February 4, 2021

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Chief Counsel's Office
Office of the Comptroller of the Currency (OCC)
Attention: 1557-0081
400 7th Street SW, Suite 3E-218
Washington, DC 20219

Re: Call Report Deposit Insurance Assessment-Related Revisions: 1557-0081

This letter is in response to your request for comments on the proposed rules and Call Report changes that aim to eliminate double counting of CECL reserves in connection with deposit insurance assessments. In the course of reviewing the latest Call Report form it has become apparent that there may be another potential double-counting that arises in the computation of the leverage ratio denominator. This too can have an impact on deposit insurance assessments and your request for comments seems like a good excuse to provide these thoughts. I apologize if this is too far off topic but I believe it is an important issue for every bank.

For simplicity, I have skipped background explanations and definitions. I assume the reader is familiar with the banking agency regulations, Call Report forms, etc. In fact, I have skipped any introduction and invite you to launch into an example to illustrate the nature of my concern.

Example

Assume ABC Bank's balance sheet is as follows:

ABC Bank Balance Sheet ($mm)
Dr. / <Cr.>

Assets			Liabilities & Equity		
Cash	$	10,000	Deposits	$	(85,000)
Loans	$	86,000	Unfunded pension obligation	$	(3,000)
Goodwill	$	4,000	Deferred tax liabilities, net	$	(1,000)
Total Assets	$	100,000	Total liabilities	$	(89,000)
			Common stock	$	(10,000)
			Retained earnings	$	(2,500)
			AOCI	$	1,500
			Total equity	$	(11,000)
			Total liabilities and equity	$	(100,000)

Regulatory Adjustments

ABC is a category III bank and has made the AOCI opt-out election under 12 C.F.R. § 3.22(b). ABC is required to subtract goodwill and add-back its debit balance pension accumulated other comprehensive income ("AOCI") account for purposes computing common equity tier one capital ("CET1") and total tier one capital ("Tier 1").

Goodwill

Goodwill is required to be subtracted in computing CET1 pursuant to 12 C.F.R. § 3.22(a)(1). This regulation provides that goodwill is subtracted net of any associated deferred tax liabilities ("DTLs"). In my example, ABC is required to subtract all of its $4 billion of goodwill on a net-of-tax basis. Assume ABC possesses a $1 billion DTLs related to goodwill because it has fully amortized its goodwill for federal and state income tax purposes (assuming a blended 25 percent tax rate, $4 billion x 25% = $1 billion). In computing regulatory capital, ABC is permitted to net these two accounts and is only required to subtract the net $3 billion amount in computing CET1.

Pension AOCI

Under ASC 715-20 (and SFAS No. 158 prior to codification), a pension liability associated with prior service costs (e.g., upon adoption of a plan amendment) is required to be accrued as part of an unfunded pension liability with an offsetting debit to AOCI. This debit is later moved out of AOCI and charged to the income statement as the employees fulfill their service obligations. The purpose of this GAAP accounting rule is to force companies to fully disclose the extent of any underfunded pension but allow the charges to profit and loss to occur over a period of time that matches the performance of service by the pension beneficiaries. Under ASC 715-20, the debit entry to AOCI is offset by the corresponding future tax benefit, resulting in a debit to a deferred tax asset ("DTA") account and a credit to AOCI.

In my example, assume that $2 billion of ABC's pension liability relates to unamortized prior service costs. As a result, ABC's AOCI includes a debit entry for the net-of-tax amount of $1.5 billion and its DTA account includes a debit of $0.5 billion ($2 billion x 25%). ABC's cumulative entries can be summarized by the following journal entry:

Dr.	AOCI – prior service costs	$ 1.5 bb	
Dr.	Deferred tax asset	$ 0.5 bb	
Cr.	Unfunded pension liability		$2.0 bb

Under 12 C.F.R. § 3.22(b)(2)(i)(D), a bank that has made an AOCI opt-out election is required to "[s]ubtract any amounts recorded in AOCI attributed to defined benefit postretirement plans resulting from the initial and subsequent application of the relevant GAAP standards that pertain to such plans . . .." By its plain language, this regulation permits banks to "add back" any debit balances in AOCI in the process of computing regulatory capital. Remember, the structure of Schedule RC-R, Part I includes all AOCI in lines 3 and 5, but utilizes the various rows in line 9 to eliminate the elements of AOCI that are not required to be included in CET1, such as AOCI

associated with pension plans. In other words, this regulation allows banks to "unwind" the GAAP entries for pension plan accounting that involve AOCI. In some sense, one could say that the regulatory capital rules apply a FAS 87 framework for determining pension accruals by way of eliminating the accrual of prior service costs imposed by FAS 158. Similar to goodwill, 12 C.F.R. § 3.22(b)(2)(i)(D) requires banks to eliminate the net-of-tax balance embedded in AOCI.

DTAs

Under 12 C.F.R. § 3.22(d)(1)(iv) and (e)(1), banks are permitted to make corresponding adjustments to the balance of any DTAs or DTLs that are eliminated by the regulation capital adjustments for pension AOCI and goodwill, respectively. In my example, ABC possesses a net DTL for GAAP purposes of $1 billion, consisting of $1 billion of DTL related to goodwill, $500 million of other DTLs and $500 million of DTAs related to the prior service cost layer of ABC's pension liability. For regulatory capital purposes, the goodwill DTL and the AOCI DTA are removed in computing regulatory capital and must also be removed in determining whether ABC possesses a resulting DTA subject to limitation. However, in this case, the residual DTL is $500 million. Therefore, ABC is not subject to any DTA limitations on RC-R, Part I, lines 8 or 15a.

To summarize, ABC's CET1 and Tier 1 capital are computed as follows:

ABC Bank Call Report Schedule RC-R, Part I ($mm)		
Line 1	Common stock etc.	$ 10,000
Line 2	Retained earnings	$ 2,500
Line 3	AOCI	$ (1,500)
Line 5	CETA before adj's	$ 11,000
Line 6	Goodwill	$ (4,000)
Line 6	Goodwill DTL	$ 1,000
Line 9d	AOCI pension	$ 1,500
Line 19	CET1	$ 9,500
Line 26	Tier 1 capital	$ 9,500

Leverage Ratio Questions

Now to the focal point of my letter: how to adjust a bank's total assets for purposes of computing the leverage ratio denominator. The plain language of the form instructions might require ABC to deduct $3 billion of goodwill and add $1.5 billion of AOCI related to prior service costs. However, an alternative interpretation might allow ABC to deduct $4 billion of goodwill and make no adjustment for pension AOCI.

Leverage Ratio	Net Approach	Gross Approach
Line 27 Total assets	$ 100,000	$ 100,000
Line 28 Deduction on line 6	$ (3,000)	$ (4,000)
Line 29 Pension AOCI	$ 1,500	$ -
Line 30 Total assets for leverage	$ 98,500	$ 96,000
Line 31 Leverage ratio	9.64%	9.90%

Line 28 Goodwill Adjustment

The foregoing chart shows the two potential treatments of the goodwill subtraction. The Call Report instructions for Schedule RC-R, Part I, line 28 indicate that ABC must "report the sum of the amounts deducted from common equity tier 1 capital and additional tier 1 capital in Schedule RC-R, Part I, items 6, 7, 8, 10.b, 13.a, 14.a, 15.a, 17 (column A), and 24." This could be interpreted to mean that ABC must simply deduct the amount on line 6. However, that would leave $1 billion of goodwill in the leverage denominator, which really makes no sense. Goodwill requires dollar-for-dollar capital and this is accomplished by removing it entirely from Tier 1 capital. It would make no sense to include a residue of goodwill in the leverage ratio denominator as that would amount to requiring more than 100 percent capital.

Recall, ABC had $4 billion of goodwill but was only required to subtract the net-of-tax amount. However, the tax effect associated with goodwill resides on the liability side of the balance sheet. Thus, if the balance sheet were being reconfigured to match the regulatory capital treatment, one would expect that the asset side would be reduced by $4 billion while the liability and equity side would be reduced by $4 billion — $3 billion for the common equity subtraction made pursuant to 12 C.F.R. § 3.22(a)(1) and $1 billion for the DTL elimination required under 12 C.F.R. § 3.22(e)(1).

The regulations also leave room for interpretation. The capital adequacy regulations define *leverage ratio* in 12 C.F.R. § 3.10(b)(4) as follows: "the ratio of the national bank's or Federal savings association's tier 1 capital to the national bank's or Federal savings association's average total consolidated assets as reported on the national bank's or Federal savings association's Call Report minus amounts deducted from tier 1 capital under § 3.22(a), (c), and (d)." Similar to the form instructions, these regulations are not clear whether the "amounts deducted" refer to the gross amounts or the actual amount subtracted, which is the net-of-tax amount.

Despite the lack of clarity in the regulations, there is an overarching theme in these rules which suggests that the regulatory capital ratios depend on the as-adjusted "regulatory capital" balance sheet adjusted for all the elements removed from the GAAP basis balance sheet. The Board of Governors of the Federal Reserve System ("the Board") has embraced this view in a series of frequently asked questions ("FAQs"). For example, in CCAR Frequently Asked Questions, Thursday, December 10, 2015, ID # SUM0041, the Board observed: "[i]n calculating the amounts of goodwill, MSAs, and any intangible assets other than goodwill and MSAs to be deducted from common equity tier 1 capital, a banking organization is allowed to net associated

DTLs in line with section 22(e). However, for purposes of risk weighting amounts of MSAs or any intangible assets . . . that are not deducted from common equity tier 1 capital, a banking organization cannot net associated DTLs." In ID #SUM0050 the Board was asked whether "BHCs risk weight mortgage servicing assets (MSAs) that are not deducted from capital on a gross (pre-tax) basis or . . . net of associated deferred tax liabilities (DTLs)?" The Board's response: "MSAs that are not deducted from capital are subject to risk weighting on a gross (pre-tax) basis."

Following the rationale expressed by the Board in its FAQs, it is my view that banks ought to remove the gross amount of items subtracted on lines 6, 7, 8, etc. for both risk weighting purposes *and* for purposes of determining the leverage ratio denominator.

Line 29 Pension AOCI Adjustment

In the case of pension-related AOCI, the form instructions for RC-R, Part I, line 29 state:

> If the reporting institution sponsors a single-employer defined benefit postretirement plan, such as a pension plan or health care plan, accounted for in accordance with ASC Topic 715, Compensation-Retirement Benefits (formerly FASB Statement No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans"), the institution should adjust total assets for leverage ratio purposes for any amounts included in Schedule RC, item 26.b, "Accumulated other comprehensive income" (AOCI), affecting assets as a result of the initial and subsequent application of ASC Topic 715.

The underscored portions of this quote could suggest one of two things. Either all of the AOCI amounts removed from line 9(d) are added to the leverage ratio denominator, or these amounts are only added if the bank otherwise reports an overfunded pension *asset*.

Under ASC 715-20-25-2, an employer is required to "aggregate the statuses of all overfunded plans and recognize that amount as an asset" and "aggregate the statuses of all underfunded plans and recognize that amount as a liability in the statement of financial position." Whether a pension plan is overfunded or underfunded, there can be debit balances in AOCI to the extent of any unamortized prior service costs. However, if the pension plan is underfunded, the regulatory capital adjustment that removes this AOCI entry does not impact any *asset* account. As a result, it seems hard to understand why the AOCI adjustment would create an asset against which a leverage ratio capital requirement would apply.

Consider the facts in my example. ABC possesses a $3 billion underfunded pension liability, $2 billion of which is the result of prior service costs that are offset by a $2 billion loss recorded in AOCI. However, under ASC 740, the tax effects of losses charged to AOCI are required to be recorded to AOCI as well. As a result, ABC would have recorded $0.5 billion DTA associated with its expected future pension deduction ($2 billion x 25%) with an offsetting credit to AOCI. , resulting in a net charge to AOCI of only $1.5 billion. Under 12 C.F.R. § 3.22(b)(2)(i)(D), ABC is permitted to add back the net $1.5 billion debit balance in AOCI amount and is required to

make a curative adjustment to its GAAP DTA under 12 C.F.R. § 3.22(d)(1)(iv). In my view, this collection of rules implies that ABC is supposed to "undo" the GAAP accounting entry by making appropriate adjustments to its pension liability account, the associated DTA, and associated AOCI account. In other words, for regulatory capital purposes ABC is treated as having an underfunded pension liability of only $1 billion rather than the $3 billion reported on its GAAP balance sheet. And since ABC does not possess an overfunded pension asset, it would not make sense for ABC to add the $1.5 billion adjustment to its leverage ratio denominator.

Summary

A picture is worth a thousand words. To properly conceive of what should be in the leverage ratio denominator, I constructed a "regulatory capital" balance sheet. I believe the results are self-explanatory and convince me that the proper way to determine the leverage ratio denominator is to make the entries on lines 28 and 29 on a "gross" basis.

ABC Bank Regulatory Capital Balance Sheet
Dr. / <Cr.>

Assets	GAAP	Adj's	Reg Cap Basis
Cash	$ 10,000		$ 10,000
Loans	$ 86,000		$ 86,000
Goodwill	$ 4,000	$ (4,000)	$ -
Total Assets	$ 100,000	$ (4,000)	$ 96,000

Liabilities & Equity	GAAP	Adj's	Reg Cap Basis
Deposits	$ (85,000)		$ (85,000)
Unfunded pension obligati	$ (3,000)	$ 2,000	$ (1,000)
DTLs (1)	$ (1,000)	$ 500	$ (500)
Total liabilities	$ (89,000)	$ 2,500	$ (86,500)
Common stock	$ (10,000)	$ 3,000	$ (7,000)
Retained earnings	$ (2,500)		$ (2,500)
AOCI	$ 1,500	$ (1,500)	$ -
Total equity	$ (11,000)	$ 1,500	$ (9,500)
Total liabilities and equit	$ (100,000)	$ 4,000	$ (96,000)

Note:
(1) DTLs are adjusted by removing the $1,000 goodwill DTL and the $500 pension AOCI DTA, leaving only the ABC's other DTLs of $500.

Please let me know your thoughts on these issues and whether you agree with my conclusion that the leverage ratio denominator is best harmonized with the regulatory adjustments by making the entries on lines 28 and 29 on a "gross" basis. If you would like to talk through this, please feel free to call me at (602) 322-3643 or (602) 882-9852. I can also be reached by email at john.taylor1@ey.com.

Sincerely,

John M. Taylor
Phoenix, Ariz.