

**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 organiza-

tion. 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 investments 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

#### *Federal Deposit Insurance Act*

§1828(m) Activities of Savings Associations and Subsidiaries  
 §1831e(c) Equity investments

### Code of Federal Regulations (12 CFR)

#### *FDIC Rules and Regulations*

§303.13 Applications and Notices by Savings Associations  
 §303.13(d) Equity investments

#### *OTS Rules and Regulations*

Part 559 Subordinate Organizations  
 §560.30 General Lending and Investment Powers  
 §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  
 Part 567 Capital

### Accounting Principles Board (APB) Opinions

No. 18 Equity Method of Accounting for Investments in Common Stock  
 No. 21 Interest on Receivables and Payables

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

No. 34 Capitalization of Interest Cost  
 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

### Other References

AICPA Audit and Accounting Guide, Banks and Savings Institutions