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Office of Thrift Supervision
Department of the Treasury
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John F. Downey
Executive Director, Supervision

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Any attachments to this document are rescinded only as they relate to national banks and federal savings associations.

MEMORANDUM FOR: Chief Executive Officers

FROM: John F. Downey
Executive Director, Supervision

SUBJECT: Inclusion of Purchased Allowance for Loan and Lease Losses in Supplementary Capital

The OTS is modifying its current regulatory capital policy to permit the inclusion of purchased allowances for loan and lease losses (ALLL) in supplementary capital for risk-based capital purposes. Purchased ALLL generally arise when institutions acquire loans subject to OTS's ALLL policy from other parties (1) through a business combination accounted for as a purchase or (2) through the purchase of a loan or a package of loans.

Policy Guidance

The OTS will permit the inclusion of purchased ALLL in supplementary capital in instances where the balance and nature of the purchased ALLL is consistent with OTS policy. OTS policy is described in the Thrift Activities Regulatory Handbook: Section 260, "Classification of Assets" (TARH 260), and Section 261, "Adequacy of Valuation Allowances" (TARH 261). The OTS may disallow the inclusion of purchased ALLL in supplementary capital in instances not consistent with OTS policies.

OTS policy regarding ALLL is described in TARH 261. Institutions must maintain an ALLL at a level that is adequate to absorb all estimated credit losses associated with the loan portfolio, including purchased loans. Any valuation allowance or other contra-asset account at a level significantly in excess of that needed to absorb estimated credit losses may not be characterized as an ALLL. In addition, that portion of a purchase discount associated with matters other than credit risk, such as value adjustments caused by interest-rate movements, may not be included in the ALLL.

In addition, for any portion of an asset classified Loss, institutions shall either 1) establish a specific valuation allowance equal to 100 percent of that amount, or 2) charge off such amount. Specific valuation allowances or charge-offs related to loan amounts classified as Loss, are not part of the ALLL, and are therefore not includable in regulatory capital.

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Where the purchased loans are troubled, collateral-dependent loans for which collection in full of contractual amounts due is not probable, the amount classified Loss should be no less than any recorded amount in excess of the fair value of the collateral. As a result, a significant portion of the purchase discount on such loans generally should be classified Loss. For purchased loans, the amount classified Loss may be characterized by a contra-asset account (for example, specific valuation allowance or charge-off). However, the amount classified Loss may not be characterized as an ALLL.

The OTS will implement this revised policy by amending the Thrift Financial Report instructions for thrifts to follow in computing the amount of ALLL to include in supplementary capital (Schedule CCR Line 350: Allowance for Loan and Lease Losses). No regulatory change is necessary.

Background

This policy change makes the OTS policy consistent with the policies of the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve System (Board), all of which permit the inclusion of purchased ALLL in supplementary capital. The OCC issued OCC Bulletin OCC 95-21: "Accounting for the Allowance for Loan and Lease Losses in a Business Combination" (April 14, 1995). While the FDIC and Board have not issued any specific written guidance on this issue, we understand that all three agencies now follow the OCC approach of permitting the inclusion of purchased ALLL in capital, regardless of whether it results from negative-bid acquisitions or other purchase transactions.