FEDERAL RESERVE BANK
OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

August 18, 1992

DALLAS, TEXAS 75222

Notice 92-73

TO: The Chief Executive Officer of each
member bank and others concerned in
the Eleventh Federal Reserve District

SUBJECT

Request for Comment on and Consideration of Various Regulatory Reporting and Capital Treatments for Net Deferred Tax Assets of Federally Supervised Banks and Savings Associations

DETAILS

The Federal Financial Institutions Examination Council (FFIEC) has requested public comment on and will consider various regulatory reporting and capital treatments for net deferred tax assets of federally supervised banks and savings associations for purposes of the Consolidated Reports of Condition and Income (Call Reports) and Thrift Financial Report (TFR).

The FFIEC's request for comment is in response to the adoption by the Financial Accounting Standards Board of Statement of Financial Accounting Standards No. 109 (FASB 109), "Accounting for Income Taxes."

ATTACHMENT

A copy of the FFIEC's notice as it appears on pages 34135-38, Vol. 57, No. 149, of the Federal Register dated August 3, 1992, is attached.

MORE INFORMATION

For more information, please contact Dorsey Davis at (214) 744-7420. For additional copies of this Bank's notice, please contact the Public Affairs Department at (214) 922-5254.

Sincerely yours,

Robert D. McTeer, Jr.

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FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Regulatory Treatment of Deferred Tax Assets

AGENCY: Federal Financial Institutions Examination Council.

ACTION: Request for comment.

SUMMARY: Under the auspices of the Federal Financial Institutions Examination Council (FFIEC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (referred to as the "agencies") are requesting comment on and considering various regulatory reporting and capital treatments for net deferred tax assets of federally supervised banks and savings associations ("depository institutions"). This request for comment is being issued in response to the adoption by the Financial Accounting Standards Board (FASB) of Statement No. 109, "Accounting for Income Taxes"("FASB 109"), in February 1992.

The alternatives under consideration by the agencies include: (1) Adopting all provisions of FASB 109 for purposes of reporting in the Consolidated Reports of Condition and Income (Call Reports) and Thrift Financial Report (TFR) and calculating regulatory capital, (2) adopting most provisions of FASB 109 for purposes of the Call Report and TFR, but prohibiting the reporting of that portion of net deferred tax assets that is not supported by the amount of taxes previously paid that are potentially recoverable through the carryback of net operating losses or tax credits, (3) adopting most provisions of FASB 109 for purposes of the Call Reports and TFR, but limiting the reporting of net deferred tax assets in a manner that is consistent with Accounting Principles Board Opinion No. 11, "Accounting for Income Taxes" ("APB 11"), and (4) adopting one of the above limitations on net deferred tax assets only for regulatory capital purposes rather than for both regulatory reporting and capital purposes. The agencies seek comment on whether, with respect to insured depository institutions, these approaches or any other approaches would be an appropriate supervisory response by the agencies to the new reporting guidance set forth in FASB Statement 109.

DATES: Comments must be received by September 2, 1990.

ADDRESSES: Comments should be directed to Joe M. Cleaver, Executive Secretary, Federal Financial Institutions Examination Council, 2100 Pennsylvania Avenue, NW., suite 200, Washington, DC 20037.

FOR FURTHER INFORMATION CONTACT: At the FRB: Gerald A. Edwards, Jr., Assistant Director (202) 452–2741, or Charles H. Holm, Supervisory Financial Analyst (202) 452–3502, Division of Banking Supervision and Regulation. At the FDIC: Robert F. Storch, Chief, Accounting Section, Division of Supervision (202) 898–8906. At the OCC: Eugene W. Green, Deputy Chief Accountant, or Stephen P. Theobald, Professional Accounting Fellow, (202) 874–5180. At the OTS: David H. Martens, Chief Accountant (202) 906–5646.

SUPPLEMENTARY INFORMATION:

I. Background

National banks, state member banks, and federally insured state nonmember banks are required to file quarterly Call Reports with the OCC, FRB, and FDIC, respectively. Savings associations are required to file TFRs with the OTS. In addition, each federally supervised financial institution is subject to the minimum capital standards issued by its primary federal regulator.

Section 1006(c) of the Federal Financial Institutions Examination Council Act authorizes the FFIEC to develop uniform reporting standards for federally supervised financial institutions. Section 1006(b) of the FFIEC Act directs the FFIEC to make recommendations to its member agencies for uniformity in supervisory matters. Therefore this request for comment is being proposed under the auspices of the FFIEC.

In addition, section 121 of the FDIC Improvement Act (FDICIA) indicates that the agencies shall maintain uniform accounting standards. Section 121 of the FDICIA also indicates that the accounting principles of the agencies should:

(A) result in financial statements and reports of condition that accurately reflect the capital of the institution;

(B) facilitate effective supervision of the institution; and

(C) facilitate prompt corrective action to resolve the institution at the least cost to the insurance funds.

If the agencies determine that the application of generally accepted accounting principles (GAAP) is inconsistent with these objectives, FDICIA permits the agencies to prescribe an accounting principle that is no less stringent than GAAP.

II. Discussion and Concerns

Characteristics of Net Deferred Tax Assets

Net deferred tax assets may arise because of specific limitations under tax laws of different tax jurisdictions that require that certain net operating losses (i.e., when, for tax purposes, expenses exceed revenues) or tax credits be carried forward if they cannot be used to recover taxes previously paid.[1] These net operating loss or tax credit carryforwards are realized only if the institution generates sufficient future taxable income during the carryforward period.

Net deferred tax assets may also arise from the tax effects of certain events that have been recognized in one period for financial statement purposes but will

[1] The term "net" deferred tax assets is used herein because FASB 109 permits the netting of deffered tax liabilities and assets within a particular tax-paying component of an enterprise and within a particular tax jurisdiction. Netting of deferred tax assets and liabilities attributable to different tax-paying components of the enterprise or to different tax jurisdictions is not permitted. The agencies intend to permit netting to the same extent that netting is permitted by FASB 109.

result in deductible amounts in future periods for tax purposes, i.e., the tax effects of deductible temporary differences. For example, many depository institutions may report higher income to taxing authorities than they reflect in their regulatory reports because of differences between tax reporting and financial reporting with respect to the treatment of the allowance for loan and lease losses.

Deferred tax assets, arising from an institution's deductible temporary differences, may exceed the amount of taxes previously paid that the institution could recover if the difference fully reversed at the report date. Thus, similar to net operating loss and tax credit carryforwards, these deductible temporary differences will be realized only if there is sufficient future taxable income during the carryforward period.[2]

Current Regulatory Policies and Progression of GAAP

In 1985, the OCC and FDIC issued supervisory policies that limited the reporting of net deferred tax assets (charges) in the Call Reports filed by national and insured state nonmember banks, respectively. The FDIC's policy, set forth in bank Letter BL-36-85, dated October 4, 1985, states:

> Banks are permitted to carry net deferred tax charges on their reports of condition to the extent that such tax charges do not exceed taxes previously paid which are potentially available through carryback of net operating losses (NOLs). A bank which is a member of a consolidated group for tax purposes (e.g., certain bank subsidiaries of holding companies) should generally calculate its NOL carryback potential based upon the assumption that it is filing a separate return. However, if the NOL carryback potential of the consolidated group is less than that of the banks (e.g., where other subsidiaries have experienced prior net operating losses), then the bank should further limit its net deferred tax charges to an amount which it could reasonably expect to have refunded by its parent. The OCC's policy, set forth in Banking Circular 202 dated July 2, 1985, includes language that is consistent with the FDIC policy. The OCC and FDIC adopted their supervisory policies because of concerns about the realizability of an institution's net deferred tax charges in excess of its net operating loss carryback potential.

With respect to the recognition of net operating loss carryforwards, the OCC's and FDIC's policies were generally consistent with APB 11, the GAAP standard in existence at the time these policies were issued. APB 11 did not allow the recognition of such benefits unless their realization was assured beyond any reasonable doubt. Furthermore, these two agencies' policies were generally consistent with FASB Statement No. 96, "Accounting for Income Taxes" ("FASB 96"), a GAAP standard issued in 1987, which some institutions subsequently adopted in lieu of APB 11.

The FRB and OTS did not issue policies explicitly addressing the recognition of net deferred tax assets. Consequently, state member banks and savings institutions were able to report net deferred tax assets in accordance with GAAP. Since the explicit guidelines issued by the OCC and FDIC were for the most part consistent with GAAP, the reporting criteria applicable to all depository institutions were similar.

In February 1992, the FASB issued Statement No. 109, which supersedes APB 11 and FASB 96. FASB 109 provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax assets. FASB 109 potentially allows some institutions to record significantly higher net deferred tax assets than previously permitted under GAAP. Statement 109 is effective for fiscal years beginning on or after December 15, 1992, but early adoption of this standard is encouraged by the FASB. The recording of additional net deferred tax assets in Call Reports and TFRs in accordance with FASB 109 would directly impact an institution's Tier 1 capital and earnings.

Contrary to the general practice under APB 11, FASB 96, and the policies off the OCC and FDIC, FASB 109 permits the reporting of deferred tax assets associated with net operating loss and tax credit carryforwards. Moreover, compared to these standards and policies, FASB 109 generally permits a more liberal recognition of net deferred tax assets arising from deductible temporary differences when the realization of deductible temporary differences is dependent upon taxable income during the carryforward period. However, FASB 109 requires the establishment of a valuation allowance that is intended to reduce the net deferred tax asset to an amount that is more likely than not (i.e., a greater than 50 percent likelihood) to be realized.

Arguments For and Against Regulatory Limitations on Net Deferred Tax Assets

Arguments can be made both for and against permitting institutions to recognize, in regulatory reports and for capital adequacy purposes, net deferred tax assets that are dependent upon future taxable income. On the one hand, institutions that are ultimately able to realize these net deferred tax assets will benefit from a reduction in the future tax payments that they otherwise would be obligated to make. For many healthy institutions, these benefits may eventually result in a realizable asset. Thus, from this perspective, it could be argued that some institutions should be able to report net deferred tax assets that are dependent upon future taxable income and increase their Tier 1 capital levels.

On the other hand, institutions that are unable to realize their net deferred tax assets may be more likely to pose a risk to the deposit insurance funds. Moreover, it may be difficult to accurately distinguish those institutions that will benefit from these assets from those that will not. The ultimate realization of a net deferred tax asset depends on the existence of taxable income during the carryback or carryforward period. The existence of taxable income and associated tax payments during the carryback period provides greater assurance that net deferred tax assets will be realized. In the absence of sufficient taxable income during the carryback period, realization of the net deferred tax asset depends on whether an institution has sufficient future taxable income during the carryforward period.

Since an institution that is in a net operating loss carryforward position is often experiencing financial difficulties, its prospects for generating sufficient taxable income in the future are at best uncertain. In addition, the condition of and future prospects for an institution often can and do change very rapidly in the environment in which depository institutions operate. This raises concerns about the realizability of net deferred tax assets that are dependent upon future taxable income, even when an institution appears on the surface to be sound and well-managed. Thus, for many institutions, such net deferred tax assets may not be realized and, for other institutions, there will be a high degree of subjectivity in determining the realizability of this asset.

In addition, as an institution's condition deteriorates, it is less likely that net deferred tax assets that are dependent upon future taxable income of the institution will be realized. Therefore, the institution would be expected under FASB 109 to reduce its net deferred tax assets through increases to the asset's valuation allowance. This reduces the institution's

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[2] Net deferred tax assets that are associated with net operating loss or tax credit carryforwards and net deferred tax assets, arising from deductible temporary differences, that exceed the amount of taxes previously paid that the institution could recover if the differences fully reversed at the report date are hereafter referred to as "net deferred tax assets that are dependent upon future taxable income".

regulatory capital at precisely the time it needs capital support the most. Thus, the reporting of net deferred tax assets that are dependent upon future incomes raises, for safety and soundness reasons, a significant supervisory concern.

Moreover, net operating loss carryforwards of an acquired institution can be severely limited to the acquirer when an acquisition or change in control occurs. If an acquisition is structured as a taxable asset purchase, the net operating loss carryforwards are generally extinguished. In addition, if an acquisition or change in control qualifies as a tax-free reorganization, a strict limitation (Section 382 of the Internal Revenue Code) on the use of the acquired institution's NOL carryforwards generally applies. This limitation is based on the value of the acquired corporation at the time of its acquisition, and thus the potential value of a carryforward to a prospective purchaser tends to decline as the institution's financial condition weakens.

Because of these concerns, the agencies recently issued separate letters to the depository institutions under their supervision indicating that the institutions should not adopt FASB 109 or regulatory purposes until the appropriate regulatory reporting and capital treatment is determined.[3]

III. Alternative Approaches for Deferred Tax Assets

As part of their consideration of FASB 109, the agencies have determined to seek public comment on alternative treatments of net deferred tax assets for regulatory reporting and capital purposes. In general, the agencies believe that most provisions of FASB 109 are appropriate for supervisory purposes and can be adopted by the agencies for regulatory reporting purposes. However, the agencies are concerned about those provisions of FASB 109 that, as noted above, permit institutions to recognize net deferred tax assets that are dependent upon future taxable income. Therefore, the agencies are seeking public comment on the appropriate regulatory treatment for these assets. The alternatives under consideration by the agencies include:

1. Amending the Call Report and TFR instructions to adopt all aspects of FASB 109 for regulatory reporting (and capital adequacy) purposes. Because FASB 109 provides for a limitation on the recognition of net deferred tax assets through establishing a valuation allowance, it could be argued that the agencies might not need to provide for additional limitations on these assets. The reporting of this asset would be subject to review by examiners and, if applicable, an institution's external auditor. This approach has the advantage of maintaining consistency between GAAP and the regulatory reporting and capital treatment of net deferred tax assets. However, as noted above, the agencies are concerned that this alternative could result in an immediate and potentially significant reduction in capital at precisely the time the institution needs capital support the most.

A variation of this approach would be for the agencies to issue supervisory guidance on the determination of the amount of the valuation allowance needed for an institution's net deferred tax assets to supplement the guidance provided in FASB 109. Institutions exhibiting financial weaknesses are generally less likely to be able to realize this asset than institutions that are in a stronger financial condition. In order to provide greater protection to the deposit insurance funds and to provide more objectivity to the valuation process, this supervisory guidance would likely mandate valuation allowance levels for institutions experiencing financial difficulties. Thus, this supervisory guidance may not be entirely consistent with FASB 109. Furthermore, this approach does not necessarily alleviate the concern that capital would be reduced at the time the institution needs capital support the most.

2. Amending the Call Report and TFR instructions to adopt most aspects of FASB 109, but limiting the reporting of net deferred tax assets, net of their valuation allowance, to the amount of taxes previously paid that are potentially recoverable through the carryback of net operating losses or unrealized tax credits.[4] This approach would not be consistent with FASB 109. However, it would be consistent with the current supervisory policies of the FDIC and OCC. Furthermore, this approach would, for the most part, be consistent with the policies of the FRB and OTS, which permitted institutions to report net deferred tax assets in accordance with FASB 96 and APB 11. The agencies have long believed that such limitations on the reporting of net deferred tax assets are appropriate because of the concerns noted above with respect to the realization of this asset. While no final determination will be made until all comments are received, the agency staffs believe this approach would be the most appropriate course of action at this time because of the concerns noted above.[5]

3. Amending the Call Report and TFR instructions to adopt most aspects of FASB 109, but limiting the reporting of net deferred tax assets, net of their valuation allowance, in a manner that is consistent with APB 11. APB 11 generally does not permit the reporting of net deferred tax assets arising from net operating loss carryforwards. However, some accountants believe that APB 11 in some cases permits the reporting of net deferred tax assets arising from temporary differences (referred to as "timing differences" in APB 11) that are realizable only if there is sufficient future taxable income. By limiting the amount of such assets that could be reported under this approach, the Tier 1 capital of an institution would similarly be affected. This approach has the advantage of generally being consistent with the existing policies of the FRB and OTS, which permitted institutions to report net deferred tax assets under APB 11 (or alternatively, under FASB 96). On the other hand, this approach would maintain a reporting standard for net deferred tax assets that has been superseded by FASB 109 and

[3] OTS' letter indicated that savings associations could adopt the provisions of FASB 109, except that any net deferred tax asset could not exceed what was allowed to be reported under APB 11 or FASB 96.

[4] An institution that is a member of a consolidated group for tax purposes (e.g., certain depository institution subsidiaries of holding companies) would be instructed generally to calculate its carryback potential based upon the assumption that it is filing a separate return. However, if the carryback potential of the consolidated group is less than that of the institution (e.g., where other subsidiaries of the holding company have experienced prior net operating losses), then the institution would be instructed to further limit its net deferred tax asset to an amount that it could reasonably expect to have refunded by its parent.

[5] Although this proposed reporting instruction is, for the most part, consistent with GAAP prior to the adoption of FASB 109, some differences exist. For example, APB 11 did not require the automatic write-off of net deferred tax assets arising from deductible temporary differences (referred to as "timing differences" in APB 11) that are dependent on future taxable income. Since state member banks and savings associations previously followed GAAP for reporting net deferred tax assets, these institutions may have reported some net deferred tax asset amounts in excess of what they would be allowed under this approach. Therefore, state member banks and savings associations would be able to continue to report such excess net deferred tax assets, to the extent they remain unamortized, provided the assets are recorded prior to the adoption of a final rule. This provision would also be followed if another alternative were adopted that required a limitation on deferred tax assets that is stricter than the limitation under APB 11.

would be inconsistent with the current policies of the OCC and FDIC.

4. The above approaches could provide for a more stringent reporting limitation on net deferred tax assets than is required by FASB 109. Rather than adopting a more stringent limitation for reporting purposes, an alternative would be to adopt one of the above limitations only as an adjustment to regulatory capital calculations. Net deferred tax assets in excess of the prescribed limitation would be deducted in determining Tier 1 capital for risk-based, leverage, and tangible capital ratio purposes, and a depository institution would have the same regulatory capital ratios as if the same limitation had been adopted for regulatory reporting purposes. This approach has the advantage of maintaining consistency between regulatory reporting instructions and GAAP. However, unlike a reporting limitation, it would allow institutions to report earnings based on net deferred tax assets that may not be realized. Furthermore, since certain dividend restrictions (i.e., 12 U.S.C. 60 and similar state statutes) for banking institutions are based on reported earnings, it could allow such institutions to pay dividends based on the increased earnings arising from reporting such assets.

IV. Issues for Comment

The agencies seek comment on which, if any, of the above possible approaches for addressing net deferred tax assets is appropriate in light of the agencies' supervisory concerns about net deferred tax assets that are dependent upon future taxable income and the objectives that regulatory accounting principles must satisfy as set forth in FDICIA. Comment is also sought on whether any other approaches might be appropriate. In addition, specific comment is solicited on the following issues:

1. Whether there are certain deferred tax assets, associated with specific events or other factors, that possess characteristics that reduce or eliminate the agencies' concerns relative to the realization of net deferred tax assets.

2. What criteria could be used to distinguish institutions that are likely to be able to realize net deferred tax assets that are dependent upon future taxable income from those institutions that are not likely to realize these assets.

3. If an approach were adopted by the agencies that is more conservative with respect to net deferred tax assets than APB 11, whether the grandfathering provision for state member banks and savings associations that is discussed in footnote 5 should be adopted.

Dated: July 29, 1992.

Joe M. Cleaver,

Executive Secretary, Federal Financial Institutional Examination Council.

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