation:

1. The purchase price (cash or cash equivalent) of each single-family dwelling unit, the development of which is financed under this Special Rule, may not exceed $500,000. This requirement is to apply literally to the actual final sales or purchase price.

2. The thrift must be, and continue to be, in compliance with the fully phased-in capital standards. The term "fully phased-in capital standards" is defined as the standards that will be in effect as of January 1, 1995, at the expiration of all phase-in requirements set forth in §§ 567.2, 567.5, and 567.9 of the regulations.

If the thrift falls out of compliance with this capital requirement it may no longer avail itself of this Special Rule until it again qualifies and, if eligible, submits a notice or, if ineligible for the notice procedure, applies for and receives a new order from the regional director. The OTS will permit thrifts to continue funding a legally binding loan commitment made under this Special Rule if the thrift should fall out of compliance with its fully phased-in capital requirement, provided such binding commitment to the borrower was made when the thrift was in compliance.

3. A thrift eligible under 12 CFR § 516.3 for using the notice procedure must submit the notice prior to using the higher limit and must have received a written approval (order) by the regional director. For a thrift that is not eligible under § 516.3 for the notice procedure, the thrift must submit an application to the regional director re-

questing approval to use the Special Rule for Housing Development. Following application by a thrift, the regional director, by order, must have permitted the thrift to use the higher limit.

Such an order does not constitute a "waiver" of the LTOB limits, but merely permission to use the Special Rule. Such order may contain additional requirements or set forth additional conditions or restrictions governing the exercise of this Special Rule. Moreover, the regional director has the right to rescind any such order, as well as the authority to generally impose more stringent restrictions on a thrift's loans to one borrower if it is determined that such restrictions are necessary to protect the safety and soundness of the thrift under the HOLA at 12 USC § 1464(u)(3).

4. All loans made under this Special Rule are limited in the aggregate to 150% of the thrift's LTOB capital and surplus. Neither loans made under the $500,000 Special Rule, nor loans made under the general limit fall within this 150% limit.

5. Loans made by a thrift under this Special Rule must comply with the loan-to-value requirements applicable to federal thrifts found in § 545.32(d).

<u>Guidelines for Approval of Use of Special Rule For Housing Development</u>

A regional director may provide a blanket approval for a thrift to use higher LTOB limits for lending to develop domestic residential housing upon determination that the higher limits pose no undue risk to the safety and soundness of the thrift.

Thrifts desiring the higher LTOB limits must either (1) file a notice with the regional director, if the thrift is eligible to use the notice procedure under § 516.3 or (2) apply to the regional director for approval. Notices and applications must include sufficient information to permit a thorough evaluation of the merits and risks of approving the higher LTOB limits.

Applications for approval of use of the special rule for housing development will be processed in accordance with Section 920 of the Application Processing Handbook, Lending Exceptions - Loans to One Borrower.

Expanded Transition Lending Authority

To qualify for this transition authority, an association must first meet its fully phased-in capital requirement; that is, the capital standards that will be in effect as of January 1, 1995. Second, an association must not be designated a problem association. The term "problem" as it is used here, is defined as any association that: (1) has a composite CAMEL rating of 4 or 5; (2) is undercapitalized under prompt corrective action standards; (3) is subject to a capital directive or cease and desist order, a consent order, or a formal written agreement, relating to the safety and soundness or financial viability of the association, unless OTS informs it otherwise; or (4) has been designated, by OTS, a problem association or one in troubled condition.

The rule provides that during the period beginning August 9, 1989 through December 31, 1990, qualifying thrifts' total loans and extensions of credit to one borrower could not exceed 60% of LTOB capital and surplus. During the period beginning January 1, 1991 through December 31, 1991, qualifying thrifts' loans and extensions of credit to one borrower could not exceed 30% of capital and surplus. After December 31, 1991, all loans and extensions of credit to one borrower by qualifying thrifts must be within the regular limits found in § 563.93(c)(1), (c)(2), and (d). Since August 9, 1989, all other thrifts that did not qualify to use the temporary transition authority must comply with the regular lending limits.

The expanded authority permits funding to continue on projects begun before FIRREA's enactment where disbursements were halted due to imposition of the new lending limits. This expanded authority gave qualifying thrifts more time to establish loan participation networks to serve the financing needs of major borrowers, thus fostering continuation of profitable relationships. If a thrift's post-transition lending limit will not be sufficient to accommodate major borrowers in the future, the thrift should actively seek competent lending partners during the transition period to be able to continue serving these borrowers with adequate funding under lower lending limits.

Qualifying thrifts may have used the expanded lending authority as soon as they provided the regional director with a certification form (OTS Form 1516 available from the regional office) indicating the thrift's intent to use the transition lending authority. This procedure was intended to provide the regional office staff with advance notice when the form is requested of a thrift's possible intent to use the expanded authority.

For safety and soundness reasons, the regional director may have restricted a thrift's right to use the expanded transition lending authority generally, or to restrict its use with respect to particular loans or extensions of credit. Regional directors may formally restrict lending or may disqualify a thrift by designating it a problem association.

This temporary transition authority applied to only two types of lending:

(1) new loans to develop domestic residential housing units where the final purchase price of each single-family dwelling unit, the development of which is financed under the transition authority, does not exceed $500,000; and

(2) loans to complete the development of residential and nonresidential projects that were incomplete as of FIRREA's enactment and where the qualifying thrift had advanced funds secured by real property under a loan or extension of credit prior to enactment. Qualifying thrifts must carefully consider whether providing funds to complete such pre-FIRREA projects is consistent with safe and sound practice and considered risk analysis.

The only loans permitted under this transition authority, whether new residential development loans or loans to complete a pre-FIRREA project, were those loans and extensions of credit that:

- are fully secured by a first lien on real estate per § 545.32(c);
- comply with the applicable loan-to-value requirements that apply to federal thrifts per § 545.32(d);
- provide that the borrower is personally liable for the full indebtedness arising from the loan or extension of credit; and
- receive prior approval of the qualifying thrift's board of directors.

To protect against a potential deficiency, the OTS required that the loan documents provide that the borrower is personally liable for the debt. This ensures that the thrift has full recourse against the borrower as well as the collateral.

The rule provided that the amount of a qualifying thrift's loans to all borrowers that exceeds 15% of LTOB capital and surplus shall not, in the aggregate, exceed 150% of LTOB capital and surplus during the period beginning January 1, 1991 through December 31, 1991.

This 150% aggregate limit is applied to the amount of loans to all borrowers that exceeds 15% of LTOB capital and surplus, including loans made under authority of the Special Rule for loans to develop domestic residential housing units. However, consistent with the exclusion of the "first" 15% from the aggregate limit, a qualifying thrift's loans made under the authority of the additional 10% lending limit for loans secured by readily marketable collateral under § 563.93(c)(2) will not be included in the 150% aggregate limit. Moreover, should a qualifying thrift use the $500,000 Special Rule (because the transition amount would be less), the $500,000 loans will also not fall within the aggregate limit.

Regulators are to carefully review expanded transition authority loans made to complete projects to ensure that all regulatory conditions are met, that such projects were clearly under way but incomplete as of enactment, and that limited funding to complete such projects is demonstrated to be economically prudent and consistent with safety and soundness. In monitoring compliance with this rule, regulators should closely scrutinize the lending practices of thrifts that have recently experienced an unusually rapid growth in assets or that have experienced a change in ownership or a change in officers or directors. Any abuse of the expanded transition lending authority should result in immediate enforcement action to prevent recurrence and should address remuneration from directors for any resultant losses.

SUPERVISORY CONCERNS

Regulators are responsible for assessing how well management and the board of directors formulate, implement, and monitor policies that address concentrations, self dealing, anxiety for income, complacency, poor selection of risks, inexperience, and adequacy of controls. A major area of concern is the thrift's business philosophy, which should be stated in the mission statement of the business plan. Regulators should determine whether the practices and the current loan portfolio mix agree with the overall mission of the thrift. Where concentrations involve credit risk, additions to loss allowances or additional capital must be available to absorb possible losses.

In examining and supervising thrifts, regulators should determine whether:

- the institution is in compliance with laws and regulations;
- directors and management are adequately involved and not complacent;
- there is an adequate review process to monitor concentrations and loan quality;
- management and the directorate receive adequate and timely reports and require strict control procedures; and
- the thrift has adequately experienced staff in all lending areas.

Regulators should identify existing and potential problems and present solutions to obtain positive corrective action.

REFERENCES

United States Code (12 USC)

Chapter 2: National Banks

§ 84	Lending Limits

Chapter 3: Federal Reserve System

§ 371c	Banking Affiliates
§ 371c-1	Restrictions on Transactions with Affiliates
§ 375b	Loans to Insiders

Home Owners' Loan Act

§ 1464(c)	Investment Authority
§ 1464(u)	Limits on Loans to One Borrower
§ 1464 note	Transitional Rules
§ 1467a	Holding Companies
§ 1467a(m)	Qualified Thrift Lender Test
§ 1468	Transactions with Affiliates and Loans to Insiders

Federal Deposit Insurance Act

§ 1813	Definitions
§ 1831e	Activities of Thrifts

Code of Federal Regulations (12 CFR)

Chapter I: Comptroller of the Currency
Part 3: Minimum Capital (for National Banks)

§ 3.3	Transitional Rule (Intangible Assets)
§ 3.100	Capital and Surplus
§ 3.100 Appendix A, Section 2	Components of Capital

Part 32: Lending Limits (for National Banks)

§ 32.2(a)	Loans
§ 32.2(b)	Person
§ 32.2(d)	Commitment
§ 32.2(f)	Disqualified Loan Commitments
§ 32.5	Combining Loans
§ 32.6	Exceptions
§ 32.102	Federal Funds Sold
§ 32.108	Interest and Discount

Chapter III: Federal Deposit Insurance Corporation
Subchapter A: Procedures and Rules of Practice

§ 303.13	Applications by Thrifts

Chapter V: Office of Thrift Supervision
Subchapter C: Regulations for Federal Savings Associations

§ 541.3	Combination Home and Business
§ 541.4	Combination Residential and Business
§ 541.14	Home
§ 541.23	Residential Real Estate
§ 541.25	Single-Family Dwelling
§ 545.32	Real Estate Loans
§ 545.35	Other Real Estate Loans
§ 545.46	Commercial Loans
§ 545.74	Service Corporations
§ 545.75	Commercial Paper and Corporate Debt

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.19	Financial Institutions
§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.43	Restrictions on Loans, Other Investments, and Real and Personal Property Transactions Involving Affiliated Persons
§ 563.93	Loans to One Borrower
§ 563.96	Bank Accounts, Fed Funds, Deposits
§ 563.170(c)	Records
§ 567	Capital Requirements
§ 571.12	Application Processing Guidelines
§ 571.13	Participation Interests in Pools of Loans
§ 584.6	Qualified Thrift Lender Test

Office of Thrift Supervision Resolutions on LTOB Rules

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