Calculating the Tier One Capital Deferred Tax Disallowance Under Basel III

By Charles A. Laetsch, CPA, and Tiffany A. Richardson, CPA

The new Basel III capital rules that took effect this year for larger banks subject to the advanced approaches rule will kick in on Jan. 1, 2015, for all other banks subject to the standardized approach.[1] In addition to raising the minimum regulatory capital ratios and establishing new criteria for regulatory capital, the rules make significant changes to the treatment of deferred tax assets (DTAs). The first call reports that will require compliance with the Basel III rules will be on March 31, 2015. As a result, financial institutions should take steps now to determine how the limitations on DTAs will affect their capital ratios.

Current Rules

Under existing rules, the amount of net DTAs that can be counted in tier one capital is limited to the amount that could be realized upon carryback as well as the amount expected to be realized in the next 12 months. To determine the allowable net DTA, banks first assume that their DTAs and deferred tax liabilities (DTLs) will fully reverse as of the reporting date. If the institution is in a net DTA position, this would result in a net operating loss (NOL). Next, banks determine the amount of NOL that could be realized if carried back to the two most recent taxable years. This amount is allowable in tier one capital without limitation. Banks then calculate an estimated tax liability for the succeeding four quarters to determine the amount of NOL that could be realized. If a tax benefit can be realized over the next 12 months, the DTA recognized cannot exceed 10 percent of tier one capital. The remaining net DTA, not realizable through the previous steps, is disallowed and thereby deducted from tier one capital.

Basel III Rules

The new rules contain some similarities to the existing rules, such as placing no limitation on DTAs that can be realized through carryback. However, the new rules also contain significant differences that require a bank to segregate certain types of DTAs and apply rules for netting DTLs against DTAs.

New Disallowance Procedures

Under the final Basel III rules, banks should follow a different set of steps when calculating the disallowance:

1. Segregate DTAs into two buckets. The first bucket should consist of DTAs arising from temporary differences, such as allowance for loan losses and other real estate write-downs. The second bucket should consist of tax-attribute DTAs such as credit carryforwards and NOLs.
2. Determine the amount from the first bucket that could be realized through NOL carryback if all of those temporary differences were deemed to reverse. This amount is not required to be deducted from common equity tier one (CET1) capital and will be risk weighted at 100 percent.
3. Net DTLs against all remaining DTAs.[2] DTLs related to assets that are required to be deducted from CET1 capital (mortgage servicing rights, goodwill, and other intangible assets) can be removed from this analysis and netted with the related asset in other areas of the CET1 capital calculation. The remaining DTLs can be netted on a pro rata basis between the two buckets. If after netting the DTLs a net DTL results in the first bucket, it is not necessary to analyze further. If a net DTA remains in the first bucket, however, it is necessary to go to one more step, as described next.
4. The remaining net DTAs in the first bucket (DTAs related to temporary differences that cannot be realized through carryback, net of DTLs) will be subject to further limitation. The amount that individually exceeds 10 percent of CET1 capital or 15 percent of CET1 when aggregated with other limited items[3] must be deducted. Includable net DTAs arising from temporary differences are risk weighted at 100 percent during the transition period and 250 percent starting in 2018.
5. The net DTAs in bucket two (tax-attribute DTAs, net of DTLs) must be deducted from CET1 capital.

It's important to remember that carryback rules vary by jurisdiction. For federal purposes, a bank can carry back NOLs two years, but many states don't allow carrybacks. Moreover, the rules provide that banks must calculate DTAs and DTLs on a state-by-state basis rather than treating all states as a single pooled jurisdiction with a single net DTA or DTL. If a multistate bank has DTLs in one jurisdiction but not another, it cannot net DTLs in the first jurisdiction against DTAs in the other.

Some banks might be surprised to learn that the Basel III rules allow them to net DTLs against tax-attribute DTAs before deducting from CET1 capital. Depending on a financial institution's allocations of DTAs (bucket one or bucket two), the amount it must deduct from CET1 capital could be less than expected.

An Example (Amounts Shown in Thousands of Dollars)

	Net DTA at reporting date	Carryback capacity	Net DTA after carryback	DTL allocation	Net tax-attribute DTA deducted	Net temporary DTA subject to limitation
Temporary DTAs	440	200	240	(100)		140
Credit/NOL DTAs	960		960	(400)	560	
DTLs	(500)		(500)			
	900					

The Phase-In Question

Some uncertainty has lingered about whether the new deduction from total tier one capital of net tax-attribute DTAs would be phased in beginning in 2015 and ending in 2018. Basel III redefines tier one capital as two components: CET1 capital and additional tier one capital. The final rule makes clear that the impact on total tier one capital is immediate. The phase-in applies only to CET1 capital and only to the extent that the bank has sufficient additional tier one capital to absorb the remainder. The deduction of net tax-attribute DTAs from CET1 capital is phased in over a four-year period. However, in the event there is no additional tier one capital to cover the deduction, the total disallowance must be deducted from CET1 capital.

Act Now

Banks that wait until the first call report is due to apply the new process and determine their capital ratios could be in for a rude awakening. The better approach is to start thinking now about the new process and steps discussed earlier and evaluating the potential impact of the new Basel III requirements on your institution’s capital ratios.

Contact Information

Chuck Laetsch is a partner with Crowe Horwath LLP in the Fort Lauderdale, Fla., office. He can be reached at 954.202.8560 or chuck.laetsch@crowehorwath.com.

Tiffany Richardson is with Crowe in the Fort Lauderdale office. She can be reached 954.489.4757 or tiffany.richardson@crowehorwath.com.

[1] Generally, the advanced approaches rules apply to national banks and federal savings associations with $250 billion or more in consolidated assets or $10 billion or more in foreign exposure.

[2] With one exception, the netting of DTLs against assets subject to deduction from CET1 is permitted but not required. Once a method is chosen, a bank cannot change the method without approval from its primary federal regulator. AOCI items that are deducted from CET1 capital under Section 22(b) of the final rule are required to be deducted net of their associated deferred tax effects.

[3] This includes mortgage servicing assets and significant investments in the capital of unconsolidated financial institutions.

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