



REGULATORY INTERPRETATION 2012-RI-01

Subject: Calculation of Insurance Company Tangible Capital

Issue: Whether, for purposes of applying regulatory limits on members' access to advances, a Federal Home Loan Bank (Bank) may base the calculation of tangible capital for certain insurance company members on financial statements prepared using Statutory Accounting Principles (SAP).

Conclusion: Subject to the considerations herein, a Bank may base its calculation of tangible capital for an insurance company member on SAP-based financial statements, if the insurance company member does not otherwise prepare financial statements based on Generally Accepted Accounting Principles (GAAP).

Background:

Section 1266.4(b) of Federal Housing Finance Agency (FHFA) regulations provides that a Bank cannot make new advances to any member that does not have positive tangible capital, unless the member's appropriate federal or state regulator or insurer¹ requests in writing that the Bank make such an advance. This provision further states that for purposes of determining a member's tangible capital a "Bank shall use the most recently available Thrift Financial Report, Report of Condition and Income, or other regulatory report of financial condition" 12 CFR 1266.4(b). In turn, § 1266.1 of the regulations defines "tangible capital" for any member that is not regulated by the Office of Thrift Supervision (OTS), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) or the board of Governors of the Federal Reserve (FRB), as "capital calculated according to GAAP, less intangible assets as defined by a Bank, . . . provided that the Bank shall include a member's purchased mortgage servicing rights to the extent such rights are included for the purposes of meeting regulatory capital requirements."² This definition of tangible capital would apply for all insurance company members.

¹ The text of the relevant provisions in § 1266.4 of the FHFA's regulations generally refers only to a member's "appropriate federal banking agency or insurer," but § 1266.4(f) of the FHFA's regulations specifically states that for members that "are not federally insured depository institutions, the references . . . to 'appropriate federal banking agency or insurer' shall mean the member's state regulator acting in a capacity similar to an appropriate federal banking agency or insurer." 12 CFR 1266.4(f).

² For members regulated by the OTS, OCC, FDIC or FRB, "tangible capital" is defined in relevant part as "capital, calculated according to GAAP, less intangible assets except for purchased mortgage servicing rights to the extent such assets are included in a member's core or Tier 1 capital . . ." 12 CFR 1266.1.

An issue arises for insurance companies, however, in applying the definition of tangible capital to the extent that the definition provides that capital should be calculated under GAAP. Insurance companies file required financial statements with their state regulators that are based on SAP, and not GAAP, standards.³ More importantly, insurance companies generally will not prepare separate GAAP statements unless they are required to do so because they are public companies required to file financial disclosure documents with the United States Securities and Exchange Commission (SEC) or for other similar reasons. As a result, only a few insurance company members would prepare and file financial reports based on GAAP, and for most insurance company members, periodic GAAP financial reports would not be readily available for the Banks to review. This problem has prompted one Bank to inquire whether the rules could be interpreted to allow the tangible capital of insurance members to be calculated based on SAP financial statements if the member does not otherwise prepare GAAP financial reports.

The regulation provisions at issue were first adopted by the Federal Housing Finance Board (Finance Board) in January 1994. *See* Final Rule: *Advances to Capital Deficient Members, and Other Matters*, 59 FR 2945 (Jan. 20, 1994). In December 2010, FHFA published a final rule which transferred and readopted these provisions, along with the other parts of the advances regulation, to part 1266, in conjunction with making other changes to the advances rule.⁴ *See* Final Rule: *Use of Community Development Loans by Community Financial Institutions to Secure Advances; Secured Lending by Federal Home Loan Banks to their Members and Their Affiliates; Transfer of Advances and New Business Activity Regulations*, 75 FR 76617 (Dec. 9, 2010). The tangible capital provisions and related definitions, however, have not been substantively changed since they were originally adopted in January 1994.

Analysis:

As already noted, the rules implementing the tangible capital test specifically provide that for purposes of determining a member's tangible capital, "[a] Bank shall use the most recently available Thrift Financial Report, Report of Condition and Income, or other regulatory report of financial condition . . ." 12 CFR 1266.4(b)(2). The Finance Board highlighted that it adopted this approach largely because the amount of all members' tangible capital could be "easily verif[ied] using currently available regulatory reports." 59 FR at 2948. In fact, the Finance

³ SAP standards apply only to insurance companies and provide the framework under which regulated insurance companies prepare financial statements for their state regulators. SAP standards are generally based on broad principles outlined by the National Association of Insurance Commissioners (NAIC), but actual accounting rules can vary state-by-state, based on state law. The differences between GAAP and SAP standards reflect, in part, the different purposes for which these standards were developed and how financial statements based on them are used. SAP standards are meant to help determine how well an insurance company can pay on its claims, and SAP-based financial statements help to show how well a company could meet obligations if all its policy holders had an immediate claim. Under SAP, information provided would generally show the value of an insurance company if it ceased operations immediately. The underlying assumptions of GAAP guidelines are that a company is and is expected to continue as a going concern; therefore, GAAP places more emphasis on matching revenues and expenses to help better judge profitability of the firm.

⁴ At the time the tangible capital provisions were first adopted, the advances rules were found at part 935 of the Finance Board regulations. These rules were later moved to part 950 of the Finance Board regulations. *See*, Final Rule: *Reorganization of Federal Housing Finance Board Regulations*, 65 FR 8253, 8254 (Feb. 18, 2000).

Board rejected alternative measures of capital suggested by some commenters to the proposed rule because such measures were not reported in regulatory filings. The Finance Board stated that if such alternative definitions were adopted, “the Banks or their members would be required to perform a separate calculation to determine a member’s capital level, and . . . [this] would place an unnecessary burden on the Banks and their members.” *Id.*

The regulatory definition of “tangible capital,” which is “capital calculated according to GAAP, less intangible assets,” appears inconsistent with the requirement that Banks consider an insurance company member’s most recent regulatory filing of financial condition to determine tangible capital because insurance companies do not generally prepare such reports based on GAAP. In essence, a Bank could require an insurance company member to present specially prepared GAAP financial statements as a basis for calculating tangible capital, or it could use the insurance company’s regulatory filing as the basis for calculating tangible capital, but it generally cannot use the regulatory filing to estimate tangible capital defined as “capital calculated in accordance with GAAP less intangible assets. . . .” The Supplementary Information to the proposed or final Finance Board rule did not identify this apparent conflict or indicate how it should be resolved.

Instead, when first proposing the definition of tangible capital, the Finance Board noted that Banks would need to adjust an insurance company’s reported regulatory capital to exclude “certain insurance and reserve accounts that may not be appropriate to the definition of tangible capital.”⁵ Proposed Rule: *Advances*, 57 FR 45338, 45339 (Oct. 1, 1992). Therefore, the Finance Board defined “tangible capital” to allow the Banks broad flexibility to define “intangible assets” for insurance company and credit union members, although it did not provide similar flexibility for defining intangible assets of other members. *Id.* The Finance Board also stated that “[f]or credit union and insurance company members, the level of tangible capital will be determined by the Bank consistent with the parameters used for savings associations and commercial bank members.” *Id.* The Finance Board reiterated the point that it provided the Banks flexibility to adjust “intangible assets” for members not regulated by the OTS, FDIC, the OCC or FRB when it later re-proposed the tangible capital provisions and again underscored its expectation that, with regard to this flexibility, “each Bank will define intangible assets in the same manner for all of its members and will treat all members equally.” 58 FR at 49448.

In adopting the final rule, the Finance Board made clear that it intended tangible capital to be based on a member’s regulatory filings so as not to place “unnecessary” burdens on members or Banks by mandating a “separate calculation” of capital levels. *See* 59 FR at 2948. It further

⁵ While the Finance Board first proposed the tangible capital requirements along with other general amendments to the advances regulations, it did not adopt the tangible capital provisions as part of this initial rulemaking. Instead, “[d]ue to the important points raised by the commenters, particularly those provided by the regulators,” it decided to defer action on the provision until a subsequent rulemaking. Final Rule: *Advances*, 58 FR 29456, 29457 (May 20, 1993). It subsequently re-proposed the provisions related to the tangible capital requirement without much substantive change from the original proposal, although it added a proposed provision (later adopted) that a Bank cease lending to an undercapitalized but tangibly solvent member if informed in writing by the member’s regulator or insurer that the member’s use of advances had been prohibited. *See* Proposed Rule: *Advances to Capital Deficient Members and Other Matters*, 58 FR 49446, 49447 (Sept. 23, 1993).

made clear that it defined tangible capital for insurance company and credit union members flexibly so Banks could adjust these entities' reported regulatory capital based on other information in the members' regulatory filing to assure that their tangible capital was "consistent" with that of savings associations and commercial bank members. *See* 57 FR at 45339. Given these statements, it is reasonable to interpret the definition of tangible capital as allowing a Bank to adjust an insurance company's reported regulatory capital by subtracting intangible assets, using information in the company's regulatory filing, even if such information is calculated under SAP, so long as the resulting tangible capital number would be reasonably comparable to that of non-insurance company members that provide GAAP-based financial statements. Otherwise, insurance company members that do not normally prepare GAAP financial statements would have additional and extra burdens imposed on them in order to borrow from the Bank, which the Finance Board did not intend. Instead, the Finance Board implemented a flexible approach that would allow the Banks to readily calculate tangible capital for all members based on such members' regulatory filings in such a manner that the resulting numbers would be comparable across all membership classes. For insurance company members that otherwise prepare periodic GAAP financial statements, it is equally reasonable that the Banks would use such statements as the most comparable starting point for calculating those members' tangible capital.⁶

To comport with good governance, as well as to provide an appropriate basis for examination and verification, each Bank should document how it adjusted the SAP-based regulatory capital numbers so that the resulting tangible capital is comparable to that of members that file financial statements based on GAAP standards. In particular, Banks should identify cases in which an insurance company member has been granted permission from its regulator to deviate from applicable SAP standards in calculating reserves or other financial statement items. Where such permitted practices have been allowed, the Bank should assess them and make appropriate adjustments to the calculations appearing in the member's regulatory filing. Banks also should comply with any future interpretive guidance that the FHFA may provide as to specific adjustments that should be made to SAP-based financial statements to achieve broad comparability with GAAP-based statements.

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This Regulatory Interpretation is issued pursuant to 12 CFR 907.5 and is subject to modification or rescission by the Director of the Federal Housing Finance Agency.

⁶ In addition, if an insurance company member is part of a larger corporate group that prepares GAAP statements, a Bank should make reasonable efforts to obtain GAAP-based financial information from the insurance company member to the extent such information is prepared for use in the financial statements of the corporate group.