COMPOSITION OF CAPITAL

This appendix provides an overview of how to calculate Tier 1, Tier 2, and Total Risk-Based capital, and provides a description of the various components that comprise Tier 1, Tier 2, and Total Risk Based capital. Refer to the capital regulation at 12 CFR § 567 and schedule CCR of the Thrift Financial Report (TFR) for additional details and other items not included in this appendix. You will find relevant definitions in 12 CFR § 567.1. We have organized this appendix as follows:

- Calculating Risk-Based Capital.
- Components of Risk-Based Capital.

CALCULATING RISK-BASED CAPITAL

Total Risk-Based capital is essentially the sum of Tier 1 and Tier 2 capital less adjustments for certain equity investments, low-level recourse exposures, and residual interests. The calculation of Tier 1 capital begins with the savings association's generally accepted accounting principles (GAAP) capital, and then adjustments are made for various items that are included in GAAP capital but are not included in regulatory capital. The items below are further discussed under Components of Capital in this appendix.

Tier 1 (Core) Capital

Tier 1 (core) capital is calculated in the following manner:

- Equity capital (as reported on the savings association's TFR). This includes common stock, retained earnings, perpetual preferred stock, additional paid-in capital (APIC), and accumulated other comprehensive income (AOCI). Items included in AOCI are reported net of deferred taxes.
- *Qualifying* noncontrolling interests in the accounts of consolidated subsidiaries (minority interests).[1]

<u>Less</u>

- Equity instruments not qualifying for Tier 1 capital (for example, cumulative perpetual preferred stock).
- Investments in and advances to nonincludable subsidiaries.
- Goodwill (that may be deducted net of any associated deferred tax liabilities). (See 12 CFR § 567.12.)

[1] Statement of Financial Accounting Standard (SFAS) 160, "Noncontrolling Interests in Consolidated Financial Statements," establishes the accounting and reporting standards for noncontrolling interests in a subsidiary and for the deconsolidation of a subsidiary. It also changed the reference from "minority" interest to "noncontrolling" interest.

- Intangible assets (other than servicing assets and purchased credit card relationships (PCCRs)) acquired in a taxable transaction (12 CFR § 567.12).

- Intangible assets (other than servicing assets and PCCRs) acquired in a nontaxable transaction (that may be deducted net of any associated deferred tax liabilities) (12 CFR § 567.12).

- Servicing assets and PCCRs in excess of specified limitations set forth at 12 CFR § 567.12.

- Disallowed deferred tax assets as set forth at 12 CFR § 567.12.

- Credit-enhancing interest-only strips (CEIOs) in excess of 25 percent of Tier 1 capital as set forth at 12 CFR § 567.5 and 12 CFR § 567.12.

- Accumulated unrealized gains on certain available-for-sale (AFS) debt and equity securities and qualifying cash-flow hedges net of tax (as reported in AOCI).

- Accumulated surpluses (gains) reported under Statement of Financial Standard (SFAS) No. 158, *Employer's Accounting For Defined Benefit Pension and Other Postretirement Plans* (SFAS 158). See also December 15, 2006 Joint Press Release. Until the agencies determine otherwise through a rulemaking, banking organizations including savings associations should exclude from regulatory capital any amounts recorded in AOCI resulting from the adoption and application of SFAS 158. Therefore, any unrealized gains related to pensions under SFAS 158 reported in AOCI for GAAP purposes should be reversed out (or neutralized) net of tax for regulatory capital reporting purposes on TFR schedule CCR.

- Initial and subsequent gains recorded due to a decline of an institution's "own" creditworthiness under either mandatory or optional fair value accounting for liabilities. Exclude from Tier 1 capital the cumulative change in the fair value of all financial liabilities (accounted for under a fair value option that is otherwise included in retained earnings) attributable to changes in an organization's own creditworthiness. Savings associations should report in this item, the amount of this cumulative change, net of applicable taxes. In addition, for regulatory capital purposes, this excluded portion of the change in fair value should be reported so the adjustment is taken into account in determining the core capital subtotal that is used to determine the regulatory capital limits on such items as servicing assets, deferred tax assets, and CEIOs.

<u>**Plus**</u>

- Securities issued to and purchased by the U.S. Department of the Treasury pursuant to the Troubled Asset Relief Program (TARP) and Capital Purchase Program (CPP).

- Specified nonwithdrawable and pledged deposit accounts held in mutual savings associations.

- Accumulated unrealized losses on certain AFS debt securities and on qualifying cash-flow hedges as reported in AOCI, net of applicable deferred taxes.

- Accumulated deficits (losses) on pensions reported under SFAS 158. Losses reported for GAAP purposes are added back (or, neutralized) for regulatory capital reporting purposes, net of applicable deferred taxes. Note that in any future rulemakings, this level of capital relief for losses may not continue; associations should plan accordingly.

- Initial and subsequent losses due to an increase in an association's "own" creditworthiness resulting from the fair value option. Note that in any future rulemakings, this treatment for losses may not continue; associations should plan accordingly.

Tier 2 (Supplementary) Capital

Note: Tier 2 capital may not exceed Tier 1 capital (i.e., Tier 2 capital may be included up to 100 percent of Tier 1 capital).

Tier 2 (supplementary) capital includes the following up to 100 percent of the Tier 1 capital limitation:

- Permanent capital instruments such as:

  — Mutual capital certificates and nonwithdrawable accounts not counted for Tier 1 capital.

  — Cumulative perpetual preferred stock.

- Perpetual subordinated debt and mandatory convertible subordinated debt issued in compliance with 12 CFR § 563.81.

- Maturing capital instruments (for example, nonperpetual preferred stock, subordinated debt and mandatorily convertible subordinated debt).

- Allowance for loan and lease losses (ALLL) up to 1.25 percent of total risk-weighted assets.

- Up to 45 percent of unrealized gains, net of unrealized losses, on AFS equity securities with readily determinable fair values.

Total (Risk-based) Capital

An association's total (risk-based) capital includes:[2]

- Tier 1 capital.

- Tier 2 capital (to the extent that Tier 2 capital does not exceed 100 percent of Tier 1 capital).

[2] Unlike the other banking agencies, the OTS has not adopted the Market Risk Rule, which provides for a Tier 3 capital requirement for those institutions subject to the rule. Until OTS adopts the Market Risk Rule, savings associations do not include any instrument as Tier 3 capital.

<u>Less</u>

- Reciprocal holdings of the capital instruments of another depository institution.

- Equity investments as defined in 12 CFR § 567.1, which excludes among other things equity investments permissible for a national bank (for a list of activities permissible for a national bank, see OCC publication entitled "Activities Permissible for a National Bank, 2007").

- Low-level recourse exposures and residual interests that the association chooses to deduct using the simplified/direct deduction method (excluding those CEIOs already deducted from Tier 1 capital above).

COMPONENTS OF RISK-BASED CAPITAL

Tier 1 (Core) Capital Components

OTS, along with the other banking agencies, affirms that common stockholder's equity is the key form and should be the predominant form of Tier 1 capital. Moreover, consistent with The Basel Committee on Banking Supervision's[3] position on "Instruments eligible for inclusion in Tier 1",[4] the banking agencies agree that the following requirements should be met by all other forms of Tier 1 capital instruments:

- Must be issued and fully paid.

- Must be noncumulative.

- Must be able to absorb losses with the bank on a going-concern basis.

- Must be junior to depositors, general creditors, and subordinated debt of the bank.

- Must be permanent.

- Must not be secured or covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors.

- Must be callable at the initiative of the issuer only after a minimum of five years with supervisory approval and under the condition that it will be replaced with capital of same or

[3] The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision.

[4] See Basel Committee on Banking Supervision Press Release dated October 27, 1998.

better quality unless the supervisor determines that the bank has capital that is more than adequate for its risks.

- Must include no or limited dividend step ups after a minimum of 10 years after issue date.

Savings associations should avoid overreliance on noncommon equity instruments, such as preferred stock, noncontrolling interests, and other nonvoting equity elements, within Tier 1 capital.

Common Stockholder's Equity

Common stockholder's equity is included in GAAP capital and consists of voting common stock, APIC, and retained earnings. Common stockholder's equity is the most desirable capital element from a supervisory perspective, and should be the predominant element within Tier 1 capital. Common stockholder's equity provides a savings association with the maximum amount of financial flexibility necessary to weather financial difficulties because of its availability and capacity to absorb losses, its ability to conserve resources in times of stress (the issuer is able to waive any payments, i.e., dividends, to investors without any future obligations), and the ability of investors through voting rights to provide market discipline over a savings association's management. Common stock with mandatorily redeemable provisions is not includable in Tier 1 capital. In addition, stock issuances where the dividends that are not paid in one period are reset based on current market conditions or the savings association's current credit rating are not includable as both common and preferred in Tier 1 capital.

Noncumulative Perpetual Preferred Stock

Noncumulative perpetual preferred stock can qualify for inclusion in Tier 1 capital. The stock has no maturity date and cannot be redeemed at the option of the holder. Preferred stock typically entitles a holder to a fixed dividend, which is received before any common stockholders may receive dividends. Noncumulative simply means that dividends are not carried over to subsequent dividend periods.

The general rule, however, is that noncumulative perpetual preferred stock qualifies for inclusion in Tier 1 capital only if it can absorb losses while the issuer of the stock operates as a going concern. Clauses, covenants, and restrictions inserted in preferred stock issuances that make the issuance more debt-like may also make it unacceptable for Tier 1 capital. As with common stock, preferred stock issuances where the dividends are reset based on current market conditions or the association's current credit rating are not includable in Tier 1 capital. A noncash dividend payment that is made when a cash dividend payment cannot be paid is subject to supervisory approval in order to count the preferred stock toward Tier 1 capital.

Preferred stock issued by a savings association or a subsidiary that is, in effect, collateralized by assets of the savings association or one of its subsidiaries is not included in capital.

Preferred Securities Issued Pursuant to the Capital Purchase Program

Equity interests (e.g., senior preferred securities) sold to the U.S. Department of the Treasury under its Capital Purchase Program implemented under the Emergency Economic Stabilization Act of 2008 are includable in Tier 1 capital.

Noncontrolling Interests in Equity Accounts of Fully Consolidated Includable Subsidiaries (Minority Interests)[5]

Noncontrolling interests are created when a depository institution owns a controlling interest, but not 100 percent of a subsidiary, and the remaining interest is owned by third parties, referred to as noncontrolling shareholders. While noncontrolling interests are includable in GAAP equity, only *qualifying* noncontrolling interests are includable in Tier 1 capital. A key consideration in making this determination is the extent of the contribution, if any, of a noncontrolling interest to a savings association's capital adequacy and ability to absorb losses. Additionally, the noncontrolling interest transaction should satisfy, at a minimum, the following criteria:

- The subsidiary capital instrument issued to the investors must have the terms and features that would allow the instrument to qualify as a Tier 1 capital instrument if issued directly by the parent banking organization. Common stock and noncumulative perpetual preferred stock issued by a banking organization have the potential to be treated as Tier 1 capital on a consolidated basis through a noncontrolling interest in a consolidated subsidiary. For example, a capital instrument held by the noncontrolling interest owners of the subsidiary would not be includable in Tier 1 capital of its parent banking organization if the instrument: (1) includes any terms or conditions that could require the instrument to be repaid on a specified future date, or at the option of the holders of the instrument; (2) is secured or effectively secured; (3) pays noncancellable or cumulative distributions; or (4) contains other provisions that limit the ability of the noncontrolling interest to effectively absorb losses. A subsidiary capital instrument should also allow for the cancellation of dividends when the parent savings association is experiencing financial stress.

- The noncontrolling interest should absorb losses in the subsidiary commensurate with the subsidiary's capital needs and it should not represent an essentially risk-free or low-risk investment for the holders of the subsidiary capital instrument. It is essential that a noncontrolling interest provide meaningful capital support to the subsidiary, and in turn its consolidated parent. A noncontrolling interest in a subsidiary would be viewed by the agencies as a risk-free or low-risk investment where the subsidiary has been formed to hold only high-quality assets of the savings association, or where the subsidiary has been essentially over-collateralized in relation to the noncontrolling interest owners' claim on the subsidiary's assets. The subsidiary capital instrument should not be disproportionate to the capital needs of the subsidiary in which the investment will absorb losses.

Noncontrolling interests generally do not provide capital support to absorb losses arising elsewhere in the consolidated organization, including losses on assets in the subsidiary's parent savings association or affiliates within the consolidated banking organization. This issue has been addressed in certain instruments accepted by the agencies as eligible for Tier 1 capital through the inclusion of an exchange feature (see the discussion below on real estate investment trusts below). This feature requires an exchange or conversion of the subsidiary instrument into common or noncumulative perpetual

[5] Savings associations should follow all relevant accounting standards for consolidation.

preferred stock of the parent savings association, or savings association holding company (with a required contribution of the subsidiary instrument to the association) upon the deterioration of the financial condition of the subsidiary or parent savings association organization. However, the exchange feature alone does not result in an instrument qualifying for Tier 1 eligibility. The OTS will review all the terms and features of a subsidiary instrument on a case-by-case basis to determine eligibility for inclusion in Tier 1 capital of the parent banking organization.

Real Estate Investment Trust (REIT) Preferred Shares and Other Noncontrolling Interests

Companies with a primary business of investing in real estate or mortgages secured by real estate can elect to be categorized as a REIT, under the income tax code. The election enables the REIT to avoid corporate level taxation as long as certain criteria are met.

REITs have been treated as wholly owned special purpose entities (SPE). The SPE, as the REIT, issues noncumulative perpetual preferred securities into the market, and uses the proceeds from the issuance to purchase mortgage-related assets from the savings association, its sole common shareholder.

Generally, the REIT is fully consolidated with the savings association for regulatory reporting purposes. In the consolidated financial statements, the association reports the REIT preferred stock that was issued to third parties as a noncontrolling interest in includable consolidated subsidiaries, and the noncontrolling interest is included in Tier 1 capital.

However, the asset-backed nature of REIT preferred stock raises supervisory concerns when a savings association issues it through a subsidiary. If the association faces difficulty, all assets of the consolidated entity must be immediately available for the association's use. As a result, OTS limits includable noncontrolling interests in REIT preferred stock to 25 percent of Tier 1 capital. Moreover, OTS requires savings association subsidiaries to include certain restrictive covenants in REIT preferred stock offerings. Among the criteria that must be met in order for REIT preferred stock to be included in Tier 1 capital:

- The terms of the stock issuance must meet all the same terms and conditions as Tier 1 eligible stock issued directly by the parent (e.g., be permanent (or perpetual) and noncumulative as to dividends).
- Stock can only be redeemed with the approval of the OTS.
- The stock must be convertible into common equity of the parent savings association in the event of a conversion event (e.g., the savings association becomes undercapitalized or is placed into receivership).
- Shareholders must sign an agreement acknowledging that transfers of shares to a nonqualifying shareholder is prohibited.

- The terms of the REIT and shareholder agreements must clearly specify that upon a conversion event, all assets of the REIT become assets of the savings association. Shareholders should sign an acknowledgment of that point.

A REIT preferred interest that does not meet these terms is deemed a "secured equity investment." A noncontrolling REIT interest that functions as "secured equity" is not eligible for inclusion in Tier 1.

If the SPE issues common stock rather than preferred stock to third parties, OTS would consider the noncontrolling interest in the common stock of the REIT subject to the same restrictions and the aggregate 25 percent of Tier 1 capital that currently applies to REIT preferred stock. REIT common stock would not necessarily provide the same level of capital support that common stock issued by a savings association itself would provide. It also raises other safety and soundness concerns in that it would be unable to provide capital support if the savings association incurred losses.

Pledged Deposits and Nonwithdrawable Accounts

Savings associations organized as mutual savings associations do not issue capital stock and have no stockholders. Instead, mutual savings associations must build capital almost exclusively through retained earnings. Thus, it was common for founding members of mutual savings associations to pledge savings deposit accounts (referred to as nonwithdrawable accounts or pledged deposits) for the period of time required for the new mutual to build-up capital through profitable operations and retention of earnings. OTS regulation, 12 CFR § 567.5(a)(1)(iv) allows *nonwithdrawable accounts and pledged deposits* of mutual savings associations (excluding any treasury shares held by the savings association) meeting certain criteria to count toward Tier 1 capital. The criteria in 12 CFR § 567.5(a)(1)(iv) requires that the accounts or deposits have no fixed maturity date, cannot be withdrawn at the option of the accountholder, and do not earn interest that carries over to subsequent periods. If the criteria listed in 12 CFR § 567.5(a)(1)(iv) are not met, 12 CFR § 567.5(b)(1)(iii) allows these instruments to count toward Tier 2 capital as long as they meet other criteria set out in 12 CFR § 561.42 for savings accounts.

ADDITIONS TO TIER 1 CAPITAL

Accumulated Gains and (Losses) on Certain AFS Securities

For Tier 1 capital purposes, savings associations must reverse (or neutralize) all unrealized gains related to AFS debt and AFS equity securities, and also reverse (or neutralize) unrealized losses on AFS debt securities, net of applicable taxes. Only unrealized losses from AFS equity securities reported in AOCI for GAAP purposes remain to reduce Tier 1 capital, and are not reversed or neutralized for regulatory capital reporting purposes. See Tier 2 (supplementary) capital for reporting unrealized gains on AFS equity securities.

On April 9, 2009, the FASB released FASB Staff Position (FSP) FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP FAS 115-2). FSP FAS 115-2 amends U.S. GAAP for AFS and held-to-maturity (HTM) *debt* securities. It does not amend existing recognition and measurement guidance related to other-than-temporary impairment (OTTI) of *equity* securities. It also improves the presentation and disclosure of OTTI for debt and equity securities in the financial statements.

FSP FAS 115-2 Debt Securities

Under GAAP, when the fair value of an AFS or HTM security is less than its amortized cost basis, it is considered impaired. The impairment is either temporary or OTTI. Under FSP FAS 115-2, an OTTI of either an AFS or HTM debt security, in certain circumstances, is separated into (1) the credit loss amount recognized in earnings and (2) the amount related to all other factors (noncredit loss) recognized in other comprehensive income, net of applicable taxes. For regulatory capital purposes, amounts reported as AFS or HTM in AOCI will be subject to neutralization, net of applicable taxes.

Under FSP FAS 115-2:

- If (1) an institution intends to sell the debt security, or (2) it is "more likely than not" that it will be required to sell the security before recovery of the security's amortized cost basis (less any current-period credit loss), OTTI equal to the entire difference between the security's amortized cost basis and its fair value is recognized in earnings.

- If, however, (1) an institution does not intend to sell the debt security, and (2) it is not "more likely than not" that the institution will be required to sell the security before recovery of the security's amortized cost basis (less any current-period credit loss), and (3) it does not expect to recover the entire amortized cost basis, the OTTI is separated and recognized as follows:

  — The credit loss amount shall be recognized in earnings.

  — The noncredit loss shall be recognized in other comprehensive income (OCI), net of applicable taxes.

The difference between the present value of the cash flows expected to be collected and the amortized cost basis is referred to as the credit loss. One way of estimating the credit loss amount is to use the methodology described in paragraphs 12-16 of SFAS No. 114, *Accounting by Creditors for Impairment of a Loan* (SFAS 114). Under a SFAS 114 methodology, an institution discounts the cash flows management expects to collect at the effective interest rate implicit in the debt security at the date of acquisition. If the discounted amount is less than the debt security's amortized cost basis, the difference represents the credit loss amount to be recognized through earnings.

The regulatory capital treatment of losses on debt securities has *not* changed. Note that the new accounting guidance may result in a different amount of noncredit losses on AFS and HTM debt securities being recognized in OCI instead of earnings. These noncredit losses in AOCI will then be added back as part of unrealized losses in determining Tier 1 capital on TFR Schedule CCR.

Accumulated Gains and (Losses) on Cash Flow Hedges

SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), requires that changes in the fair value of properly designated and qualifying derivatives used as a cash flow hedge initially also be reported in AOCI, and reclassified into earnings in the same future period that the hedged transaction affects earnings. (Refer to SFAS 133, Appendix A, Section 2, for further information.) Generally, under SFAS 133, the savings association would exclude from net income the "effective" portion of the change in fair value of a derivative designated as a cash flow hedge and record it instead in AOCI. For regulatory reporting purposes, accumulated net gains or losses on cash flow hedges included in AOCI are reversed (or neutralized), net of applicable deferred taxes. In other words, gains are reversed and losses are added-back to Tier 1 capital, net of tax.

DEDUCTIONS FROM TIER 1 CAPITAL

Equity Instruments Not Qualifying for Tier 1

This includes Cumulative Perpetual Preferred Stock (and related surplus) (collectively, cumulative perpetual preferred stock). Cumulative perpetual preferred stock may be includable in Tier 2 capital but not Tier 1 capital. Cumulative perpetual preferred stock means perpetual preferred stock and related surplus where the issuer has the option to waive payments of dividends; however, dividends waived or deferred accumulate to future periods and represent a claim on the issuer.

Additionally, stock with a feature where the dividend is reset periodically based on current market conditions and the savings association's current credit rating, including but not limited to, auction rate, money market, or remarketable preferred stock, are assigned to Tier 2 capital, regardless of cumulative or noncumulative characteristics under 12 CFR § 567.5(a)(1).

Nonincludable Subsidiaries

Under OTS capital rules, a subsidiary is defined as an entity in which the parent savings association has a majority ownership interest and the assets of which are consolidated with those of the savings association for GAAP purposes (12 CFR § 567.1). For purposes of OTS capital rules, a subsidiary is either an includable subsidiary or a nonincludable subsidiary. An includable subsidiary is defined as a subsidiary that:

- Engages solely in activities not impermissible for a national bank (see OCC handbook entitled "Activities Permissible for a National Bank, 2007);
- Engages in activities not permissible for a national bank, but only if acting solely as agent for its customers;
- Engages solely in mortgage banking activities;
- Is an insured depository institution or a holding company whose sole investment is an insured depository institution (acquired before May 1, 1989); or
- Is a subsidiary of a federal savings association existing as such on August 9, 1989, and was either previously chartered by a state savings bank prior to October 15, 1982, or acquired its principal assets from a state savings bank prior to this date.

A nonincludable subsidiary is one that does not meet the definition of an includable subsidiary. A savings association must deconsolidate and deduct from capital the amount of its investment in and advances to any subsidiary that is a nonincludable subsidiary for Tier 1 capital purposes.

Goodwill and Other Intangible Assets

OTS follows GAAP in defining goodwill and intangible assets. Intangible assets include, but are not limited to:

- goodwill
- core deposit premiums
- PCCRs
- servicing assets (mortgage and nonmortgage)
- favorable leaseholds
- covenants to not compete and
- computer software.

Deduct goodwill from a savings association's Tier 1 capital. A savings association may elect to deduct goodwill on a basis that is net of any associated deferred tax liabilities.

Savings associations must also deduct other intangible assets (other than servicing assets and PCCRs) from Tier 1 capital, but may elect to deduct certain of these other intangible assets on a basis net of associated deferred tax liabilities if the association acquired the intangible assets in a nontaxable transaction. Core deposit intangibles, covenants to not compete, and trade names are examples of intangibles that must be deducted from Tier 1 capital. However, if acquired as a result of a nontaxable transaction, the savings association could elect to deduct them net of any associated deferred tax liabilities, if any. As a departure from the general intangible deduction rules, savings associations may choose also to not deduct computer software (purchased or internally developed) as an intangible asset for Tier 1 capital purposes.

Except as noted above, the only intangible assets that are eligible to be included in – that is, not deducted from – a savings association's capital are mortgage servicing assets (MSAs), nonmortgage servicing assets (NMSAs), and PCCRs. However, these intangibles are subject to limitations (see below).

Servicing Assets and Purchased Credit Card Relationships in Excess of Limitations (Disallowed amounts)

Servicing assets result from contracts to service financial assets for which the benefits of servicing (revenues from contractually specified servicing fees, late charges, and other ancillary income sources) are expected to more than adequately compensate the servicer for performing the servicing. Adequate compensation fully covers servicing costs and provides an adequate and reasonable profit margin. Servicing liabilities result from contracts to service financial assets for which the benefits of servicing are not expected to adequately compensate the servicer for performing the servicing. Relevant accounting standards are SFAS No. 65, *Accounting for Certain Mortgage Banking Activities* (SFAS 65), as amended by SFAS No. 140, *Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS 140), and SFAS No. 156, *Accounting for Servicing of Financial Assets* (SFAS 156). See Examination Handbook Section 750, Mortgage Banking: Accounting Considerations.

As mentioned, MSAs, NMSAs, and PCCRs are eligible for inclusion in Tier 1 capital. The amount of MSAs, NMSAs, and PCCRs that a savings association may include in capital is limited to the lesser of (1) 90 percent of their fair value,[6] (2) 100 percent of their book value (amortized cost), (3) or 100 percent of Tier 1 capital (the "three-part test"). [7] The total amount of NMSAs and PCCRs is subject to a separate aggregate sublimit of 25 percent of Tier 1 capital.

For example, assume a savings association has servicing assets of $150, its Tier 1 capital is $80, and fair value and cost are both $150 such that 90 percent of fair value is $135. Under the "three-part" test, $80 is the lesser value, and becomes the amount of (or limit on) servicing assets that the savings association may include in regulatory capital. The limit, or $80, is subtracted from the recorded servicing assets, or $150, and the difference, $70 ($150 - $80), is the amount of disallowed servicing assets. This amount of ***disallowed servicing assets*** is the amount a savings association would deduct if it did not take the "netting" election (as discussed below).

Net of Deferred Tax Liability Calculation for Servicing Assets (Gross Assets Method)

Savings associations may elect to deduct disallowed servicing assets (MSRs and NMSRs) on a basis that is net of associated deferred tax liabilities ("netting" election).

Using the example above, the savings association chooses to offset the disallowed servicing assets deduction of $70 by a **portion** of the related deferred tax liabilities by making the "netting" election. Assuming a blended effective income tax rate of 40 percent, that portion is calculated as $28 ($70 x 40 percent estimated tax rate). Assuming the savings association recorded associated deferred tax liabilities under GAAP,[8] it nets $28 against the disallowed servicing assets, or $70, and reduces the deduction from Tier 1 (core) capital to $42 ($70 less $28). Without the election, the deduction would have been $70.

[6] Servicing assets accounted for at fair value will generally have a servicing deduction at least equal to the 90 percent of fair value "haircut."

[7] The haircut is determined as the lesser of cost or 90 percent of fair value. This haircut amount is then compared to the overall Tier 1 capital limit. An illustration is provided in this section.

[8] This example assumes that the savings association reported $60 as the associated deferred tax liability ($150 x 40 percent).

Assume Tier 1 Capital is $80 MSAs (fair value)	$150	
Allowed portion in Tier 1	($ 80)	Calculated as the lesser of: [9] (1) 100% of Tier 1 capital = $ 80 (given); (2) 90% of $150 fair value = $135;or (3) Cost = $150.
Excess MSAs	$ 70	
Calculation of Applicable Deferred Tax Liability:	(28)	($70 x 40% = 28)
Regulatory Capital Deduction	$42	

If an association has PCCRs, the calculation becomes somewhat more complex because it must calculate both the overall limit as well as the sublimit.

Disallowed Deferred Tax Assets

Taxes paid in prior carry-back years and future reversals of existing taxable temporary differences as determined under GAAP (SFAS No. 109, *Accounting for Income Taxes* (SFAS 109)) are included in Tier 1 capital without limitation. However, the amount of other deferred tax assets reported on the balance sheet may be limited in Tier 1 capital. Generally, deferred tax assets that are dependent upon future taxable income are limited in Tier 1 capital to the lesser of: (i) the amount of such deferred tax assets that the savings association expects to realize within one year of the calendar quarter-end date, based on its projected future taxable income for that year or (ii) 10 percent of the amount of the savings association's Tier 1 capital (calculated before any deduction for deferred tax assets).

For purposes of this limitation, all existing temporary differences should be assumed to fully reverse at the calendar quarter end date. The recorded amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, in excess of this limitation will be deducted from assets and from equity capital for purposes of determining Tier 1 capital under this part. The amount of deferred tax assets that can be realized from taxes paid in prior carry back years and from the reversal of existing taxable temporary differences generally would not be deducted from assets and from equity capital.

Projected future taxable income should not include net operating loss carry-forwards expected to be used within one year of the quarter-end report date or the amount of existing temporary differences expected to reverse within that year. Projected future taxable income should include the estimated effect of tax planning strategies expected to be implemented to realize carry-forwards that will otherwise expire during that year. Each reporting savings association's calculations should be made on a separate entity basis.

[9] This example illustrates the statutory "haircut." For the haircut, determine the lesser of cost (see footnote 2) or 90 percent of fair value (items 2 and 3). In addition to the haircut, the lesser amount in items (2) and (3) is then compared to the overall Tier 1 capital limit in item (1). In this example, the lesser of all the amounts is $80 (item 1), or the Tier 1 capital amount before counting servicing assets.

When a deferred tax liability is netted against other assets, such as AFS debt securities, goodwill, servicing assets, other intangible assets, or CEIO strips, the taxable temporary difference that gives rise to this deferred tax liability must be excluded from existing taxable temporary differences when determining the amount of deferred tax assets that are dependent upon future taxable income and calculating the maximum amount of such assets. This means that deferred tax liabilities that are netted against other assets for regulatory capital deduction purposes for those assets cannot also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income.

In addition, if an institution nets a deferred tax liability against an associated asset, it must consistently apply this netting approach even where the deferred tax liability becomes as deferred tax asset.

Credit Enhancing Interest-only Strips in Excess of Limitations

CEIOs are high risk residual interests in securitizations, often retained by the originator of securitization transactions. Generally, savings associations are prohibited from purchasing residual interests as they are typically unrated or rated well below investment grade.

As defined in 12 CFR § 567.1, a CEIO strip means an on-balance-sheet asset that in form or in substance: (i) represents the contractual right to receive some or all of the interest due on transferred assets; and (ii) exposes the savings association to credit risk directly or indirectly associated with the transferred assets that exceed its pro rata share of the savings association's claim on the assets whether through subordination provisions or other credit enhancement techniques.

OTS will consider the economic substance of a transaction and reserve the right to identify other cash flows or related interests as a CEIO strip. For those that meet the regulatory definition in 12 CFR § 567.1, a maximum aggregate amount of CEIO strips may be included in Tier 1 capital up to 25 percent of the amount of core capital. For purposes of computing the limit, core capital is computed before the deduction of disallowed servicing assets, disallowed credit card relationships, disallowed deferred tax assets, and disallowed CEIO strips. The limitation applies to both retained and purchased CEIO strips.

Interest-only strips (IOs) issued by government-sponsored entities (e.g., Fannie Mae or Freddie Mac) or other IOs that do not function in a credit enhancing or otherwise subordinate capacity are NOT deducted from core capital. They receive a 100 percent risk weight.

A savings association may elect to deduct disallowed CEIO strips on a basis that is net of any associated deferred tax liability.

TIER 2 COMPONENTS

Tier 2 (Supplemental) Capital Instruments

Tier 2 capital counts toward total capital up to a maximum of 100 percent of a savings association's Tier 1 (core) capital. It is comprised of, within certain limitations: (1) permanent capital instruments that do not count for Tier 1; (2) maturing capital instruments; (3) allowance for loan and lease losses; (4) certain unrealized gains on equity securities.

Permanent Capital Instruments

Permanent capital instruments include (i) equity instruments qualifying for Tier 2 capital such as cumulative perpetual preferred stock and other nonTier 1 capital eligible perpetual preferred stock issued pursuant to OTS regulations; (ii) nonwithdrawable accounts and pledged deposits not included in Tier 1; (iii) perpetual subordinated debt issued pursuant to OTS regulations and memoranda; (iv) mandatory convertible subordinated debt (capital notes) issued pursuant to OTS regulations and memoranda; and (v) certain certificates (mutual capital, net worth, and income capital).

Equity Instruments Qualifying for Tier 2 Capital but not Tier 1 Capital

Cumulative perpetual preferred stock is includable in Tier 2 capital. Cumulative Perpetual Preferred Stock and related surplus (collectively, cumulative perpetual preferred stock) does not have a maturity date, cannot be redeemed at the option of the holder, and has no other provisions that would require future redemption of the issue. Cumulative perpetual preferred stock means perpetual preferred stock and related surplus where the issuer has the option to waive payments of dividends. Dividends so waived accumulate to future periods and represent a claim on the issuer.

Noncontrolling interests in excess of the amount includable in Tier 1 capital may also be included in Tier 2 capital.

Nonwithdrawable Accounts and Pledged deposits not included in Tier 1 Capital

To the extent nonwithdrawable accounts and pledged deposits were not included in Tier 1 capital, they may be included in Tier 2 capital if they meet the eligibility requirements for savings accounts set out in 12 CFR § 561.42. (See discussion under Tier 1 Components.)

Perpetual Subordinated Debt and Mandatory Convertible Subordinated Debt (Capital Notes)

Perpetual subordinated debt and mandatory convertible subordinated debt (capital notes) issued pursuant to regulations and memoranda of OTS, including 12 CFR sections 567.5(b), 563.81, 563.80, and 563g, and approved by the OTS for inclusion in regulatory capital may be includable in Tier 2 capital.

Other Capital Instruments Provided for in OTS regulations

OTS capital rules allow inclusion of net worth certificates (12 CFR § 567.5(b)(1)(iv)),[10] mutual capital certificates (12 CFR § 567.5(b)(1)(ii)),[11] and income capital certificates (12 CFR § 567.5(b)(1)(v))[12] in Tier 2 capital. All of these instruments are tied to the industry's financial difficulties in the 1980s.

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[10] Net worth certificates, issued under the Garn-St. Germain Depository Institutions Act, provided assistance to savings associations suffering losses and regulatory capital deterioration due to economic conditions. The FDIC purchased a net worth certificate from a qualified institution in exchange for an FDIC issued promissory note. The note was an asset on the institution's books, with the offsetting liability of the net worth certificate counted toward regulatory capital. The FDIC paid interest on the note as cash, while the institution, if it had earnings and achieved a certain level of net worth, paid part of its net income back to the FDIC. As savings associations regained financial health, they redeemed the certificates.

Since the above three types of permanent capital instruments resulted from the 1980s, and most likely no longer exist on any savings associations' regulatory reports, you should contact the regional or Washington office if you discover any institution reporting them.

Maturing Capital Instruments

Intermediate Term Preferred Stock

Intermediate term preferred stock refers to preferred stock issuances with an original maturity of less than 20 years. Intermediate term preferred stock may qualify for Tier 2 capital under certain guidelines. It must have an original weighted average maturity of at least five years. The portion of intermediate term preferred stock and subordinated debt discussed below is limited to 100 percent of Tier 1 capital (12 CFR § 563.81).

Subordinated Debt and Mandatory Convertible Subordinated Debt

Subordinated debt and mandatory convertible subordinated debt (capital notes) issued pursuant to regulations and memoranda of OTS, including 12 CFR sections 567.5(b), 563.81, including 12 CFR sections 567.5(b), 563.81, 563.80 and 563g, and approved by the OTS for inclusion in regulatory capital may be includable in Tier 2 capital.

Pursuant to 12 CFR § 567.5(b), savings associations issuing maturing capital instruments after November 7, 1989, may choose to elect one of two methods (Paragraph A or Paragraph B) to determine the amount of maturing capital instruments includable in Tier 2 capital:

A. At the beginning of each of the last five years of the life of the maturing capital instrument, the amount that is eligible to be included as Tier 2 capital is reduced by 20 percent of the original amount of that instrument (net of redemption).

B. Only the aggregate amount of maturing capital instruments that mature in any one year during the seven years immediately prior to an instrument's maturity that does not exceed 20 percent of an institution's capital will qualify as Tier 2 capital.

Example

Paragraph A looks at a particular issuance of subordinated debt, and in a series of step-downs, reduces the amount that can be included in Tier 2 capital. Basically, you take off 20 percent a year consecutively, each of the last five years.

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[11] The Home Owners' Loan Act (HOLA) authorizes mutual capital certificates, which are long-term debt securities issued by a federal mutual savings association that are subordinated to all other claims on assets, and are not covered by federal deposit insurance. A savings association may count them toward capital to the extent permitted by the OTS Director. (12 USC 1461). Typically, the FDIC purchased the certificates from savings associations as a temporary way to help savings associations meet minimum capital standards.

[12] The Federal Savings and Loan Insurance Corporation (FSLIC) developed income capital certificates (ICC). These instruments also provided assistance to troubled savings association institutions. Under the program, savings associations issued ICCs to the FSLIC in return for cash or the FSLIC's promissory notes. If held by FSLIC, and later by the FDIC, the savings association could count outstanding ICCs toward regulatory capital. As the savings association regained financial health, it retired the ICCs.

Example: The amount of the instrument is $100. It matures in 12/31/2014. (Assume no redemptions.)

- Up to 12/31/2009: $100 eligible for inclusion in Tier 2 capital
- Beginning 12/31/2009: $80 eligible
- Beginning 12/31/2010: $60 eligible
- Beginning 12/31/2011: $40 eligible
- Beginning 12/31/2012: $20 eligible
- Beginning 12/31/2013: $0 eligible

If the bank had two other issuances of $100 each, maturing in 2012 and 2016, each would step down based on its own maturity (see table below). The 2012 would have started stepping down in 2007. The 2016 will start stepping down in 2011.

	Issuance 1 ($100) matures 12/2012	Issuance 2 ($100) matures 12/2014	Issuance 3 ($100) matures 12/2016	**Total Amount Includable in Tier 2 Capital**
12/08 to 12/09	80	100	100	**280**
12/09 to 12/10	40	80	100	**220**
12/10 to 12/11	20	60	100	**180**
12/11 to 12/12	0	40	80	**120**
12/12 to 12/13		20	60	**80**
12/13 to 12/14		0	40	**40**
2015			20	**20**
2016			0	**0**

Paragraph B looks at the aggregate amount of subordinated debt and compares it with total capital. We limit the amount that can be included in Tier 2 capital during the last seven years of the instrument's life. Only the aggregate amount of maturing capital instruments that mature in any one year during the seven years immediately prior to an instrument's maturity that does not exceed 20% of a saving association's capital will qualify as supplemental capital. Assume total capital holds steady at $1,000. Also, assume $200 of a subordinated debt instrument matures in 2014 and that $200 does not exceed 20 percent of total capital. Therefore, all $200 is eligible for inclusion up to the end. No need for the step down as in the Paragraph A example. On the other hand if the instrument were $300, only $200 would be eligible at any given time in this period, because $300 exceeds $200 (the maximum limit of 20 percent of capital.) If two subordinated debt instruments mature in the same year (e.g. 2015 per the example below) then only $200 of the aggregate amount maturing in that year would be included in Tier 2 capital.

Example assuming multiple issuances with different maturity dates:

Assumes Capital is $1000 and Remains Constant					
	Issue 1—amount 200 (matures 12/2014)	Issue 2—amount 300 (matures 12/2015)	Issue 3—amount 100 (matures 12/2012)	Issue 4—amount 100 (matures 12/2015)	**Amount includable in Tier 2 Capital**
2004	200	300	100	100	**700**
2005	200	300	100	100	**700**
2006	200	300	100	100	**700**
2007	200	300	100	100	**700**
2008	200	300	100	100	**700**
2009	200	300	100	100	**500**
2010	200	300	100	100	**500**
2011	200	300	100	100	**500**
2012	200	300	100	100	**500**
2013	200	300		100	**400**
2014	200	300		100	**400**
2015		300		100	**200**

Qualifying Trust Preferred Securities

Trust preferred securities are undated cumulative preferred securities issued out of an SPE usually in the form of a trust, in which a savings association holding company or bank holding company owns all of the common securities. The trust issues cumulative preferred securities into the market. The trust's only assets are deeply subordinated debentures of the corporate issuer (the holding company), which the trust purchases with the proceeds from the sale of its common and preferred securities. The corporate issuer makes periodic interest payments on the subordinated debentures to the trust, which uses these payments to pay periodic dividends on the trust preferred securities to the investors. These trusts provide certain tax advantages in that dividends paid on the trust securities are tax deductible.

Generally, a holding company issues trust preferred securities. However, it is possible that these securities could be issued at a savings association level. OTS must approve any issuance of these securities or any form of these securities at the savings association level. The approval must be advance of any issuance, and the issuance would only be includable in Tier 2 capital.

Allowance for Loan and Lease Losses (ALLL)

The regulatory capital rules allow savings associations to add the ALLL to Tier 2 capital up to 1.25 percent of risk-weighted assets. The 1.25 percentage is applied to the subtotal risk-weighted assets. The amount added to Tier 2 capital for the ALLL consists of credit losses associated with on-balance sheet loans and leases, such as the ALLL reported on mortgage loans on the balance sheet. The amount determined as the ALLL may not include the ALLL of unconsolidated subordinate organizations or nonincludable subsidiaries. In addition, the ALLL does not include recourse liability accounts that arise from recourse obligations for any transfers of loans or other assets that the savings association reported as a sale. These recourse liability accounts are separate and distinct from the ALLL.

For example, if the subtotal risk-weighted assets equal $500 million, then up to $6.25 million of the ALLL may be added into Tier 2 capital (1.25 percent times $500 million). Therefore, if a savings association has recorded $8 million as the ALLL, then it may add $6.25 million to Tier 2 capital provided it meets all accounting guidelines for estimating the ALLL.

Excess ALLL arises only if a savings association reports more ALLL on TFR schedule SC than it may add to Tier 2 capital. The excess, if any (not including liabilities for credit losses on off-balance sheet credit exposures), is deducted for risk-weighting purposes.

However, if in the above example, the savings association has only $5 million recorded as the ALLL and $3 million recorded as liabilities for credit losses on off-balance sheet credit exposures (commitments, standby letters of credit, and guarantees) that are not related to sales of loans or other assets with recourse, the savings association would include in Tier 2 capital $5 million of the ALLL related to loans and leases plus $1.25 million recorded as liabilities for credit losses on off-balance sheet credit exposures, for a total $6.25 million, which is the overall limit on including the ALLL in Tier 2 capital. Thus, the ALLL potentially includable in Tier 2 capital is the sum of (1) the ALLL on mortgage and nonmortgage loans, and leases, and (2) liabilities for credit losses on off-balance sheet credit exposures such as commitments, standby letters of credit, and guarantees.[13]

For example, if the savings association reports a liability for credit losses on off-balance sheet credit exposures as an "other liability" on schedule SC, and it is comprised of $50,000 associated with letters of credit and $20,000 associated with sales of loans with recourse, only the $50,000 may be includable in the 1.25 percent risk-weighted assets limitation. Sometimes it may be difficult to discern between a recourse liability reserve and a liability for a credit loss on an off-balance sheet credit exposure. Generally, the accounting rules will determine whether a reserve may be considered a liability for credit losses on off-balance sheet credit exposures versus a recourse liability reserve. There have been situations where an arrangement to buy back loans fell within the 120 day rule for recourse, such that, the arrangement was not treated as recourse for purposes of this rule. Therefore, depending on all other considerations, such an amount may be considered for Tier 2 capital treatment as part of the ALLL add-back.

Unrealized Gains on AFS Equity Securities

SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS 115), requires institutions to report unrealized gains and losses from AFS debt and equity securities in AOCI. For Tier

[13] SFAS No. 166, *Accounting for Transfers of Financial Assets-An Amendment of FASB Statement No. 140* (SFAS 166) and SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)* (SFAS 167) made substantive changes to how financial institutions account for many items, including securitized assets. Savings associations affected by these new accounting standards will be subject to higher risk-based capital requirements. Because of this, the federal banking agencies issued an interagency rule on January 28, 2010 (75 FR 4636) that allows financial institutions, including savings associations, an optional four quarter transition period to account for the impact on risk-weighted assets and also on ALLL in Tier 2 capital. The optional treatment provides a two quarter exclusion period and a two quarter phase-in period for assets reported on-balance sheet due to these new accounting standards, and therefore, provides some regulatory capital relief. Specific relief is also provided to certain ALLL. This temporary treatment is explained at 12 CFR § 567.0 (c).

1 capital purposes, as discussed above, a savings associations must reverse (or, neutralize) all unrealized gains related to AFS equity securities reported in AOCI from Tier 1 capital.

However, for Tier 2 capital purposes, a savings association may include up to 45 percent of unrealized gains on AFS equity securities with readily determinable fair values. A savings association reports unrealized gains net of unrealized losses (before income taxes).

TOTAL RISK-BASED CAPITAL

Total Risk-Based capital is the sum of Tier 1 and Tier 2 capital less the following:

Equity Investments and Other Assets Required to be Deducted

Assets required to be deducted from total capital include:

- Investments in other depository institutions (reciprocal holdings) that other depository institutions may count in their regulatory capital (such as capital stock, qualifying subordinated debt, etc.).
- Debt and equity investments in subordinated organizations not constituting subsidiaries under 12 CFR § 567.1 and engaged in activities impermissible for national banks.
- All other equity investments as defined in 12 CFR § 567.1, which is defined to exclude equity investments permissible for a national bank).

For purposes of the capital rule, equity investments are defined as investments in *equity securities* and *real property* that would be considered an equity investment under GAAP (see 12 CFR § 567.1).

Under this definition, the term *equity securities* does NOT include: investments in a subsidiary as defined in 12 CFR § 567.1; equity investments permissible for a national bank; ownership interests in pools of assets that are risk-weighted in accordance with 12 CFR § 567.6; and, stock of Federal Home Loan Banks and Federal Reserve Banks.

Under this definition, the term equity investments in *real property* does NOT include interests in real property that are acquired in satisfactions of a debt previously contracted in good faith or acquired in sales under judgments, decrees, or mortgages held by the savings association, provided that the property is not intended to be held for real estate investment purposes and is expected to be disposed of within five years or a longer period as approved by the OTS.

Deduction for Low-Level Exposures

When recourse is legally and contractually limited to an amount less than the on-balance sheet capital requirement, the savings association can choose to deduct using the simplified/direct deduction method (excluding those CEIO strips already deducted from Tier 1 capital).