

**Meeting between Board staff  
and Representatives of The Clearing House (TCH)  
September 20, 2011**

**Participants:** Art Lindo, Anna Lee Hewko, Juan C. Climent, Matt Kincaid and Page Conkling (Federal Reserve Board)

Paul D. Polivy (Citi); John P. Kinsella (US Bank); William L. McNairy (Bank of America); Mark G. Servis (Capital One); Myron Rosenberg and Dennis M. Saslofsky (JPMorgan Chase); David J. Wagner and Brett M. Waxman (TCH)

**Summary:** Representatives of TCH met with Federal Reserve Board staff to discuss issues related to the implementation of Basel III. As part of this discussion, TCH representatives went over the main points of a letter dated September 19, 2011, from TCH to the Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation on deferred tax asset (DTA) calculations under Basel III. A copy of the letter is attached.

During the meeting, TCH expressed the following views on Basel III-related issues:

- 1) Clarifying that U.S. GAAP is the starting point for the regulatory capital treatment of DTAs under Basel III would be beneficial;
- 2) Existing regulatory capital guidance on DTAs should be retained as long as Basel III does not specifically override it;
- 3) DTAs realizable via loss carry-backs should not be subject to deduction (in line with the treatment of these assets under current rules);
- 4) Netting deferred tax liabilities associated with mortgage servicing rights (MSRs) against MSR deductions should be permitted for purposes of determining the MSR deduction thresholds;
- 5) The 10 and 15 percent threshold calculations for DTAs, MSRs and significant investments in financial institutions should be further clarified;
- 6) The rules under the transition arrangements should be easily administrable and ensure consistency across jurisdictions.

Federal Reserve Board staff thanked TCH for sharing their views and concerns and mentioned that the Board was in the process of developing a notice of proposed rulemaking (NPR). Staff also highlighted that once the NPR is issued, TCH and other market participants will have a chance to comment and react to the proposals.

Attachment



September 19, 2011

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Division of Banking Supervision and Regulation  
Board of Governors of the Federal Reserve System  
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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”)<sup>1</sup>, 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

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<sup>1</sup> 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](http://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”).<sup>2</sup> 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.<sup>3</sup>

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.<sup>4</sup>

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”)<sup>5</sup> be retained, except to the extent they have been specifically overridden by the DTA Proposals;

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<sup>2</sup> Basel Committee on Banking Supervision, “Basel III: A global regulatory framework for more resilient banks and banking systems”, December 2010.

<sup>3</sup> Basel III, paragraph 94(a).

<sup>4</sup> 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](http://www.theclearinghouse.org) (under “Association” and the “Capital” tabs).

<sup>5</sup> 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.<sup>6</sup> 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.<sup>7</sup>

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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<sup>6</sup> 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.

<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup>

## **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.<sup>10</sup> 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<sup>11</sup> 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.<sup>12</sup> 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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<sup>8</sup> ASC paragraphs 740-10-30-17 and 30-18.

<sup>9</sup> See IAS 12, paragraphs 15-18 and 24-27.

<sup>10</sup> All of the statements in this paragraph are drawn from Basel III, paragraph 69.

<sup>11</sup> The rules for the threshold limits discussed in this paragraph are provided in Basel III, paragraphs 86 - 89.

<sup>12</sup> 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.<sup>13</sup> 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.<sup>14</sup> 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).<sup>15</sup> 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.<sup>16</sup> 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")<sup>17</sup> 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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<sup>13</sup> The guidance for the transition rules is provided in Basel III, paragraph 94 and Annex 4.

<sup>14</sup> 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.

<sup>15</sup> See FRB Preamble FR at p. 65920 ; FDIC Preamble FR at p. 8182-8183 ; OCC Preamble FR at p. 7903-7904.

<sup>16</sup> See *infra* note 6.

<sup>17</sup> 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.”<sup>18</sup> 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<sup>19</sup>, 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.<sup>20</sup> 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).<sup>21</sup> 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,<sup>22</sup> be applied first, and then any resulting net DTAs arising solely from temporary differences be tested for carryback potential.<sup>23</sup> 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

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<sup>18</sup> Basel III, paragraph 69.

<sup>19</sup> Formerly, FASB Interpretation No. 21 (FIN 21).

<sup>20</sup> See FRB Preamble FR at p. 65923; FDIC Preamble FR at p. 8187; OCC Preamble FR at p. 7906.

<sup>21</sup> Fed Preamble FR at p. 65922; FDIC Preamble FR at pp. 8185-8186; OCC Preamble FR at p. 7905.

<sup>22</sup> Basel III, paragraph 69.

<sup>23</sup> 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<sup>24</sup> 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,<sup>25</sup> 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<sup>26</sup> that was retained in the DTA Proposals, the interpretation of the FAQ remains valid.<sup>27</sup>

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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<sup>24</sup> 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.

<sup>25</sup> See Basel FAQ 2010, Question 3.3(1).

<sup>26</sup> 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."

<sup>27</sup> 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).”<sup>28</sup> 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.<sup>29</sup>

#### **4. Banks should be permitted to elect to net DTLs associated with MSR assets against their MSR assets before the MSR assets 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 MSR assets in making their Tier 1 Common Equity regulatory capital calculations. Banks electing to do so would net the associated DTLs against MSR assets before applying the threshold limits (once netted, the DTLs cannot be used again in the threshold calculations). Our recommendation would preserve the treatment of MSR assets under the Current Rules.<sup>30</sup>

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). MSR assets 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 MSR assets must be interpreted as suggesting a different treatment of associated DTLs. Netting DTLs against MSR assets 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.<sup>31</sup>

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

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<sup>28</sup> 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).

<sup>29</sup> ASC Paragraph 740-10-30-18.

<sup>30</sup> 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 MSR assets); 12 CFR § 325.5(f) (which provides the FDIC rule for MSR assets); § 2 (c)(2) of Appendix A to 12 CFR, Part 3, (which provides the OCC Rule for MSR assets).

<sup>31</sup> 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,<sup>32</sup> 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<sup>33</sup>. 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 carryforward 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.<sup>34</sup> 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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<sup>32</sup> See Basel Committee, Instructions for Basel III implementation monitoring (May 2011) (the “Basel III Instructions”), section 1.

<sup>33</sup> See Basel Instructions, section 4.3 (Panel C13).

<sup>34</sup> 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”.<sup>35</sup> 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.<sup>36</sup> Others have more liberal rules.<sup>37</sup> 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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<sup>35</sup> See Basel Committee, Basel III definition of capital - Frequently asked questions (July 2011) (“July, 2011 FAQs”), question 17.

<sup>36</sup> 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.

<sup>37</sup> In the UK, DTAs are not subtracted from Tier 1 Common Equity. See General Prudential Sourcebook 1.39 and 2.2.156.

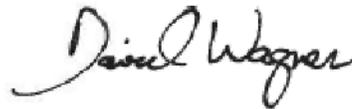
Mr. Arthur W. Lindo  
Mr. Charles Taylor  
Mr. George E. French

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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](mailto:david.wagner@theclearinghouse.org)) or Brett Waxman at (212) 612-9211 (email: [brett.waxman@theclearinghouse.org](mailto:brett.waxman@theclearinghouse.org)).

Sincerely yours,



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September 19, 2011

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