# FEDERAL RESERVE BANK
# OF NEW YORK

[ Circular No. **10769**
January 27, 1995 ]

## CAPITAL ADEQUACY GUIDELINES

### Limitation on the Amount of Deferred Tax Assets Included in Tier 1 Capital

*Effective April 1, 1995*

*To All State Member Banks and Bank Holding Companies
in the Second Federal Reserve District, and Others Concerned:*

Following is the text of a statement issued by the Board of Governors of the Federal Reserve System:

The Federal Reserve Board has issued amendments to its capital adequacy guidelines for state member banks and bank holding companies to establish a limitation on the amount of certain deferred tax assets that may be included in (that is, not deducted from) Tier 1 capital for risk-based and leverage capital purposes.

The amendments are effective April 1, 1995.

The capital rule was developed in response to the Financial Accounting Standards Board's (FASB) issuance of Statement No. 109, "Accounting for Income Taxes" (FAS 109).

Under the final rule, deferred tax assets that can only be realized if an institution earns taxable income in the future are limited for regulatory capital purposes to the amount that the institution expects to realize within one year of the quarter-end report date — based on its projection of taxable income — or 10 percent of Tier 1 capital, whichever is less. Deferred tax assets that can be realized from taxes paid in prior carryback years would generally not be limited.

Enclosed — for state member banks, bank holding companies, and others who maintain sets of the Board's regulations — is the text of the amendments, effective April 1, 1995, as published in the *Federal Register.* Questions regarding this matter may be directed to Stephanie Martin, Senior Financial Specialist, Bank Analysis Department (Tel. No. 212-720-1418).

William J. McDonough,
*President.*

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CAPITAL ADEQUACY GUIDELINES

Amendments
Effective April 1, 1995

**FEDERAL RESERVE SYSTEM**

**12 CFR Parts 208 and 225**

**[Regulations H and Y; Docket No. R–0795]**

**Capital; Capital Adequacy Guidelines**

**AGENCY:** Board of Governors of the Federal Reserve System.

**ACTION:** Final rule.

**SUMMARY:** The Board of Governors of the Federal Reserve System (Board or Federal Reserve) is revising its capital adequacy guidelines for state member banks and bank holding companies to establish a limitation on the amount of certain deferred tax assets that may be included in (that is, not deducted from) Tier 1 capital for risk-based and leverage capital purposes. The capital rule was developed in response to the Financial Accounting Standards Board's (FASB) issuance of Statement No. 109, "Accounting for Income Taxes" (FAS 109). Under the final rule, deferred tax assets that can only be realized if an institution earns taxable income in the future are limited for regulatory capital purposes to the amount that the institution expects to realize within one year of the quarter-end report date—based on its projection of taxable income—or 10 percent of Tier 1 capital, whichever is less.

**EFFECTIVE DATE:** April 1, 1995.

**FOR FURTHER INFORMATION CONTACT:** Charles H. Holm, Project Manager, (202) 452–3502; Nancy J. Rawlings, Senior Financial Analyst, (202) 452–3059, Regulatory Reporting and Accounting Issues Section; Barbara J. Bouchard, Supervisory Financial Analyst, (202) 452–3072, Policy Development Section, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202) 452–3544.

[Enc. Cir. No. 10769]

**SUPPLEMENTARY INFORMATION:**

## I. Background

### *A. Characteristics of Deferred Tax Assets*

Deferred tax assets are assets that reflect, for financial reporting purposes, benefits of certain aspects of tax laws and rules. Deferred tax assets may arise because of specific limitations under tax laws of different tax jurisdictions that require that certain net operating losses (e.g., when, for tax purposes, expenses exceed revenues) or tax credits be carried forward if they cannot be used to recover taxes previously paid. These "carryforwards" are realized only if the institution generates sufficient future taxable income during the carryforward period.

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 result in deductible amounts in a future period for tax purposes, i.e., the tax effects of "deductible temporary differences." For example, many depository institutions and bank holding companies may report higher income to taxing authorities than they reflect in their regulatory reports [1] because their loan loss provisions are expensed for reporting purposes but are not deducted for tax purposes until the loans are charged off.

Deferred tax assets arising from an organization's deductible temporary differences may or may not exceed the amount of taxes previously paid that the organization could recover if the organization's temporary differences fully reversed at the report date. Some of these deferred tax assets may theoretically be "carried back" and recovered from taxes previously paid. On the other hand, when deferred tax assets arising from deductible temporary differences exceed such previously paid tax amounts, they will be realized only if there is sufficient future taxable income during the carryforward period. Such deferred tax assets, and deferred tax assets arising from net operating loss and tax credit carryforwards, are hereafter referred to as "deferred tax assets that are dependent upon future taxable income."

### *B. Summary of FAS 109*

In February 1992, the FASB issued Statement No. 109, "*Accounting for Income Taxes*" which supersedes Accounting Principles Board Opinion No. 11 and FASB Statement No. 96. FAS 109 provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax assets. FAS 109 potentially allows some state member banks and bank holding companies to record significantly higher deferred tax assets than previously permitted under generally accepted accounting principles (GAAP) and the federal banking agencies' prior reporting policies.[2] Unlike the general practice under previous standards, FAS 109 permits the reporting of deferred tax assets that are dependent upon future taxable income. However, FAS 109 requires the establishment of a valuation allowance 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.

FAS 109 became effective for fiscal years beginning on or after December 15, 1992. The adoption of this standard has resulted in the reporting of additional deferred tax assets in Call Reports and FR Y–9C reports that directly increase institutions' undivided profits (retained earnings) and Tier 1 capital.

### *C. Concerns Regarding Deferred Tax Assets That Are Dependent Upon Future Taxable Income*

The Federal Reserve has certain concerns about including in capital deferred tax assets that are dependent upon future taxable income. Realization of such assets depends on whether a banking organization has sufficient future taxable income during the carryforward period. Since a banking organization 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 uncertain. In addition, the condition of and future prospects for an organization

[1] State member banks are required to file quarterly Consolidated Reports of Condition and Income (Call Reports) with the Federal Reserve. Bank holding companies with total consolidated assets of $150 million or more file quarterly Consolidated Financial Statements for Bank Holding Companies (FR Y–9C reports) with the Federal Reserve

[2] The federal banking agencies consist of the Federal Reserve Board (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (hereafter the "agencies")

often can and do change very rapidly in the banking environment. This raises concerns about the realizability of deferred tax assets that are dependent upon future taxable income, even when an organization may be sound and well-managed. Thus, for many organizations such deferred tax assets may not be realized, and for other organizations there is a high degree of subjectivity in determining the realizability of this asset. Furthermore, while many organizations may be able to make reasonable projections of taxable income for relatively short periods and actually realize this income, beyond a short time period, the reliability of the projections tends to decrease significantly. In addition, unlike many other assets, banking organizations generally cannot obtain the value of deferred tax assets by selling them.

Moreover, as an organization's condition deteriorates, it is less likely that deferred tax assets that are dependent upon future taxable income will be realized. Therefore, the organization is required under FAS 109 to reduce its deferred tax assets through increases to the asset's valuation allowance. Additions to this allowance would reduce the organization's regulatory capital at precisely the time it needs capital support the most. Thus, the inclusion in capital of deferred tax assets that are dependent upon future taxable income raises supervisory concerns.

Because of these concerns, the agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), considered whether it would be appropriate to adopt FAS 109 for regulatory reporting purposes. On August 3, 1992, the FFIEC requested public comment on this matter, and on December 23, 1992, after consideration of the comments received, the FFIEC decided that banks and savings associations should adopt FAS 109 for reporting purposes in Call Reports and Thrift Financial Reports (TFRs) beginning in the first quarter of 1993 (or the beginning of their first fiscal year thereafter, if later). Furthermore, the Board decided that bank holding companies should adopt FAS 109 in FR Y-9C Reports at the same time.

*D. Proposal for the Treatment of Deferred Tax Assets*

The FFIEC, in reaching its decision on regulatory reporting, also recommended that each of the agencies amend its regulatory capital standards to limit the amount of deferred tax assets that can be included in regulatory capital. In response to the FFIEC's recommendation, on February 11, 1993, the Board issued for public comment a proposal to adopt the recommendation of the FFIEC in full, as summarized below (54 FR 8007, February 11, 1993). The FFIEC recommended that the agencies limit the amount of deferred tax assets that are dependent upon future taxable income that can be included in regulatory capital to the lesser of:

i. the amount of such deferred tax assets that the institution expects to realize within one year of the quarter-end report date, based on its projection of taxable income (exclusive of net operating loss or tax credit carryforwards and reversals of existing temporary differences), or

ii. 10 percent of Tier 1 capital, net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships (and before any disallowed deferred tax assets are deducted). Deferred tax assets that can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences would generally not be limited under the proposal.

**II. Public Comments on the Proposal**

The comment period for the Board's proposal ended on March 15, 1993. The Board received nineteen comment letters including ten from multinational and large regional banking organizations, and three community banks. In addition, the Board received four comment letters from bank trade associations and two from finance companies. Sixteen commenters offered support for the Board's proposal to require banking organizations to *report*, for regulatory purposes, deferred tax assets in accordance with FAS 109. In addition, fifteen commenters indicated that it would be preferable for the Board to place no limit on the amount of deferred tax assets allowable in capital. These commenters indicated that, in their view, embracing FAS 109 in its entirety would achieve consistency between regulatory standards and GAAP as well as maintain consistency with the intent of Section 121 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. Commenters asserted that the criteria set forth in FAS 109 to recognize and value deferred tax assets is sufficiently conservative to limit any exposure to the bank insurance fund and that an arbitrary or mechanical formula, such as the ones proposed, would not provide a more accurate or reliable result.

While preferring no capital limit on deferred tax assets, some commenters noted that the proposal represented a compromise and a step forward from prior regulatory policies that permitted little or no inclusion in regulatory reports or capital of deferred tax assets that are dependent upon future taxable income. Two commenters generally supported the proposal or expressed their understanding of the regulator's concern regarding the realizability of deferred tax assets and one commenter indicated the capital treatment should be consistent with the capital treatment for identifiable intangible assets.

*A. Responses to the Board's Questions*

Question 1. (Gross-up of Intangible Assets) Nine commenters responded to the Board's first question regarding whether certain identifiable intangible assets acquired in a nontaxable business combination accounted for as a purchase should be adjusted for the tax effect of the difference between the market or appraised value of the asset and its tax basis. Under FAS 109, this tax effect is recorded separately in a deferred tax liability account, whereas under preexisting GAAP, this tax effect reduced the amount of the intangible asset. This change in treatment could cause a large increase (i.e., gross-up) in the reported amount of certain identifiable intangible assets, such as core deposit intangibles, which are deducted for purposes of computing regulatory capital.

Seven commenters indicated that banking organizations should be permitted to deduct the net after-tax amount of the intangible asset from capital, not the gross amount of the intangible asset. These commenters argued that FAS 109 will create artificially high values for intangible assets and the related deferred tax liability when a banking organization acquires the assets with a carryover basis for tax purposes but revalues the asset for financial reporting purposes. The commenters generally indicated that, under FAS 109, the balance sheet will not accurately reflect the value paid for the intangibles. Furthermore, commenters indicated that the increased value of the intangible posed no risk to institutions, because a reduction in the value of the asset would effectively extinguish the related deferred tax liability.

On the other hand, two commenters indicated that the pretax (gross) value of intangible assets should be deducted for regulatory capital purposes in this situation. This organization contended that intangible assets should be treated similarly to other assets, which are not reduced by any related liability.

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Question 2: The Board's second question inquired about (i) the potential burden associated with the proposal and whether a limitation based on projections of taxable income would be difficult to implement, and (ii) the appropriateness of the separate entity method for deferred tax assets and tax sharing agreements in general.

i. *Methodology Based on Income Projections.* The Board received eleven letters from commenters who responded directly to this aspect of the question. Four commenters supported using income projections and stated that calculating deferred tax asset limitations for capital purposes based on projected taxable income would not be difficult to implement and would not impose an additional burden because many banking organizations already forecast taxable income in order to recognize their deferred tax assets. One commenter added that these calculations should not pose any problems, provided they are done on a consolidated basis. In addition, one commenter suggested that the Board clarify the term "realized within one year" so that readers understand that the phrase means the amount of deferred tax assets that could be used to offset income taxes generated in the next 12 months, and not the amount of deferred tax assets that actually will be used.

Four commenters specifically opposed an income approach, citing the additional burden that would be created by the detailed calculations. One commenter specifically favored implementing the percentage of capital method since it is certain and exact and does not involve as many estimations or fluctuations as the income approach.

Five commenters supported an approach based on the financial condition of the institution, some of whom also offered support or opposition to the income or percentage of capital approach. One commenter suggested that "healthy" institutions be permitted to include deferred tax assets in regulatory capital in an amount based on a specified percentage of Tier 1 capital. Another commenter supported an approach that excluded "well capitalized" banks from the limitation. On the other hand, one commenter did not support using an approach for calculating the capital limitation based upon the perceived "health" of the institution, stating that this method could lead to arbitrary and inconsistent measures of capital adequacy.

ii. *Separate Entity Approach.* Twelve commenters specifically addressed this part of the question. Under the Board's proposal, the capital limit for deferred tax assets would be determined on a separate entity basis for each state member bank so that a bank that is a subsidiary of a holding company would be treated as a separate taxpayer rather than as part of the consolidated entity. All of the commenters opposed the separate entity approach. They argued that the separate entity approach is artificial and that tax-sharing agreements between financially capable bank holding companies and bank subsidiaries should be considered when evaluating the recognition of deferred tax assets for regulatory capital purposes. Commenters also stated that the separate entity method is unnecessarily restrictive and that any systematic and rational method should be permitted for the calculation of the limitation for each bank.

One commenter based its opposition for the separate entity approach on the view that the limitation is not consistent with the Board's 1987 "Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks" which, in some respects, treats a controlled group as one entity. Another commenter contended that the effect of a separate entity calculation would be to reduce bank capital which is needed for future lending which would be inconsistent with the March 10, 1993, "Interagency Policy Statement on Credit Availability". The same commenter also noted that the regulatory burden and cost of calculating the deferred tax asset on a separate entity basis would be substantial for both bankers and regulators.

Question 3: The Board's third question addressed three specific provisions of the proposal. These provisions included (i) requiring tax planning strategies to be part of an institution's projection of taxable income for the next year, (ii) requiring organizations to assume that all temporary differences fully reverse at the report date, and (iii) permitting the grandfathering of amounts previously reported if they were in excess of the proposed limitation.

i. *Inclusion of Tax Planning Strategies.* Two commenters addressed this issue. Both commenters stated that they support including tax planning strategies in an institution's projection of taxable income. One commenter stated that the proposal should be modified to permit institutions to consider strategies that would ensure realization of deferred tax assets within the one-year time frame. The proposal provided that organizations should consider tax planning strategies that would realize tax carryforwards or net operating losses that would otherwise expire during that time frame.

ii. *Temporary Differences.* Four commenters specifically addressed this aspect of the question, and all agreed that it is appropriate to require the assumption that all temporary differences fully reverse as of the report date. One commenter noted that this assumption would eliminate the burden of scheduling the "turnaround" of temporary differences.

iii. *Grandfathering.* Five commenters discussed the proposal's provision on grandfathering which would allow the amount of any deferred tax assets reported as of September 1992 in excess of the limit to be phased out over a two year period ending in 1994. Four commenters offered support for grandfathering but argued that excess deferred tax assets should be grandfathered until the underlying temporary differences reversed, rather than be phased out over two years. The other commenter disagreed with the grandfathering proposal and stated that such provisions would be inconsistent with the proposal's capital adequacy objectives.

## III. Final Amendment to the Capital Adequacy Guidelines

### *A. Limitation on Deferred Tax Assets*

Consistent with the FFIEC's recommendation and the Board's proposal, the Board is limiting in regulatory capital deferred tax assets that are dependent on future taxable income to the lesser of:

i. The amount of such deferred tax assets that the institution expects to realize within one year of the quarter-end report date, based on its projection of taxable income (exclusive of net operating loss or tax credit carryforwards and reversals of existing temporary differences), or

ii. 10 percent of Tier 1 capital, net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships (and before any disallowed deferred tax assets are deducted).

Deferred tax assets that can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences are generally not limited under the final rule. The reported amount of deferred tax assets, net of its valuation allowance, in excess of the limitation would be deducted from Tier 1 capital for purposes of calculating both the risk-based and leverage capital ratios. Banking organizations should not include the amount of disallowed

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deferred tax assets in weighted-risk assets in the risk-based capital ratio and should deduct the amount of disallowed deferred tax assets from average total assets in the leverage capital ratio. Deferred tax assets included in capital continue to be assigned a risk weight of 100 percent.

To determine the limit, a banking organization should assume that all existing temporary differences fully reverse as of the report date. Also, estimates of taxable income for the next year should include the effect of tax planning strategies the organization is planning to implement to realize net operating losses or tax credit carryforwards that will otherwise expire during the year. Consistent with FAS 109, the Board believes tax planning strategies are carried out to prevent the expiration of such carryforwards. Both of these requirements are consistent with the proposal.

The capital limitation is intended to balance the Board's continued concerns about deferred tax assets that are dependent upon future taxable income against the fact that such assets will, in many cases, be realized. This approach generally permits full inclusion of deferred tax assets potentially recoverable from carrybacks, since these amounts will generally be realized. This approach also includes those deferred tax assets that are dependent upon future taxable income, if they can be recovered from projected taxable income during the next year. The Board is limiting projections of future taxable income to one year because, in general, the Board believes that organizations are generally capable of making projections of taxable income for the following twelve month period that have a reasonably good probability of being achieved. However, the reliability of projections tends to decrease significantly beyond that time period. Deferred tax assets that are dependent upon future taxable income are further limited to 10 percent of Tier 1 capital, since the Board believes such assets should not comprise a large portion of an organization's capital base given the uncertainty of realization associated with these assets and the difficulty in selling these assets apart from the organization. Furthermore, a 10% capital limit also reduces the risk that an overly optimistic estimate of future taxable income will cause the bank to significantly overstate the value of deferred tax assets.

Banking organizations already follow FAS 109 for regulatory reports and accordingly, are making projections of taxable income. Banking organizations already report in regulatory reports the amount of deferred tax assets that would be disallowed under the proposal. In addition, the 10 percent calculation of Tier 1 capital is straightforward. Therefore, the Board believes that banking organizations will have little difficulty implementing this final rule.

*B. Guidance on Specific Implementation Issues*

In response to the comments received and after discussions with the other agencies, the Board is providing the following guidance.

Originating Temporary Differences—Consistent with the Board's proposal, the final rule does not specify how the provision for loan and lease losses and other originating temporary differences should be treated for purposes of projecting taxable income for the next year. Banking organizations routinely prepare income forecasts for future periods and, in theory, income forecasts for book income should be adjusted for originating temporary differences in arriving at a projection of taxable income. On the other hand, requiring such adjustments adds complexity to the final rule. Furthermore, deductible originating temporary differences, such as the provision for loan and lease losses, generally would lead to additional deferred tax assets. Thus, arguably, such temporary differences should not be added back to book income in determining the amount of deferred tax assets that will be realized. Accordingly, the Board is permitting each institution to decide whether or not to adjust projected book income for originating temporary differences. While the Board is not specifying a single treatment on originating temporary differences in the final rule, institutions should follow a reasonable and consistent approach.

Gross-up of Intangibles—As noted above, FAS 109 could lead to a large increase (i.e., gross-up) in the reported amount of certain intangible assets, such as core deposit intangibles, which are deducted for purposes of computing regulatory capital. Commenters stated that the increased value of an intangible posed no risk to institutions, because a reduction in the value of the asset would effectively extinguish the related deferred tax liability. The Board concurs with this position and, consequently, will permit, for capital adequacy purposes, netting of deferred tax liabilities arising from this gross-up effect against related intangible assets. To ensure this benefit is not double counted, a deferred tax liability netted in this manner could not also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income. Netting will not be permitted against purchased mortgage servicing rights (PMSRs) and purchased credit card relationships (PCCRs), since only the portion of these assets that exceed specified capital limits are deducted for capital adequacy purposes.

Leveraged Leases—While not expected to significantly affect many banking organizations, one commenter stated that future net tax liabilities related to leveraged leases acquired in a purchase business combination are included in the valuation of the leveraged lease and are not shown on the balance sheet as deferred tax liabilities. This artificially increases the amount of deferred tax assets for those institutions that acquire a leveraged lease portfolio. Thus, this commenter continued, the future taxes payable included in the valuation of a leveraged lease portfolio in a purchase business combination should be treated as a taxable temporary difference whose reversal would support the recognition of deferred tax assets, if applicable. The Board agrees with this commenter and, therefore, banking organizations may use the deferred tax liabilities that are embedded in the carrying value of a leveraged lease to reduce the amount of deferred tax assets subject to the capital limit.

Tax Jurisdictions—Unlike the proposal, the final rule does not require an institution to determine its limitation on deferred tax assets on a jurisdiction by-jurisdiction basis. While such an approach may theoretically be more accurate, the Board does not believe the greater precision that would be achieved in mandating such an approach outweighs the complexities involved and its inherent cost to institutions. Thus, banking organizations may make projections of their taxable income on an organization-wide basis and use a combined tax rate for purposes of calculating the one-year limitation.

Timing—Institutions may use the future taxable income projections for their current fiscal year (adjusted for any significant changes that have occurred or are expected to occur) when applying the capital limit at an interim report date rather than preparing a new projection each quarter. Several commenters requested this treatment because it reduces the frequency with which banking organizations are required to revise their estimate of future taxable income.

Available for Sale Securities—Under FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (FAS 115), "available-for-sale" securities are

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reported in regulatory reports at market value, and unrealized gains and losses on such securities are included, net of tax effects, in a separate component of stockholders equity. These tax effects may increase or decrease the amount of deferred tax assets an institution reports.

The Board has recently decided to exclude from regulatory capital the amount of net unrealized gains and losses on available for sale securities (except net unrealized losses of available-for-sale equity securities with readily determinable fair values) (59 FR 63241, December 8, 1994). Thus, excluding for capital adequacy purposes deferred tax effects arising from reporting unrealized holding gains and losses on available-for-sale securities is consistent with the regulatory capital treatment for such gains and losses. On the other hand, requiring the exclusion of such deferred tax effects would add significant complexity to the capital guidelines and in most cases would not have a significant impact on regulatory capital ratios.

Therefore, when determining the capital limit for deferred tax assets, the Board has decided to permit, but not require, institutions to adjust the reported amount of deferred tax assets for any deferred tax assets and liabilities arising from marking-to-market available-for-sale debt securities for regulatory reporting purposes. This choice will reduce implementation burden for institutions not wanting to contend with the complexity arising from such adjustments, while permitting those institutions that want to achieve greater precision to make such adjustments. Institutions must follow a consistent approach with respect to such adjustments.

Separate Entity Method—The proposed capital limit was to be determined on a separate entity basis for each state member bank. Use of a separate entity approach on income tax sharing agreements (including intercompany tax payments and current and deferred taxes) is generally required by the Board's 1978 Policy Statement on Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State Member Banks, and similar policies are followed by the other banking agencies. Thus, any change to the separate entity approach for deferred tax assets would also need to consider changes to this policy statement, which is outside the scope of this rulemaking. The Board notes that regulatory reports of banks are generally required to be filed using a separate entity approach and consistency between the reports would be reduced if the Board permitted institutions to use other methods for calculating deferred tax assets in addition to a separate entity approach. Thus, while a number of the commenters suggested that the Board consider permitting other approaches, the Board will generally require the separate entity approach.[3]

As proposed, the final rule contains an exception to the separate entity approach when a state member bank's parent holding company does not have the financial capability to reimburse the bank for tax benefits derived from the bank's carryback of net operating losses or tax credits. In these cases, the amount of carryback potential the bank may consider in calculating the capital limit on deferred tax assets is limited to the lesser amount which it could reasonably expect to have refunded by its parent.

Grandfathering—The proposal would grandfather any deferred tax assets reported as of September 1992 in excess of the proposed limit, but would require that such excess amounts be phased out over a two year period ending in 1994. Since all grandfathered amounts are now fully amortized, the Board's final rule does not include any grandfathering provision.

## IV. Regulatory Flexibility Act Analysis

The Board does not believe that the adoption of this final rule will have a significant economic impact on a substantial number of small business entities (in this case, small banking organizations), in accordance with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.). In this regard, the vast majority of small banking organizations currently have very limited amounts of net deferred tax assets, which are the subject of this proposal, as a component of their capital structures. In addition, this final rule, in combination with the adoption by the Board of FAS 109 for regulatory reporting purposes, allows many organizations to increase the amount of deferred tax assets they include in regulatory capital. Moreover, because the risk-based and leverage capital guidelines generally do not apply to bank holding companies with consolidated assets of less than $150 million, this proposal will not affect such companies. The Board did not receive any comment letters specifically addressing regulatory flexibility concerns, and therefore, no alternatives to the proposal were considered to address regulatory flexibility.

[3] State member banks should project taxable income for the bank, generally on a consolidated basis including subsidiaries of the bank Bank holding companies should project taxable income for the holding company generally on a consolidated basis including bank and non-bank subsidiaries of the holding company

## V. Paperwork Reduction Act and Regulatory Burden

The Board has determined that this final rule will not increase the regulatory paperwork burden of banking organizations pursuant to the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*).

Section 302 of the Riegle Community Development and Regulatory Improvement Act of 1994 (Pub. L. 103–325, 108 Stat. 2160) provides that the federal banking agencies must consider the administrative burdens and benefits of any new regulation that impose additional requirements on insured depository institutions. Section 302 also requires such a rule to take effect on the first day of the calendar quarter following final publication of the rule, unless the agency, for good cause, determines an earlier effective date is appropriate.

## List of Subjects

*12 CFR Part 208*

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Securities.

*12 CFR Part 225*

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, the Board is amending 12 CFR parts 208 and 225 as set forth below:

## PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for part 208 continues to read as follows:

**Authority:** 12 U.S.C. 36, 248(a), 248(c), 321–338, 371d, 461, 481–486, 601, 611, 1814 1823(j), 1828(o), 1831o, 1831p–1, 3105, 3310, 3331–3351 and 3906–3909; 15 U S.C. 78b, 78l(b), 78l(g), 78l(i), 78o–4(c) (5), 78q, 78q–l, and 78w; 31 U.S.C. 5318.

2. Appendix A to part 208 is amended by adding a new paragraph (iv) to the introductory text of Section II.B. to read as follows:

### Appendix A to Part 208—Capital Adequacy Guidelines for State Member Banks: Risk-Based Measure

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II. * * *

B. * * *

(iv) Deferred tax assets—portions are deducted from the sum of core capital elements in accordance with section II.B.4. of this Appendix A.

* * * * *

3. Appendix A to Part 208 is amended by:

a. Revising footnote 19 in section II.B.3.;

b. Removing footnote 20 from the end of section II.B.3.; and

c. Adding section II.B.4.

The additions and revisions read as follows:

* * * * *

II. * * *

B. * * *

3. * * * [19] * * *

4. *Deferred tax assets.* The amount of deferred tax assets that are dependent upon future taxable income, net of the valuation allowance for deferred tax assets, that may be included in, that is, not deducted from, a bank's capital may not exceed the lesser of: (i) the amount of these deferred tax assets that the bank is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year,[20] or (ii) 10 percent of tier 1 capital. For purposes of calculating this limitation, Tier 1 capital is defined as the sum of core capital elements, net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships (and before any disallowed deferred tax assets are deducted). The amount of deferred tax assets that can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences and that do not exceed the amount which the bank could reasonably expect to have refunded by its parent (if applicable) generally are not limited. The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of these amounts is to be deducted from a bank's core capital elements in determining tier 1 capital.

* * * * *

[19] Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's Policy Statement on Nonvoting Equity Investments, 12 CFR 225.143 (Federal Reserve Regulatory Service 4–172.1; 68 Federal Reserve Bulletin 413 (1982)). In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital. The Board intends to monitor nonreciprocal holdings of other banking organizations' capital instruments and to provide information on such holdings to the Basle Supervisors' Committee as called for under the Basle capital framework.

[20] Projected future taxable income should not include net operating loss carryforwards to be used during that year or the amount of existing temporary differences a bank expects to reverse within the year. Such projections should include the estimated effect of tax planning strategies that the organization expects to implement to realize net operating losses or tax credit carryforwards that would otherwise expire during the year. Institutions may use the future taxable income projections for their current fiscal year (adjusted for any significant changes that have occurred or are expected to occur) when applying the capital limit at an interim report date rather than preparing a new projection each quarter. To determine the limit, an institution should assume that all existing temporary differences fully reverse as of the report date.

4. Appendix B to part 208 is revised to read as follows:

## Appendix B to Part 208—Capital Adequacy Guidelines for State Member Banks: Tier 1 Leverage Measure

### I. Overview

a. The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of state member banks.[1] The principal objective of this measure is to place a constraint on the maximum degree to which a state member bank can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

b. The guidelines apply to all state member banks on a consolidated basis and are to be used in the examination and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

### II. The Tier 1 Leverage Ratio

a. The Board has established a *minimum* level of tier 1 capital to total assets of 3 percent. An institution operating at or near these levels is expected to have well-diversified risk, including no undue interest-rate risk exposure; excellent asset quality; high liquidity; and good earnings; and in general be considered a strong banking organization, rated composite 1 under CAMEL rating system of banks. Institutions not meeting these characteristics, as well as institutions with supervisory, financial, or operational weaknesses, are expected to operate well above minimum capital standards. Institutions experiencing or anticipating significant growth also are expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. For example, most such banks generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banks. Thus for all but the most highly rated banks meeting the conditions set forth above, the minimum tier 1 leverage ratio is to be 3 percent plus an additional cushion of a least 100 to 200 basis points. In all cases, banking institutions should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.

[1] Supervisory risk-based capital ratios that related capital to weighted-risk assets for state member banks are outlined in Appendix A to this part.

b. A bank's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital for year-end 1992 as set forth in the risk-based capital guidelines contained in Appendix A of this part will be used.[2] As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the bank's Reports of Condition and Income (Call Report), less goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of tier 1 capital; all other intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from tier 1 capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of the limitation set forth in section II.B.4 of this Appendix A.[3]

c. Whenever appropriate, including when a bank is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual bank's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines an long-standing Board policy and practice with regard to leverage guidelines. Banks experiencing growth, whether internally or by acquisition, are expected to maintain strong capital position substantially above minimum supervisory levels, without significant reliance on intangible assets.

## PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 continues to read as follows:

**Authority:** 12 U.S.C. 1817(j)(13), 1818, 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(i),

[2] At the end of 1992, Tier 1 capital for state member banks includes common equity, minority interest in the equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, as a general matter, Tier 1 capital excludes goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; all other intangible assets; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

[3] Deductions from Tier 1 capital and other adjustments are discussed more fully in section II.B in Appendix A of this part.

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3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. Appendix A to part 225 is amended by adding a new paragraph (iv) to the introductory text of section II.B. to read as follows:

### Appendix A to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure

* * * * *

II. * * *

B. * * *

(iv) Deferred tax assets—portions are deducted from the sum of core capital elements in accordance with section II.B.4. of this Appendix A.

* * * * *

3. Appendix A to part 225 is amended by:

a. Revising footnote 22 in section II.B.3.;

b. Removing footnote 23 from the end of section II.B.3. and;

c. Adding section II.B.4.

The revisions and additions read as follows:

* * * * *

II. * * *

B. * * *

3. * * * [22] * * *

4. *Deferred tax assets.* The amount of deferred tax assets that are dependent upon future taxable income, net of the valuation allowance for deferred tax assets, that may be included in, that is, not deducted from, a banking organization's capital may not exceed the lesser of: (i) the amount of these deferred tax assets that the banking organization is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year,[23] or (ii) 10 percent of tier 1 capital. For purposes of calculating this limitation, tier 1 capital is defined as the sum of core capital elements, net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships (and before any disallowed deferred tax assets are deducted). The amount of deferred tax assets that can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences generally are not limited. The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of these amounts is to be deducted from a banking organization's core capital elements in determining tier 1 capital.

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[22] Deductions of holdings of capital securities also would not be made in the case of interstate "stake out" investments that comply with the Board's Policy Statement on Nonvoting Equity Investments, 12 CFR 225.143 (Federal Reserve Regulatory Service 4–172.1; 68 Federal Reserve Bulletin 413 (1982)). In addition, holdings of capital instruments issued by other banking organizations but taken in satisfaction of debts previously contracted would be exempt from any deduction from capital. The Board intends to monitor nonreciprocal holdings of other banking organizations' capital instruments and to provide information on such holdings to the Basle Supervisors' Committee as called for under the Basle capital framework.

[23] Projected future taxable income should not include net operating loss carryforwards to be used during that year or the amount of existing temporary differences a bank holding company expects to reverse within the year. Such projections should include the estimated effect of tax planning strategies that the organization expects to implement to realize net operating loss or tax credit carryforwards that will otherwise expire during the year. Banking organizations may use the future taxable income projections for their current fiscal year (adjusted for any significant changes that have occurred or are expected to occur) when applying the capital limit at an interim report date rather than preparing a new projection each quarter. To determine the limit, a banking organization should assume that all existing temporary differences fully reverse as of the report date.

4. Appendix D to part 225 is revised to read as follows:

### Appendix D to Part 225—Capital Adequacy Guidelines for Bank Holding Companies: Tier 1 Leverage Measure

#### I. Overview

a. The Board of Governors of the Federal Reserve System has adopted a minimum ratio of tier 1 capital to total assets to assist in the assessment of the capital adequacy of bank holding companies (banking organizations).[1] The principal objectives of this measure is to place a constraint on the maximum degree to which a banking organization can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital measure.

b. The guidelines apply to consolidated basis to banking holding companies with consolidated assets of $150 million or more. For bank holding companies with less that $150 million in consolidated assets, the guidelines will be applied on a bank-only basis unless (i) the parent bank holding company is engaged in nonbank activity involving significant leverage[2] or (ii) the parent company has a significant amount of outstanding debt that is held by the general public.

c. The tier 1 leverage guidelines are to be used in the inspection and supervisory process as well as in the analysis of applications acted upon by the Federal Reserve. The Board will review the guidelines from time to time and will consider the need for possible adjustments in light of any significant changes in the economy, financial markets, and banking practices.

#### II. The Tier 1 Leverage Ratio

a. The Board has established a *minimum* level of tier 1 capital to total assets of 3 percent. A banking organization operating at or near these levels is expected to have well-diversified risk, including no undue interest-rate risk exposure; excellent asset quality; high liquidity; and good earnings; and in general be considered a strong banking organization, rated composite 1 under BOPEC rating system of bank holding companies. Organizations not meeting these characteristics, as well as institutions with supervisory, financial, or operational weaknesses, are expected to operate well above minimum capital standards. Organizations experiencing or anticipating significant growth also are expected to maintain capital ratios, including tangible capital positions, well above the minimum levels. For example, most such banks generally have operated at capital levels ranging from 100 to 200 basis points above the stated minimums. Higher capital ratios could be required if warranted by the particular circumstances or risk profiles of individual banking organizations. Thus for all but the most highly rated banks meeting the conditions set forth above, the minimum tier 1 leverage ratio is to be 3 percent plus an additional cushion of a least 100 to 200 basis points. In all cases, banking organizations should hold capital commensurate with the level and nature of all risks, including the volume and severity of problem loans, to which they are exposed.

b. A banking organization's tier 1 leverage ratio is calculated by dividing its tier 1 capital (the numerator of the ratio) by its average total consolidated assets (the denominator of the ratio). The ratio will also be calculated using period-end assets whenever necessary, on a case-by-case basis. For the purpose of this leverage ratio, the definition of tier 1 capital for year-end 1992 as set forth in the risk-based capital guidelines contained in Appendix A of this part will be used.[3] As a general matter, average total consolidated assets are defined as the quarterly average total assets (defined net of the allowance for loan and lease losses) reported on the organization's Consolidated Financial Statements (FR Y–9C Report), less goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, are in excess of 50 percent of tier 1 capital; amounts of purchased credit card relationships in excess of 25 percent of tier 1 capital; all other intangible assets; any investments in subsidiaries or associated companies that the Federal Reserve determines should be deducted from tier 1 capital; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in

[1] Supervisory ratios that related capital to total assets for state member banks are outlined in Appendix B of this part.

[2] A parent company that is engaged is significant off balance sheet activities would generally be deemed to be engaged in activities that involve significant leverage.

[3] At the end of 1992, Tier 1 capital for state member banks includes common equity, minority interest in the equity accounts of consolidated subsidiaries, and qualifying noncumulative perpetual preferred stock. In addition, as a general matter, Tier 1 capital excludes goodwill; amounts of purchased mortgage servicing rights and purchased credit card relationships that, in the aggregate, exceed 50 percent of Tier 1 capital; amounts of purchased credit card relationships that exceed 25 percent of Tier 1 capital; all other intangible assets; and deferred tax assets that are dependent upon future taxable income, net of their valuation allowance, in excess of certain limitations. The Federal Reserve may exclude certain investments in subsidiaries or associated companies as appropriate.

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excess of the limitation set forth in section II.B.4 of this Appendix A.[4]

c. Whenever appropriate, including when an organization is undertaking expansion, seeking to engage in new activities or otherwise facing unusual or abnormal risks, the Board will continue to consider the level of an individual organization's tangible tier 1 leverage ratio (after deducting all intangibles) in making an overall assessment of capital adequacy. This is consistent with the Federal Reserve's risk-based capital guidelines an long-standing Board policy and practice with regard to leverage guidelines. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong capital position substantially above minimum supervisory levels, without significant reliance on intangible assets.

By order of the Board of Governors of the Federal Reserve System, December 16, 1994.

**William W. Wiles,**

*Secretary of the Board*

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