



DEFERRED TAX ASSET TREATMENT UNDER BASEL III

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In October 2013, the Federal Reserve published the final Basel III regulatory capital rules. This article will explain the impacts of Basel III on the net deferred tax asset ("DTA") for regulatory purposes.

The Basel III rules are effective January 1, 2015, with the exception of "advanced approach" banking organizations (those with assets greater than \$250 billion or foreign exposures greater than \$10 billion) for which the rules are effective January 1, 2014.

CURRENT RULES

Under the current rules, the net DTA is limited as follows:

- 1.) Assume all temporary differences reverse at the report date resulting in a net loss. Subtract from the net DTA (which may or may not include the tax effects of AOCI – the bank must follow a consistent approach each year) the taxes previously paid that the bank could recover through loss carrybacks. This net amount is the DTA dependent upon future taxable income.
- 2.) Determine the amount of DTA that could be realized over the next 12 months based on projected future taxable income. For this purpose, future taxable income

should not include utilization of carryforwards or reversal of temporary differences existing at the report date. It should include tax planning strategies expected to be implemented to utilize the DTA.

- 3.) Subtract the lower of the amount in item 2, or 10 percent of Tier 1 capital from the amount in item 1. This is the disallowed DTA, and Tier 1 Capital must be reduced accordingly.

BASEL III RULES

The DTA limitation under Basel III will be much more complex. The following is a summary of the calculation under the Basel III rules:

- 1.) From the net DTA, reverse DTAs and deferred tax liabilities ("DTLs") related to specific items that are adjusted out of Common Equity Tier 1 Capital ("CET1") net of tax, in order to avoid double-counting.
- 2.) A bank that makes the "opt out" election for AOCI must exclude the related DTA and/or DTL from the calculation.
- 3.) Segregate the remaining net DTA into 3 buckets:



- DTAs arising from net operating loss (“NOL”) and credit carryovers
- All other DTAs
- DTLs

4.) DTAs arising from NOLs and credit carryovers, and net of related valuation allowances, are deducted from CET1.

5.) Other DTAs that cannot be realized through hypothetical carryback, net of related valuation allowances and DTLs, and that exceed 10% of CET1 (computed immediately before this calculation), are deducted from CET1.

6.) DTAs (net of valuation allowances and DTLs), Mortgage Servicing Assets, and investments in other financial entities are added together and subject to a combined limitation of 15% of CET1.

7.) Capital reductions in items 4, 5, and 6 above will be reduced over the first 4 years. The percentage of capital deductions are as follows:

- 2014 – 20% (if advanced approach)
- 2015 – 40%
- 2016 – 60%
- 2017 – 80%
- 2018 – 100%

8.) DTAs offset by hypothetical carryback are subject to a 100% risk weighting.

9.) DTAs not offset by hypothetical carryback or reduced by items 4, 5, or 6 above are subject to a 250% risk weighting.

NETTING

1.) It is unclear when the netting of DTAs and DTLs should take place:

- Should the DTL netting take place before or after considering the hypothetical carryback?
- Should the DTL netting take place before or after the elimination of the DTA related to credits and NOLs?

2.) The netting question can be illustrated by the following example:

Assumptions:		
	Gross DTA - Temporary	2,000
	Gross DTL	(1,350)
	Gross DTA - Credit	500
	Net Overall DTA	1,150
	Carryback History	1,000

Note: the DTA reductions in this example are not adjusted by the phase-in percentages in item 7 above.

Basel III Netting Alternatives Schedule can be found on following page. Note that the capital reductions indicated in item 7 above are not considered.



Basel III Netting Alternatives:

Alternative 1: Carry Back Gross Temporary DTA, Then Allocate DTL Pro-Rata							
							Subject to 10% or 15% Limit
	Amounts	Carryback	Net	DTL Allocation	Reduce DTA RCR Line 8	RCR Line 15a	
Gross DTA - Temporary	2,000	(1,000)	1,000	(900)		100	
Gross DTL	(1,350)		(1,350)	1,350			
Gross DTA - Credit	500		500	(450)	50		
Net Overall DTA	1,150	(1,000)	150	-	50	100	

Alternative 2: Carry Back Gross Temporary DTA Net of DTL, Then Allocate DTL Pro-Rata							
							Subject to 10% or 15% Limit
	Amounts	Carryback	Net	DTL Allocation	Reduce DTA RCR Line 8	RCR Line 15a	
Gross DTA - Temporary	2,000	(650)	1,350	(985)		365	
Gross DTL	(1,350)		(1,350)	1,350			
Gross DTA - Credit	500		500	(365)	135		
Net Overall DTA	1,150	(650)	500	-	135	365	

Alternative 3: Allocate DTL Pro-Rata, Carry Back Gross DTA							
							Subject to 10% or 15% Limit
	Amounts	DTL Allocation	Net	Carryback	Reduce DTA RCR Line 8	RCR Line 15a	
Gross DTA - Temporary	2,000	(1,080)	920	(920)		-	
Gross DTL	(1,350)	1,350	-				
Gross DTA - Credit	500	(270)	230		230		
Net Overall DTA	1,150	-	1,150	(920)	230	-	

Alternative 4: Allocate DTL Against Gross DTA - Temporary, Carry Back Gross DTA							
							Subject to 10% or 15% Limit
	Amounts	DTL Allocation	Net	Carryback	Reduce DTA RCR Line 8	RCR Line 15a	
Gross DTA - Temporary	2,000	(1,350)	650	(650)		-	
Gross DTL	(1,350)	1,350	-				
Gross DTA - Credit	500	-	500		500		
Net Overall DTA	1,150	-	1,150	(650)	500	-	

A bank must net the DTLs against its DTAs in a consistent manner from reporting period to reporting period. A change in its manner of netting can be made only with prior written regulatory approval.

Under the current rules, in this example, the \$1,000 carryback history would be applied against the \$1,150 net DTA. The remaining

\$150 is allowed to the extent of one-year's future income.

For 2014, there is a new Part I.B, which uses the new rules and will be used by "advanced approach" banking organizations. Other banking organizations will use Part I.A, the current method, in 2014. In 2015, Part I.A will be eliminated.



The following is a detailed example of the regulatory capital calculation under Basel III. The alternatives indicated correspond to the alternatives above.

COMMON EQUITY TIER 1 CAPITAL EXAMPLE

Assumptions:		
Bank elects "Opt Out" for AOCI		
Total Capital per Books		10,000
AOCI net of tax		2,000
Goodwill Net of DTL		1,000
Intangible Assets Net of DTL		750
Mortgage Servicing Assets, net of DTL		1,500
Gross DTA - Temporary		2,000
Gross DTL not included above		(1,350)
Gross DTA - Credit		500
Net Overall DTA		1,150
Carryback History		1,000


RC-R							
Line		Alternative 1	Alternative 2	Alternative 3	Alternative 4		
1-5.	CET1 Before Adjustments	10,000	10,000	10,000	10,000		
6.	Less Net Goodwill	(1,000)	(1,000)	(1,000)	(1,000)		
7.	Less Net Intangible Assets	(750)	(750)	(750)	(750)		
8.							
	Less DTAs from NOLs and credit carryforwards	(50)	(135)	(230)	(500)		
9.	Less AOCI	(2,000)	(2,000)	(2,000)	(2,000)		
10.	Less Other Deductions	-	-	-	-		
11.	Less Non-significant investments in unconsolidated financial institutions	-	-	-	-		
12.	Subtotal	6,200	6,115	6,020	5,750		
13.	Less Significant investments in unconsolidated financial institutions in excess of 10% of line 12	-	-	-	-		
14.	Less Net MSAs in excess of 10% of line 12	(880)	(889)	(898)	(925)		
15.	Less Temporary DTAs Net of Temporary DTLs in excess of 10% of line 12	-	-	-	-		
	a. DTAs not realized through carryback	100	365	-	-		
	b. 10% of Line 12	620	612	602	575		
	c. Greater of a less b or zero	-	-	-	-		
16.	Less Significant investments in unconsolidated financial institutions, net MSAs, and Net Temporary DTAs in excess of 15% of line 12						
	a. Total Amounts	1,600	1,865	1,500	1,500		
	b. 15% of Line 12	930	917	903	863		
	c. Lines 13 through 15	880	889	898	925		
	d. Deduct c from a	720	977	602	575		
	e. Deduct b from d	-	(59)	-	-		
17.	Less Other Deductions	-	-	-	-		
18.	Total of lines 13-17	(880)	(948)	(898)	(925)		
19.	Common Equity Tier 1 Capital	5,320	5,167	5,122	4,825		

	Total significant investments in unconsolidated financial institutions, Net MSA, and Net DTA	2,650	2,650	2,650	2,650		
	Reductions to CET1	(930)	(1,083)	(1,128)	(1,425)		
	Carryback History	(1,000)	(650)	(920)	(650)		
	Net amount - 250% risk weight	720	917	602	575		



For a draft of the proposed changes to the Call Report Schedule RC-R, visit http://www.ffiec.gov/pdf/ffiec_forms/FFIEC031_20140304_f_draft.pdf. Schedule RC-R is on page 13.

For draft instructions for the new call report items, visit: http://www.ffiec.gov/pdf/ffiec_forms/FFIEC031_FFIEC041_20140110_draft_i.pdf. The RC-R instructions begin on page 14 of the PDF (page 12 of the instructions).

A large, faint, circular seal is centered in the background of the page. It features the text "100 YEARS" in the center, with "BUILT FOR" on the left and "UNPARALLELED GUIDANCE" on the right, separated by vertical lines. The seal has a textured, sunburst-like border.

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