Meeting between Federal Banking Agency Staffs and Representatives of The Clearing House (TCH)
February 27, 2012

Participants: Anna Lee Hewko, Juan C. Climent, Tom Boemio, Matthew Kincaid and David Alexander (Federal Reserve Board); David Riley, Mark Handzlik and Christine Bouvier (FDIC); and Mark Ginsberg, Amrit Sekhon and Patrick Tierney (OCC)

David Wagner (TCH); Brett Waxman (TCH); Bill McNairy (Bank of America); John Kinsella (U.S. Bancorp); Mark Servis (Capital One); John N. Bush (KPMG); Todd Voss (KPMG); and Paul Polivy (Citigroup)

Summary: Staff from the Federal Reserve Board, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) met with representatives from The Clearing House to discuss deferred tax asset calculations under Basel III. Bill McNairy, from Bank of America, made a high level summary of two letters that had been recently submitted by the TCH. The letters are attached to this summary. Representatives from The Clearing House highlighted their recommendations with respect to: (a) the implementation of transition rules that do not negatively affect U.S. institutions with respect to institutions from other jurisdictions; (b) the implementation of rules that permit banking organizations to net associated deferred tax liabilities against mortgage servicing rights; and (c) the use of U.S. GAAP as the starting point for the treatment of deferred tax assets. Representatives from the Board, FDIC and OCC expressed their appreciated to The Clearing House during the meeting and urged them to comment specifically on the Basel III NPR once it comes out.

The Clearing House

September 19, 2011

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Re: Deferred Tax Asset Calculations Under Basel III

Dear Messrs. Lindo, Taylor and French:

The Clearing House Association L.L.C. ("The Clearing House")[1], an association of major commercial banks, appreciates the opportunity to comment on the proposals dealing with the treatment of deferred tax assets ("DTAs") for regulatory capital purposes issued by the Basel Committee on Banking Supervision (the "Basel Committee") in December 2010 (hereinafter the

[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.

"DTA Proposals"). These proposals were issued by the Basel Committee as part of its global regulatory framework for more resilient banks and banking systems (hereinafter, the entire set of provisions, "Basel III").[2] These comments are made in connection with the Basel III directive that local bank regulators issue a national framework consistent with the Basel III capital proposals by the beginning of 2013.[3]

Since many U.S. financial institutions have material DTAs on their balance sheets, the treatment of DTAs for regulatory capital purposes is of great importance. The Clearing House believes that U.S. regulations implementing the DTA Proposals should 1) be consistent with the goals set out in Basel III, 2) be clearly defined and easily administrable and 3) not create a competitive disadvantage for U.S. financial institutions as compared to financial institutions in other jurisdictions.[4]

Specifically, The Clearing House

- *recommends* that U.S. generally accepted accounting principles ("U.S. GAAP") with respect to the treatment of DTAs be used as the initial source of guidance for U.S. implementation of the DTA Proposals;

- *recommends* that the rules for the treatment of DTAs previously adopted by the Federal Reserve Bank (the "FRB"), the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (the "OCC") (collectively hereinafter, the "Current Rules")[5] be retained, except to the extent they have been specifically overridden by the DTA Proposals;

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[2] Basel Committee on Banking Supervision, "Basel III: A global regulatory framework for more resilient banks and banking systems", December 2010.

[3] Basel III, paragraph 94(a).

[4] The Clearing House has submitted several letters addressing the capital requirements imposed by Basel III. This letter should be considered as a supplement to these letters. See, e.g., The Clearing House letter dated April 16, 2010 to the Basel Committee addressing "Proposals to Strengthen Capital Regulation", and The Clearing House letter dated November 5, 2010 to the U.S. Treasury and to various U.S. bank regulators addressing "Reform of Capital and Liquidity Regulation as Applied to U.S. Banks". Both letters are available on The Clearing House website, www.theclearinghouse.org (under "Association" and the "Capital" tabs).

[5] See for the Current Rules adopted by the above agencies: § II.B.4 of Appendix A to 12 C.F.R., Part 225 (FRB applicable to bank holding companies); § II.B.4 of Appendix A to 12 C.F.R., Part 208 (FRB applicable to state member banks); 12 C.F.R. § 325.5(g) and § I.B.5 of Appendix A to 12 C.F.R., Part 325 (FDIC applicable to state non-member banks); and §§ 2(c)(1), 2(c)(3) and 2(c)(6) of Appendix A to 12 C.F.R., Part 3 (OCC applicable to national banks). The most detailed explanation of how the Current Rules are to be applied by an institution is found in the preambles to the notices setting forth the Current Rules when these rules were first published. Where we believe clarity on specific issues is added by reference to these preambles, we indicate this in relevant footnotes to the text. See for the preambles: 59 Fed. Reg. 65920 (Dec. 22, 1994), amending 12 C.F.R Parts 208 and 225 (the "FRB Preamble"); 60 Fed. Reg. 8182 (Feb. 13, 1995), amending 12 C.F.R Part 325 (the "FDIC Preamble"); 60 Fed. Reg. 7903 (Feb. 10, 1995), amending 12 C.F.R Part 3 (the "OCC Preamble"). All subsequent cites to the preambles are to the relevant Federal Register (FR) page numbers.

- *recommends* that DTAs realizable via loss carrybacks be treated as assets that do not rely on the future profitability of the bank (referred to as "valid" assets for convenience hereafter) pursuant to provisions similar to those in the Current Rules;

- *recommends* that banks be permitted to elect to net deferred tax liabilities ("DTLs") associated with mortgage servicing rights ("MSRs") against their MSRs before the MSRs are subjected to the Basel III "threshold calculations" as defined *infra*;

- *recommends* that in making the required threshold calculations, 1) the 10% calculation should be made separately for each of the Specified Items (as defined below) without reduction for any of them and 2) during the transition period, the 15% calculation should be made without reduction for each of the Specified Items; and

- *requests* that the transition framework be easily administrable and ensures consistent treatment across jurisdictions, and The Clearing House suggests a framework to achieve these objectives.

A. Overview of U.S. GAAP Rules With Respect to Deferred Tax Items

The DTA Proposals use as their starting point locally adopted financial accounting rules.[6] Accordingly, a brief overview of the concept of deferred taxes as used under U.S. GAAP is provided as background for the discussion that follows.

DTAs and DTLs under U.S. GAAP are created from "temporary differences" and from net operating loss ("NOL") and tax credit carryforwards. Generally, temporary differences are differences between the tax basis of an asset or liability and its reported amount in the issuer's financial statements that will result in taxable or deductible amounts in future years when the amount reported in the financial statements is recovered or settled. Temporary differences are identified as either taxable temporary differences (differences that will result in future taxable income) or deductible temporary differences (differences that will result in future deductible amounts). Generally, taxable temporary differences create DTLs and deductible temporary differences create DTAs. As noted, NOLs and tax credit carryforwards also create DTAs.[7]

Under U.S. GAAP, DTAs are recognized (i.e., allowed to be reported as assets on the U.S. GAAP balance sheet at their full financial statement value with no offsetting valuation allowance) if they are more likely than not to be realized. In assessing this likelihood of realization, U.S. GAAP looks to the following sources of taxable income: 1) taxable income in the current year or prior years that can be offset through NOLs or tax credits carried back to

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[6] See Basel Committee, Frequently Asked Questions on the Comprehensive Quantitative Impact Study (May 18, 2010) ("Basel FAQ 2010"), Question 3.3(15). The specific question dealt with the extent of the permitted netting of DTAs and DTLs. In the answer, the Basel Committee stated that local accounting rules were to be applied in making this DTA determination. This answer was adopted in the final Basel III rules, thus indicating that local accounting rules were generally to be used in applying the DTA Proposals.
[7] Accounting Standards Codification (ASC) paragraphs 740-10-25-20 through 25-29.

earlier taxable years; 2) future taxable income that will result from the reversal of taxable temporary differences for which DTLs have been recorded; 3) taxable income that will be generated by future operations; and 4) tax planning strategies in order to realize DTAs.[8] Some foreign banks with operations in the U.S. report their financial results using International Financial Reporting Standards ("IFRS"). Generally, IFRS treats DTAs in the same way they are treated under U.S. GAAP.[9]

B. The DTA Proposals

The intent of the DTA Proposals appears to be that DTAs that are likely to result in cash savings should be included in a bank's regulatory capital calculations and all other DTAs should be subtracted from Tier 1 Common Equity.

More specifically, all DTAs that rely on the "future profitability of the bank to be realized" must be deducted in calculating Tier 1 Common Equity.[10] Thus, DTAs arising from NOLs and tax credit carryforwards are not permitted to be included in Tier I Common Equity. A major exception to this general rule is carved out for DTAs arising from temporary differences, but these DTAs are subject to a threshold limit (as described below). In making the determination of the amount of DTAs that must be subtracted, DTLs may first be netted against DTAs. The netting of DTLs against DTAs is to be done by allocating DTLs against DTAs on a pro rata basis. However, netting can only be done if the DTAs and DTLs are "levied by the same taxation authority and offsetting is permitted" by this authority.

"Threshold" limits[11] are imposed on the amount of three specified items - DTAs, MSRs and material non-consolidated investments in other financial institutions (collectively, the "Specified Items") that can be included in a bank's Tier 1 Common Equity.[12] For each item considered individually, the threshold limit is capped at 10% of a bank's Tier 1 Common Equity (calculated after the application of certain other regulatory adjustments). An additional limitation of 15% of a bank's Tier 1 Common Equity is provided for the Specified Items considered together. The application of the 10% limit is not clearly defined. As discussed below, the calculation for the 15% limit is clearly defined once the transition period for treating the Specified Items has concluded in 2018, but how to apply it during the transition period is not set forth clearly.

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[8] ASC paragraphs 740-10-30-17and 30-18.
[9] See IAS 12, paragraphs 15-18 and 24-27.
[10] All of the statements in this paragraph are drawn from Basel III, paragraph 69.
[11] The rules for the threshold limits discussed in this paragraph are provided in Basel III, paragraphs 86 - 89.
[12] In the prior letters cited in note 4 *supra*, The Clearing House recommended that the threshold limitations on DTAs and MSRs should be revisited as part of the U.S. implementation of Basel III. We will not repeat the arguments set out in those letters here, but we continue to believe that the threshold limitations should be revisited.

A four-year transition period beginning in 2014 is provided for the implementation of the threshold limits.[13] During the transition period for the 15% limit, it is unclear whether the limit should be calculated without reduction for any of the Specified Items. Once the DTA Proposals are fully implemented in 2018, the 15% calculation is to be made based on a bank's Tier 1 Common Equity after deduction of the Specified Items in full. A formula contained in Annex 2 to the proposals resolves this somewhat circular calculation.

C. Discussion of Recommendations

1. U.S. GAAP rules with respect to deferred tax items should be used as the initial source of guidance in implementing the DTA Proposals.

Regulatory capital calculations for U.S. banks begin with a bank's financial reporting maintained under U.S. GAAP.[14] Under the Current Rules, the determination of the amount of a DTA to be recorded in the financial statements and the amount of a required valuation allowance to be recorded reducing that value, if any, is made under provisions of ASC Paragraph 740 (formerly FAS 109).[15] The Basel Committee indicated after it issued a proposed framework addressing DTAs that it intended for local accounting rules to be the source of guidance in determining the validity of DTAs.[16] This has been the basic operating premise of the regulatory rules on capital for many years, and The Clearing House agrees with this approach.

2. The Current Rules should be retained as part of the U.S. implementation of Basel III, except to the extent the Current Rules have been specifically overridden by the DTA Proposals.

While the DTA Proposals were clearly intended in certain respects to replace the current national rules dealing with DTAs, there is nothing in Basel III or in the consultative document and related materials on DTAs preceding the issuance of Basel III (hereinafter, the "Historic Materials")[17] to suggest that the Basel Committee intended for all of the current national rules to be replaced by the DTA Proposals. We recommend, therefore, that the Current Rules be modified to meet the standards imposed in the DTA Proposals only in those limited circumstances in which the DTA Proposals expressly override the Current Rules. In all other circumstances, the Current Rules should be retained.

The starting and guiding principle of the DTA Proposals is that "Deferred Tax Assets (DTAs) that rely on the future profitability of the Bank to be realized are to be deducted in the

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[13] The guidance for the transition rules is provided in Basel III, paragraph 94 and Annex 4.
[14] See Instructions for Preparation of Consolidated Financial Statements for Bank Holding Companies, Reporting Form FR Y-9C, Line Item Instructions for Other Assets, Schedule HC-F, page HC-F-1, Line Item 2, and Glossary, page GL-41.
[15] See FRB Preamble FR at p. 65920 ; FDIC Preamble FR at p. 8182-8183 ; OCC Preamble FR at p. 7903-7904.
[16] See *infra* note 6.
[17] See Basel Committee on Banking Supervision, Consultative Document, "Strengthening the resilience of the banking sector" (December 2009) ("Basel 2009 Proposed Rules") and Basel FAQ 2010.

calculation of Common Tier 1 Equity."[18] Thus, where the Current Rules provide guidance for DTAs that do not rely on the future profitability of the bank, the DTA Proposals should not be interpreted as overriding them.

An example indicating how the Current Rules would be applied as part of U.S. implementation of Basel III may be helpful. Under ASC paragraphs 840-30-25 through 840-30-35[19], the DTLs associated with a leveraged lease that is acquired and accounted for under purchase accounting are embedded in the valuation of the leveraged lease in the U.S. GAAP financial statements. For regulatory capital purposes, banks are permitted under the Current Rules to gross-up these DTLs and offset them against their DTAs in calculating the amount, if any, of DTAs that must be subtracted from Tier 1 Common Equity.[20] This evidently is allowed because a taxable temporary difference that will result in future taxable income that supports the realizability of DTAs still exists even though it has been subsumed in the leverage lease for accounting purposes. The support these embedded DTLs provide for DTAs do not rely on the future profitability of the Bank. Therefore, The Clearing House believes that this treatment should be retained as part of Basel III implementation in the U.S.

See also the discussion below on carryback potential and MSRs.

3. DTAs realizable via loss carrybacks do not rely on future profitability and therefore should be treated as valid assets pursuant to provisions similar to those under the Current Rules.

The Current Rules allow the financial statement value of a DTA recorded on the regulatory balance sheet to be supported with no limitation to the extent that on presumed reversal at the reporting date, the DTA would result in recovery of taxes paid in prior years (*i.e.,* would be realized).[21] In adapting this rule for purposes of Basel III, The Clearing House suggests that the DTA Proposals, which allocate DTLs pro rata against all DTAs,[22] be applied first, and then any resulting net DTAs arising solely from temporary differences be tested for carryback potential. [23] In testing the net DTAs for carryback potential, the DTAs would be deemed to reverse on the reporting date, as under the Current Rules. The net DTAs would then be applied against prior years' taxable income for the carryback period allowed under the tax law to determine what portion, if any, of these DTAs would result in a recovery of taxes. The portion that would result in a recovery of taxes would be treated as a valid asset for Tier 1 Common

[18] Basel III, paragraph 69.
[19] Formerly, FASB Interpretation No. 21 (FIN 21).
[20] See FRB Preamble FR at p. 65923; FDIC Preamble FR at p. 8187; OCC Preamble FR at p. 7906.
[21] Fed Preamble FR at p. 65922; FDIC Preamble FR at pp. 8185-8186; OCC Preamble FR at p. 7905.
[22] Basel III, paragraph 69.
[23] There may be cases where a DTL will be allocated to a NOL DTA and to DTAs relating to deductible temporary differences. For example, this would be the case where a NOL may not be carried back because of limitations under the tax law even though there is carryback potential for deductible DTAs that are not subject to these same limitations.

Equity calculation purposes, and the balance would then be tested under the provision for testing DTAs arising from temporary differences in the DTA Proposals.

For example, assume a bank has a net DTA relating to its loan loss reserve (*i.e.,* a deductible temporary difference) of $30. Assume further that the bank does not expect to pay taxes in the current year but had paid $75 of taxes in the prior year and $25 of taxes two years ago. Under our recommendation, the DTA would be deemed to turn around at the reporting period and would be included in full in Tier 1 Common Equity. This would be because it could be carried back under the tax law for two years[24] and, therefore, recovered against the $25 of taxes paid two years ago and $5 of the $75 of taxes paid in the preceding year.

The Clearing House's recommendation is consistent with the basic philosophy of the DTA Proposals, which is to benefit DTAs that are realizable in cash, rather than those dependent on future profitability. In a preliminary discussion of the proposed DTA Proposals before the DTA Proposals were adopted, the Basel Committee specifically recognized carryback potential as a valid interpretation of its proposed framework on DTAs. In discussing a FAQ,[25] the Committee stated that DTAs that "do not rely on the future profitability of the bank to be realized include those that can be realized from taxes paid in prior carryback years." Since this FAQ referred specifically to a concept and phrase in the Basel Committee's December 2009 original proposal dealing with DTAs[26] that was retained in the DTA Proposals, the interpretation of the FAQ remains valid.[27]

Our position also is consistent with the current use of the term "deferred tax assets not dependent on future income" by U.S. regulators. In the Current Rules, the amount of DTAs not dependent upon future taxable income is determined by aggregating a bank's net DTAs and subtracting from them the "amount of income taxes previously paid that are potentially

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[24] Under Section 172(b)(1) of the Internal Revenue Code of 1986, as amended (the "Code"), a NOL may be carried back two years for banks.

[25] See Basel FAQ 2010, Question 3.3(1).

[26] Basel 2009 Proposed Rules. The relevant phrase is in the highlight box immediately preceding paragraph 98: "Deferred tax assets which rely on future profitability of the bank to be realized should be deducted from the Common Equity component of Tier 1 Capital." In paragraph 69 of the DTA Proposals, the opening sentence is substantially identical: "Deferred tax assets (DTAs) that rely on future profitability of the bank to be realized are to be deducted in the calculation of Common Equity Tier 1."

[27] The Clearing House's recommended rule is similar to the proposed rule in the regulations issued by the European Commission with respect to EU guidance on the implementation of Basel III. Article 36 of these regulations provides that DTAs "that do not rely on future profitability" include DTAs "arising from temporary differences which, in the event the institution incurs a loss, becomes insolvent or enters liquidation, are replaced, on a mandatory and automatic basis … with a claim on the central government…." Under the U.S. tax law, DTAs are not recovered on a mandatory and automatic basis by a loss-making or insolvent institution, but effectively the result is the same because the institution may reclaim any prior taxes paid by filing a refund claim for an earlier year in which taxes were paid based on the reversal of the DTAs (or such a claim will be filed on its behalf by the FDIC if the institution is insolvent).

recoverable through the carryback of net operating losses (carryback potential)."[28] Moreover, since this quoted language was not part of the prior Basel I or Basel II criteria for recognizing deferred tax assets, but has been part of the U.S. regulatory regime since 1995, we submit that the Basel Committee was referring to the U.S. concept, as evidenced by the above-referenced FAQ.

Finally, our recommendation is consistent with the U.S. GAAP rules for determining which, if any, DTAs require the recording of a valuation allowance against them. These rules specifically provide that a source of income against which to determine whether a valuation allowance is required for a DTA includes taxable income in a carryback period.[29]

4. Banks should be permitted to elect to net DTLs associated with MSRs against their MSRs before the MSRs are subjected to the Basel III threshold calculations.

The Clearing House recommends that banks be permitted to elect to net associated DTLs generated from transactions creating MSR assets against these MSRs in making their Tier 1 Common Equity regulatory capital calculations. Banks electing to do so would net the associated DTLs against MSRs before applying the threshold limits (once netted, the DTLs cannot be used again in the threshold calculations). Our recommendation would preserve the treatment of MSRs under the Current Rules.[30]

The Clearing House recommendation is analogous to the treatment of other intangible assets under Basel III. In Paragraph 67 of the Basel III proposals, DTLs associated with goodwill and other intangibles are netted against these items before the net balances are subtracted from Tier 1 Common Equity (the netted amount would then be eliminated from the threshold calculations). MSRs were removed from this paragraph in order to give them a more beneficial treatment (subject to the threshold calculations), but there is nothing in Basel III or in the Historic Materials to suggest that this separate consideration of MSRs must be interpreted as suggesting a different treatment of associated DTLs. Netting DTLs against MSRs does not rely on the future profitability of the bank because reversing DTLs are themselves a separate source of support for DTAs distinct from future profits.[31]

Instructions issued by the Basel Committee for Tier 1 Common Equity Calculations also support this conclusion. As part of its effort to monitor implementation of the Basel III

[28] See *supra* note 20; see also OCC, Bank Accounting Advisory Series (October 2010), Topic 7, Income Taxes, Response to Question 2; see also 12 CFR 225 Appendix A Section II.B.4.b as well as Line Item Instructions For Regulatory Capital, Schedule HC-R, Line Item 9(b) (June 2009).
[29] ASC Paragraph 740-10-30-18.
[30] See §§ II.B.1.d , II.B.1.e of Appendix A to Reg Y, 12 CFR, Part 225 (which provides the FRB rule for MSRs); 12 CFR § 325.5(f) (which provides the FDIC rule for MSRs); § 2 (c)(2) of Appendix A to 12 CFR, Part 3, (which provides the OCC Rule for MSRs).
[31] Basel III, paragraph 69. See also ASC paragraphs 740-10-30-17 and 30-18 and IAS 12, paragraph 28.

framework, the Basel Committee has requested banks to complete "workbooks", in which calculations on the potential impact of the Basel III proposals on a responding institution's Tier 1 Common Equity are measured. While the instructions for completing the workbook are not to be taken as an "official interpretation" of Basel III,[32] they are a clear indication of how the Basel Committee intends Basel III to be interpreted. In dealing with DTAs, the Basel III Instructions indicate DTLs are to be netted against intangibles and MSRs[33]. The Basel III Instructions provide clear evidence that the Basel Committee supports preservation of the historic rule concerning the netting of DTLs against MSRs.

While we agree with the Current Rules and the Basel Committee that associated DTLs can be netted against MSRs, we believe that this provision should be elective. Financial institutions should be allowed to elect whether to net DTLs associated with their MSRs against those MSRs or to treat those DTLs like any other DTLs against DTAs on a pro rata basis.

To illustrate why the provision should be elective, consider the following example. Assume a bank has MSRs of $50, DTLs associated with those MSRs of $20 and a DTA relating to a NOL carryfoward of $25. Assume further that the $50 of MSRs are valid within the 10% and 15% limits as measured under the threshold calculations (and are therefore included in Tier 1 Common Equity in full). In this instance, if the bank were required to allocate the DTLs of $20 solely against the MSRs of $50, the net MSRs of $30 would be included in Tier 1 Common Equity but the full NOL DTA of $25 would have to be subtracted from Tier 1 Common Equity under the DTA Proposals. By contrast, if the bank instead could allocate its DTLs against DTAs on a pro rata basis, all of the DTLs would be netted against its DTA of $25. Hence, only $5 of the NOL DTA would be subtracted from Tier 1 Common Equity. This is consistent with the fact that a sale of the MSRs at book value would result in taxable income and would result in the realization of $20 worth of the NOL DTA (*i.e.,* that portion of the NOL that did not rely on the future profitability of the bank to be realized).

This suggested flexibility to permit pro rata allocation of DTLs against DTAs is derived from the ability under the tax law to offset deductions and losses from the triggering of DTAs against income generated by reversals of DTLs without regard to the underlying transaction that gave rise to the DTL. This approach also is consistent with the general pro rata approach in the DTA Proposals and parallels the treatment under U.S. GAAP for impaired MSRs. For impaired MSRs, the associated DTLs are reversed into income since the future income giving rise to the tax liability will never be realized.[34] Finally, there is nothing in Basel III that precludes such elective treatment. Accordingly, we recommend that U.S. regulations implementing Basel III include this election.

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[32] See Basel Committee, Instructions for Basel III implementation monitoring (May 2011) (the "Basel III Instructions"), section 1.
[33] See Basel Instructions, section 4.3 (Panel C13).
[34] ASC Paragraph 740-10-25-20.

5. The threshold calculations for Specified Items should be clarified.

We recommend that the 10% threshold calculation for Specified Items be clarified by providing that this calculation is to be made separately for each of the Specified Items without reduction for the Specified Items themselves. We also recommend that in making the 15% threshold calculation for Specified Items, the calculation should be clarified by providing that it should be made without reduction for the Specified Items until January 1, 2018 when the transition period ends.

The provisions dealing with the threshold calculations are set out in paragraphs 87 and 88 in Basel III and in Annex 2. While The Clearing House believes that the Basel Committee intended that the two calculations be done in the manner recommended immediately above, the specific language in Basel III and Annex 2 is not clear with regard to the transition period. Accordingly, we request that U.S. regulations implementing Basel III include clarifying language in the fashion indicated.

We illustrate how we believe the threshold calculations should work with the following example. Assume a bank has each of the Specified Items in the net amount of $15. It has Tier 1 Common Equity of $90 before any adjustment for Specified Items. The 10% threshold calculation should be $9 for each of the three Specified Items (10% times $90). The 15% threshold calculation calculated collectively for the three Specified Items should be $13.5 (15% times $90). The 15% threshold calculation described herein would apply only during the four-year transition period ending in 2018 as the proposals specified in Annex 2 to Basel III provide for a different calculation beginning in 2018.

As can be seen from this example, the treatment of Specified Items in the 15% aggregate calculation during the transition period of 2014-2017 leads to a larger aggregate limit and lower subtractions from Tier 1 Common Equity than upon full implementation in 2018. Under our recommendation, the 15% threshold calculation in 2018 would be $7.9 (17.5% [the specified % in Annex 2] times [$90 less the Specified Items of $45]). We believe that this result was intended by the Basel Committee and should be included in the U.S. regulations.

6. The transition proposals should be easily administrable and ensure consistent treatment across jurisdictions; The Clearing House suggests a framework to achieve these objectives.

The only guidance on how the transition calculations are to be done is provided in paragraph 94 and in Annex 4 of Basel III. Paragraph 94 states that the adjustments to regulatory capital in general are to be implemented in 20% increments beginning in 2014 and that the “remainder” of the adjustments not deducted from Tier 1 Common Equity “will continue to be subject to existing national treatments".[35] These proposals are reflected in a chart contained in Annex 4. While the transition proposals are not clear as to how they should apply to DTAs, we believe that certain concerns need to be considered as part of U.S. implementation of Basel III.

Question 17 of the July, 2011 FAQs sought to clarify how the transition proposals should relate to "existing national treatments". The answer provided that in 2014, 20% of a regulatory adjustment is to be subtracted from Tier 1 Common Equity under the Basel III framework "and 80% of it is taken off the tier where this deduction used to apply under existing national treatment." We believe that applying this answer to the treatment of DTAs may lead to inconsistent results across jurisdictions.

Local jurisdictions treat DTAs for regulatory capital purposes in a variety of ways. Some countries strictly limit the amount of such assets, if any, that can be counted for regulatory capital purposes.[36] Others have more liberal rules.[37] Thus, while the measure of DTAs that are valid under the DTA Proposals will be consistent, the amount of DTAs that will be recognized under existing national treatments may vary widely. The result will be that for some banks 20% of the amount recognized under the DTA Proposals will be the effective limit, while for other banks the existing national treatment will determine the limit.

Given the above, we request that regulations incorporate rules that are easily administered and largely preserve national treatment for U.S. banks until the second half of the transition period. To accomplish those objectives, we propose that the reduction of DTAs be equal to the greater of:

(i) the amount disallowed under the DTA Proposals as adjusted for the transition percentage (20% in 2014, 40% in 2015, etc.), or

(ii) the amount disallowed under the Current Rules.

We would be pleased to discuss this proposed rule with you as well as other potential solutions that would be simple to implement and treat U.S. banks consistently as compared to those in other jurisdictions.

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[35] See Basel Committee, Basel III definition of capital - Frequently asked questions (July 2011) ("July, 2011 FAQs"), question 17.
[36] In Australia, DTAs (after netting with DTLs in specific circumstances) are subtracted from Tier 1 Common Equity except for any DTAs associated with collective provisions eligible to be included in the General Reserve for Credit Losses. See Prudential Standard APS 111 Measurement of Capital, Attachment D, paragraphs 1.
[37] In the UK, DTAs are not subtracted from Tier 1 Common Equity. See General Prudential Sourcebook 1.39 and 2.2.156.

We thank you for considering our views. We would be happy to discuss these issues further with you at your convenience. If you have any questions or need further information, 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,

David Wagner
Senior Vice President
Financial and Tax Affairs

cc: The Honorable Timothy F. Geithner
Secretary
United States Department of the Treasury

Lance Auer
Deputy Assistant Secretary
Department of the Treasury

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System

Patrick M. Parkinson
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Board of Governors of the Federal Reserve System

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Martin Pfinsgraff
Deputy Comptroller for Credit and Market Risk
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Kerri Corn
Director for Market Risk Policy
Office of the Comptroller of the Currency

Kathy Murphy
Chief Accountant
Office of the Comptroller of the Currency

The Honorable Martin J. Gruenberg
Vice Chairman
Federal Deposit Insurance Corporation

Robert Storch
Chief Accountant
Federal Deposit Insurance Corporation

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Brett Waxman
Vice President and Associate General Counsel
The Clearing House Association L.L.C.

December 13, 2011

THE CLEARING HOUSE
ALTERNATIVE 1 - TCH VIEW
BASEL III - TRANSITION CALCULATION

Assumptions:

Tier 1 Common Equity Inclusive of DTAs	$500
Net allowable DTAs before transition rule*	$100
Excess DTAs under Basel III rules (as though Computed in 2018)	$75
Allowable DTAs under Current Rules	$45
Excess DTA's under Current Rules	$55

Transition calculation:
Start with net allowable DTAs ($100) and subtract:
First, the excess of net allowable DTAs over the amount permissible under the Basel III Threshold Rules (as adjusted by the transition disallowance percentages);
Second, the figure derived by subtracting from the remainder of allowable DTAs (as adjusted by the first step) the amount permissible under Current Rules.

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*Gross DTAs less (i) DTLs allocable to such DTAs, and (ii) DTAs (net of allocable DTLs) derived from loss and foreign tax credit carryforwards.

	2014		2015		2016		2017		2018	
	Basel	Current US	Basel	Current US	Basel	Current US	Basel	Current US	Basel	Current US
Net DTA in capital before Threshold Adjustments (A)	100	100	100	100	100	100	100	100	100	100
Step 1 - Basel III calculations										
Assumed excess DTAs under Basel III rules	-75		-75		-75		-75		-75	
Basel phase in percentage	20%		40%		60%		80%		100%	
Excess DTAs under Basel III rules (B)	-15		-30		-45		-60		-75	
"Remainder not deducted subject to existing national treatment" (A-B)	85		70		55		40		25	
Step 2 - Current Rules										
Total allowable DTAs after Step 1		85		70		55		40	n/a	n/a
Limit of allowable DTAs under Current Rules		45		45		45		45		n/a
Additional Excess DTAs under Current Rules		-40		-25		-10		0		n/a
Total excess DTAs	-55		-55		-55		-60		-75	
DTA recognized under transition in particular Year	45		45		45		40		25	

December 13, 2011

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ALTERNATIVE 2 - DOUBLE DEDUCTION PROPOSAL

BASEL III - TRANSITION CALCULATION

Assumptions:

Tier 1 Common Equity inclusive of DTAs	$500
Net allowable DTAs before transition rule*	$100
Excess DTAs under Basel III rules (as though computed in 2018)	$75
Allowable DTA's under Current Rules	$45
Excess DTAs under Current Rules	$55

Transition calculation:
Start with net allowable DTAs ($100) and:
Calculate the excess DTAs over the permissible amounts under both the Basel III Threshold Rules and under the Current Rules; and
Subtract the transition percentage of excess DTAs under the Basel III rules and the reciprocal percentage under the Current Rules.

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*Gross DTAs less (i) DTLs allocable to such DTAs, and (ii) DTAs (net of allocable DTLs) derived from loss and foreign tax credit carryforwards.

	2014		2015		2016		2017		2018	
	Basel	Current US	Basel	Current US	Basel	Current US	Basel	Current US	Basel	Current US
Net DTA in capital before Threshold Adjustments	100	100	100	100	100	100	100	100	100	100
Step 1 - Basel III calculations										
Assumed excess DTAs under Basel III rules	-75		-75		-75		-75		-75	
Basel phase in percentage	20%		40%		60%		80%		100%	
Excess DTAs under Basel III rules	-15		-30		-45		-60		-75	
Step 2 - Current Rules										
Excess DTA's under Current Rules		-55		-55		-55		-55	n/a	
Reciprocal percentage		80%		60%		40%		20%	n/a	
Excess DTAs under Current Rules		-44		-33		-22		-11		
Total excess DTAs	-59		-63		-67		-71		-75	
DTA recognized under transition in particular Year	41		37		33		29		25	

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ALTERNATIVE 3 - REMAINDER NOT DEDUCTED PROPOSAL
BASEL III - TRANSITION CALCULATION

Assumptions:

Tier 1 Common Equity inclusive of DTAs	$500
Net allowable DTAs before transition rule*	$100
Excess DTAs under Basel III rules (as though Computed in 2018)	$75
Allowable DTAs under Current Rules	$45
Excess DTA's under Current Rules	$55

Transition calculation:
Start with net allowable DTAs ($100) and subtract:
First, the excess DTAs over the amount permissible under the Basel III Threshold Rules (as adjusted by the transition disallowance percentages); however the "remainder" is the excess amount of DTA's as calculated under Basel III in 2018 over the excess DTA's calculated for a particular year under the Transition Rules).
Second, the figure derived by subtracting from this "remainder" of allowable DTAs (as adjusted by the first step) the amount permissible under US Current Rules.

*Gross DTAs less (i) DTLs allocable to such DTAs, and (ii) DTAs (net of allocable DTLs) derived from loss and foreign tax credit carryforwards.

	2014		2015		2016		2017		2018	
	Basel	Current US	Basel	Current US	Basel	Current US	Basel	Current US	Basel	Current US
Tier 1 Common Equity before Threshold Adjustments	100	100	100	100	100	100	100	100	100	100
Step 1 - Basel III calculations										
Assumed excess DTAs under Basel III rules (A)	-75		-75		-75		-75		-75	
Basel phase in percentage	20%		40%		60%		80%		100%	
Phase in Portion of Excess DTAs under Basel III rules (B)	-15		-30		-45		-60		-75	
"Remainder not deducted subject to existing national treatment" (A-B)	60		45		30		15		25	
Step 2 - Current Rules										
Remainder from Step 1		60		45		30		15	n/a	n/a
Limit of allowable DTAs under Current Rules		45		45		45		45		n/a
Additional Excess DTAs under Current Rules		-15		0		0		0		n/a
Total excess DTAs	-30		-30		-45		-60		-75	
DTA recognized under transition in particular Year	70		70		55		40		25	

December 13, 2011

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Appendix 2
Basel III Threshold Calculations

I. Assumptions

Assume a bank that has Tier 1 common equity of 90. It also has a loan loss reserve (LLR), MSRs and investments in the common shares of unconsolidated financial institutions (collectively, "Specified Items"). Assume further that any DTLs have been netted against the Specified Items on a pro rata basis, resulting in the net amount of these Specified Items of:

〈 Net LLR DTA	15.0
〈 Net MSRs	15.0
〈 Net Common Equity Investments in Unconsolidated s Financial Institutions	15.0

II. Calculations:

A. Prior to 2018:

1. 10% Threshold – Specified Items		
Tier 1 Capital		90.0
a. 10% threshold calculated separately for each Specified Item (10% x 90)		
1. LLR DTA – Remaining Recognized	9.0	
2. MSRs – Remaining Recognized	9.0	
3. Interests in Financial Institutions – Remaining Recognized	9.0	
b. 10% threshold deductions		
1. LLR Net DTA Deducted	-6.0	
2. MSRs Deducted	-6.0	
3. Interests in Financial Institutions deducted	-6.0	
c. 10% threshold deductions		-18.0
2. 15% Threshold (15% x 90)	13.5	
a. Amount of Specified Items remaining before 15% threshold		
1. Net LLR DTA	9.0	
2. Net MSRs	9.0	
3. Net Interests in Financial Institutions	9.0	
b. Aggregate Specified Items remaining before application of 15% threshold	27.0	
c. Aggregate required deductions (excess of 15% threshold less aggregate Specified Items remaining before application of 15% threshold)		-13.5
3. Tier 1 Capital Calculation		
Tier 1 Capital before 10% threshold and 15% threshold deductions		90.0
Aggregate 10% threshold deductions		-18.0
Aggregate 15% threshold deductions		-13.5
Tier 1 Capital after 10% and 15% threshold deductions		58.5

B. After 2018:

1. 10% Threshold – Specified Items	
Tier 1 Capital	90.0
10% threshold deductions calculated same as for years prior to 2018	-18.0

2. 15% Threshold

Amount of Specified Items remaining before 15% threshold			
Net LLR DTA	-15.0	Deduct Full here – per annex 2	
Net MSR	-15.0	Deduct Full here – per annex 2	
Net Investments in Financial Institutions	-15.0	Deduct Full here – per annex 2	
Subtotal – “Hypothetical” Tier 1 Capital	45.0		
Annex 2 Rate	17.65%		
Aggregate 15% Threshold	7.9		
Amount of the Three Specified Items remaining before 15% threshold			
Net LLR DTA	9.0		
Net MSRs	9.0		
Net Interests in Financial Institutions	9.0		
Aggregate Specified Items remaining before application of 15% threshold			27.0
Aggregated required deductions (27-7.9)			-19.1

3. Tier 1 Capital Calculation

Tier 1 Capital before 10% threshold and 15% threshold deductions	90.0
10% Threshold deductions – individual specified items	-18.0
15% Threshold deductions – aggregate specified items	-19.1
Tier 1 Capital after 10% and 15% required deductions	52.9

The Clearing House

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 LOOS 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 LOOS 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 2013 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 2013 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 2013 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

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[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,

David Wagner

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