December 13, 2011

Arthur W. Lindo
Senior Associate Director
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
20th and C Street, NW
Washington, DC 20551

Re: Deferred Tax Asset Calculations Under Basel III

Dear Mr. Lindo:

The Clearing House Association L.L.C. ("The Clearing House" or "TCH"), an association of major commercial banks,[1] appreciated the opportunity to meet with you and other representatives of the Board of Governors of the Federal Reserve System on September 20, 2011 (the "September 20 Meeting") to discuss our letter dated September 19, 2011 (the "TCH September 19 Letter")[2] with respect to the treatment of DTAs[3] under the rules to be adopted for regulatory capital purposes. During the September 20 Meeting, you requested that we provide additional information with respect to several issues, including (1) an annual MSR election with respect to netting of DTLs; (2) transition rule examples; (3) other examples of provisions in the Current Rules that supplement U.S. GAAP; (4) a comparison treatment of leveraged leases under U.S. GAAP and IFRS; and (5) an example illustrating application of the 10% and 15% threshold calculations during the transition period as recommended by TCH and that could be included in instructions to Call Reports (or FAQs). Each of these issues is

[1] Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at www.theclearinghouse.org.

[2] The TCH September 19 Letter was submitted by The Clearing House to the Federal Reserve (the "Fed"), the Office of the Comptroller of the Currency (the "OCC") and the Federal Deposit Insurance Corporation (the "FDIC"). A copy of that letter is appended hereto.

[3] Capitalized terms used but not otherwise defined herein shall have the meanings ascribed to them in the TCH September 19 Letter.

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discussed below. We also comment on the treatment of deferred taxes associated with equity investments in unconsolidated financial institutions.

A. Annual MSR Election

In the TCH September 19 Letter, we recommended an annual election permitting banks to net their DTLs associated with MSRs against their MSRs before the MSRs are subjected to the Basel III threshold calculations, or to allocate them pro rata against all of their DTAs. At the September 20 Meeting, TCH was asked to elaborate on whether the election should be irrevocable or more limited (*e.g.,* once every few years). The TCH September 19 Letter provided an example illustrating a situation where a bank might not wish to net its DTLs associated with its MSRs directly against these MSRs, and we now provide an example where a bank might choose to make an election to net its DTL associated with its MSRs directly against its MSRs.

In the original example, a bank had MSRs of $50 (which was below the 10% and 15% threshold limits), associated DTLs of $20 and a NOL DTA of $25. In that case, if the bank were required to offset the DTLs solely against the MSRs, the net MSRs of $30 ($50 - $20) would be included in Tier 1 Common Equity, but the full NOL DTA of $25 would be subtracted from Tier I Common Equity. In contrast, if the bank is permitted instead to elect to allocate its DTLs on a pro-rata basis against its DTAs, a portion of the DTLs also would be netted against its NOL DTA of $25. Hence, under the threshold calculations, only the remaining $5 ($25 - $20) of the NOL DTA would be subtracted from Tier 1 Common Equity. This result is appropriate since on a sale of the MSRs at book value, $20 of the NOL DTA would be offset against the $20 tax arising from the $50 of taxable income resulting from the sale.

Assume in the same example that in year 2 the bank earned sufficient taxable income to absorb its NOL, generated new DTAs of $15 associated with an increase in its loan loss reserve and had the same DTL of $20. Assume further that in year 2 the bank would suffer a $20 deduction under the 10% threshold limit on its $50 of MSRs, but its new loan loss reserve DTAs of $15 would not be disallowed. In this instance, the bank would prefer to assign the DTL of $20 associated with its MSRs solely against its MSRs, thereby eliminating any reduction from its Tier One Common Equity attributable to its MSRs. In the second year, if the bank's MSRs were sold at book value, the bank's NOL would not be available to be offset against the resulting taxable income, and the bad debt deductions represented by the loan loss reserve DTAs may not yet have been realized. In these circumstances, there is logic in associating the MSR DTLs with the MSRs themselves since in the event the $50 MSRs were written off as worthless, the associated DTLs would not result in a realized liability but would be written off to the income statement, netting down the earnings and capital consequences from the MSR write-off.

As illustrated by the foregoing example, a change in a bank's circumstances from normal business operations can easily result in a change in a bank's tax attributes. It is also apparent that either approach of assigning MSR DTLs to MSRs or DTAs is a principled one. A bank's change in attributes can create a new tax profile under which the bank reasonably would desire to treat its DTL differently than it had been from a regulatory capital perspective. Hence, there

are valid reasons to make a different election in treating its DTL associated with its MSRs in year 2 versus the treatment a bank chose in year 1. For these reasons, TCH recommends that banks be permitted to make an annual election on how to treat their DTLs associated with their MSRs for regulatory capital purposes.

B. Annual Election for Equity Investments

Under Basel III, banks may treat equity investments in unconsolidated financial institutions as good assets for regulatory capital purposes subject to the threshold calculations that also apply to MSRs and DTAs.[4] For the reasons discussed below, investments of this type treated under the equity method of accounting for U.S. GAAP give rise to DTLs that TCH believes should be treated in a manner similar to that accorded to DTLs associated with MSRs.

Under U.S. GAAP, an equity investment involving 20% or more of the voting stock of a corporation up to the point where voting control is obtained is accounted for under the equity method of accounting. Pursuant to this method, an investor adjusts the carrying amount of its investment for its share of the earnings or losses of the corporation in which the investment was made.[5] Typically, this will give rise to a basis difference between the book value of the investor's investment (which is adjusted for the earnings attributable to the investment) and the tax basis in the investment (which is not so adjusted). In cases where the investee corporation has positive earnings, the book-tax basis difference will generate a DTL.[6]

Since DTLs of this nature are analogous to DTLs associated with MSRs, we recommend that they should be treated in the same manner as DTLs associated with MSRs. Accordingly, banks should be given the option annually to net the DTLs associated with unconsolidated equity investments directly against their equity investments or to allocate these DTLs pro rata against all of the Specified Items.

Transition Rules

In the TCH September 19 Letter, we discussed the then-existing guidance as to how the transition calculations for DTAs are to be made (paragraph 94 and Annex 4 of Basel III and the response to Question 17 of the July 2011 FAQs) and expressed the view that the guidance was unclear and could, depending upon how such guidance is interpreted, lead to inconsistent results across jurisdictions.[7] While the Basel Committee on Banking Supervision provided some additional guidance on the transition rules in late October, this amplification did not fully clarify the transition treatment of DTAs.

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[4] Basel III, paragraphs 80 – 86.

[5] ASC 323-10-05, et. seq.

[6] ASC 740-30-25-5.

[7] Basel Committee, "Basel III definition of capital - Frequently asked questions", October 2011 (update on FAQs published in July 2011).

We have identified three different methods of interpreting the guidance on the transition rule treatment of DTAs. These three methods are described below and each is illustrated using a single set of hypothetical facts. The three methods and analysis are also presented in Appendix 1 to this letter. While each method can be supported by the language in Basel III, TCH continues to recommend the method we suggested in the TCH September 19 Letter (referred to in the letter and below as the "TCH View").

Hypothetical Facts

"Bank" has Tier I Common Equity of $500 (inclusive of its DTAs) and net DTAs under the Basel III rules before application of the threshold limit of **$100**. For ease of illustration, these DTAs remain constant over the five-year transition period that begins in 2014. Its excess DTAs, as computed under the DTA Proposals when they are fully effective in 2018, are **$75** and its excess DTAs under the Current Rules are **$55**. (We expect this will be a typical fact pattern since the DTA Proposals are somewhat more stringent than the DTA provisions in the Current Rules.)

The TCH View

Under the TCH View, Bank first calculates the amount of DTAs to be disallowed under the transition percentages in the Basel III proposals (20% in 2014, 40% in 2015, etc.). In 2014 the disallowed amount would be $15 ($75 x .20). This amount would then be subtracted from the allowable DTAs of $100, resulting in a reduction of these DTAs to $85 ($100 - $15). Next, Bank would reduce the $85 by the amount of allowable DTAs ($45) under the Current Rules, disallowing an additional $40 ($85 - $45) of DTAs. In 2014, under this method, **$45** of DTAs would be considered as good assets for Tier I Common Equity. The same process would be applied in succeeding years except that the transition percentage would increase year-by-year.

We believe the TCH View is consistent with the intent of the DTA Proposals, since a bank's DTAs are first subject to a disallowance equal to the transition percentage set out in Basel III and then the balance (by definition 80% in 2014, 60% in 2015, etc.) is submitted to treatment under the Current Rules. Mathematically, this calculation gives the same result as reducing a U.S. bank's DTAs by the greater of the amount disallowed during the transition period under the DTA Proposals or the amount disallowed under the Current Rules.

Double Deduction Proposal

Under the method we refer to as the "Double Deduction Proposal", initially Bank would again calculate the amount of DTAs to be disallowed under the Basel III transition rule percentages. In 2014 this would be $15 ($75 x .20); Bank would then apply the remaining percentage (80% in 2014, 60% in 2015, etc.) to the amount of DTAs disallowed under the Current Rules, which would result in our example in $44 ($55 x .80). The amount in the first step ($15) would be added to the amount in the second step ($44), and the full amount ($59) would be disallowed. Under this method, in 2014 **$41** of DTAs would be considered as good assets in Tier I Common Equity (with $59 being disallowed). Because this method would

effectively add an amount on top of the amount disallowed under the Current Rules ($55 plus $4), we refer to this method as the "Double Deduction Proposal".

Remainder Not Deducted Proposal

Under the method we refer to as the "Remainder Not Deducted Proposal", initially Bank would again calculate the amount of DTAs to be disallowed under the Basel III transition rule percentages. In 2014 this would be $15 ($75 x .20); Bank would then subtract this amount from the total amount of DTAs that would be disallowed under the DTA Proposals in 2018, which would result in our example in $60 ($75 - $15). This calculation yields the remainder of the 2018 full adjustment not deducted (the $60) that is to be subjected to national treatment (in this case, under the Current Rules). The excess of the remainder not deducted ($60) over the limit of allowable DTAs under the Current Rules ($45) would then be disallowed, or $15 in the example. In 2014 under this method, **$70** of DTAs would be considered as good assets in Tier I Common Equity. This result follows the language in Paragraph 94(d) of Basel III, which states that "[d]uring this transition period, the remainder not deducted from Common Equity Tier 1 will continue to be subject to existing national treatment."

While the guidance provided to date by the Basel Committee could support each of these three methods, we believe the TCH View is the most appropriate. Specifically, the TCH View avoids the creation of a competitive disadvantage for U.S. banks as compared with non-U.S. banks. For non-U.S. banks in home countries with some form of limit on DTAs for regulatory capital purposes (*e.g.,* Australia), the TCH View maintains existing national rules for all banks, U.S. and non-U.S., with the new rules replacing existing national rules under the same formula over the transition period. For non-U.S. banks in home countries without any current limitation, the TCH View would impact their regulatory capital in equal increments over a five-year period, notwithstanding that the limitation for these banks still would be less than that for U.S. banks until the last years of the transition period. In addition, the results under the TCH View neither accelerate the impact of the DTA Proposals (as is the case under the Double Deduction Proposal) nor unduly delay their effect (as is the case under the Remainder Not Deducted Proposal). For these reasons, we believe the TCH View is the most appropriate method for applying the transition rules.

C. Current Rule Provisions Supplement U.S. GAAP and Should be Retained

In the TCH September 19 Letter, we pointed to an example pursuant to which the Current Rules supplement U.S. GAAP as a reason why the Current Rules should be retained except where they are explicitly overridden by the DTA Proposals. Another frequently applied supplementary provision provides flexibility for treating DTAs and DTLs relating to unrealized gains and losses on available for sale debt securities. Available for sale securities are reported on a bank's balance sheet at fair value, with unrealized gains and losses on such securities, net of DTAs and DTLs, included in other comprehensive income. These DTAs and DTLs may increase or decrease the reported amount of a bank's deferred taxes. The Current Rules exclude the amount of net unrealized holding gains and losses on available for sale debt securities from

regulatory capital.[8] When determining the regulatory capital limit for DTAs under the Current Rules, a bank may elect to adjust the amount of its overall DTAs for any DTAs and DTLs arising from fair valuing available-for-sale debt securities. A bank must follow a consistent approach with respect to such adjustments.[9]

D. Treatment of Leveraged Leases

In the TCH September 19 Letter, we recommended that the leveraged lease treatment included in the Current Rules be maintained going forward. During the September 20 Meeting, you asked TCH to elaborate further with respect to the treatment of deferred taxes in the Current Rules when a leveraged lease is acquired in a purchase transaction, as compared with that under IFRS.

The provision in the Current Rules dealing with leveraged leases was designed to adjust for an anomaly with respect to deferred taxes created by ASC paragraphs 840-30-25 through 840-30-35 (former FIN 21) in the context of purchase accounting for leveraged leases. This anomaly was accepted by the OCC in connection with comments made by one commenter on its proposed DTA rules.[10] The commenter noted "the valuation of a leveraged lease acquired in a purchase business combination gives recognition to the estimated future tax effect of the remaining cash flows of the lease. Therefore, any future tax liabilities related to acquired leveraged leases are included in the valuation of the leveraged leases and are not shown on the balance sheet as deferred taxes payable. This artificially increases the amount of deferred tax assets for institutions that acquire a leveraged lease portfolio. The commenter suggested that banks treat the future taxes payable included in the valuation of a leverage lease portfolio as a reversing taxable temporary difference available to support the recognition of deferred tax assets. Although this situation would not affect many banks, the OCC agreed with the commenter. Accordingly, when applying the limit on deferred tax assets, banks were permitted to use the deferred tax liabilities embedded in the carrying value of a leveraged lease to reduce the amount of deferred tax assets subject to the limit." Thus, the embedded DTL related to acquired leveraged leases was "reinstated" solely for purposes of regulatory capital calculations.

This anomaly is particular to leveraged lease accounting under U.S. GAAP. International Accounting Standard 17, *Leases* ("IAS 17") provides the standard for accounting for leases

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[8] The Basel III provisions would force banks to recognize unrealized gains or losses on available for sale securities in their capital calculations. TCH has questioned the desirability of the Basel III proposed change (see TCH letter, dated October 27, 2011), and it is not clear what the final U.S. regulatory rules will be in this area. If the exclusion is not continued, the deferred taxes associated with such unrealized gains and losses would be tested under paragraph 69 of Basel III with other deferred taxes relating to temporary differences.

[9] See Instructions for Preparation of Consolidated Financial Statements for Bank Holding Companies, Reporting Form FR Y-9C, Line Item Instructions for Regulatory Capital, Schedule HC-R, pages HC-R-8-9.

[10] See for the discussion by the OCC of this point 60 Fed. Reg. 7903 (Feb. 10, 1995), at 7906; see for the Federal Reserve and FDIC analyses of the same issue 59 Fed. Reg. 65920 (Dec. 22, 1994) at 65923, and 60 Fed. Reg. 8182 (Feb. 13, 1995) at 8187, respectively.

under IFRS. There is no leveraged lease accounting permitted under IAS 17, *i.e.,* there is no special purchase accounting approach in IFRS for leveraged leases in contrast to U.S. GAAP with respect to leveraged leases. Therefore, no regulatory adjustment is needed for an institution's accounting for leveraged leases under IFRS. Thus, maintaining the Current Rules for U.S. GAAP filers with respect to leveraged leases would not unfairly advantage such filers over IFRS filers, and, in fact, would maintain them on an equal footing.[11]

E. Example of the Calculation of the 10% and 15% Threshold Limitations During the Transition Period

During the September 20 Meeting, The Clearing House was asked to provide an example illustrating the application, during the transition period, of the 10% and 15% threshold limitations. We understood that the example was requested with an eye towards possibly including it in the Call Report instructions going forward. The example set forth below (and also in Appendix 2 to this letter) follows the recommendations made in the TCH September 19 Letter as to how these limitations should work during the transition period.

Example:

"Bank" has Tier 1 Common Equity of $90, and Specified Items as follows: DTAs of $15 relating to its loan loss reserve, MSRs of $15, and investments in common equity of unconsolidated financial institutions of $15. During the transition period, the 10% threshold limitation would be applied to each Specified Item separately; accordingly, the 10% threshold limitation for each would be **$9** ($90 x .10) (meaning that $9 of each Specified Item would be allowable in computing Tier 1 Capital, and $6 of each Specified Item would need to be deducted from Tier 1 Capital). During the transition period, the 15% threshold limitation would be calculated collectively for all the Specified Items; the collective 15% limitation would be **$13.5** ($90 x .15). Consequently, the sum total of $27 allowable for the Specified Items after applying the 10% limitation ($9 for each of the Specified Items) would be further reduced, pursuant to the 15% limitation, to **$13.5** ($27 - $13.5). The total amount of Specified Items disallowed, in the aggregate, would be **$31.5** ($45-$13.5).

By comparison, after the transition period has ended, the 10% limit is calculated exactly as above, but the 15% limit is calculated after first deducting the full amount of each Specified Item from the total Tier 1 Common Equity. Thus, the 15% limitation would be calculated by applying a percentage (17.65%) from Annex 2 to Basel III to $45 (which is the Tier 1 Common Equity of $90 minus the sum of the Specified Items, which is $45). Pursuant to the method

[11] Under the current exposure drafts on leasing issued by the FASB and the IASB, U.S. GAAP would eliminate leveraged lease accounting with no grandfathering of existing leases. See Proposed Accounting Standards Update, Leases, August 17, 2010. There was a recent announcement that there will be a re-exposure draft of leasing to be issued sometime in 2012. *See* the joint press release of FASB and IASB, dated July 21, 2011, on this subject. Currently, TCH anticipates that leveraged lease accounting will be eliminated under a converged U.S. GAAP-IFRS accounting standard. Assuming a draft is re-exposed in 2012, the earliest effective date of any final rule likely would be 2015. Thus, even if leveraged lease accounting is ultimately eliminated, it appears it would still impact U.S. GAAP filers in the early years of the Basel III transition period.

specified in Annex 2, the limit under the 15% threshold would be $7.9 ($45 times 17.65%). The $27 of the Specified Items allowed after the 10% calculation ($9 x 3) would then be reduced to **$7.9** (an additional disallowance of $19.1 ($27-$7.9), for a total disallowance of **$37.1**. This is compared with the total disallowed amount during the transition period of **$31.5**.

This example is set out in greater detail in Appendix 2 to this letter.

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We appreciate your consideration of the points raised in this letter and would welcome the opportunity to discuss these issues further with you at your convenience. If we can facilitate arranging for those discussions or if you have any questions in the interim, please contact me at 212.613.9883 (email: david.wagner@theclearinghouse.org) or Brett Waxman at (212) 612-9211 (email: brett.waxman@theclearinghouse.org).

Sincerely yours,

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