American Bankers Association
Building Success. Together.

Michael L. Gulllette
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202-663-4986

January 2, 2018

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

The Honorable Janet L. Yellen
Chair
Board of Governors of the Federal Reserve System
Eccles Board Building
20th and C Street, N.W.
Washington, D.C. 20219

Mr. Joseph Otting
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, S.W.
Washington, D.C. 20219

The Honorable Jay Clayton
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

RE: The Effects of Tax Reform on Accounting and Capital

Dear Chairman Gruenberg, Chair Yellen, Comptroller Otting, and Chairman Clayton,

The American Bankers Association[1] (ABA) appreciates the regulatory and supervisory role that the agencies assume, both individually and collectively, in ensuring the safety and soundness of individual banks and the banking industry as a whole. With that in mind, income tax reform, which has been proposed by leaders of both political parties for several years, was signed into law on December 22, 2017. The enacted changes will provide unique challenges to banks of all sizes in regards to managing the short and long-term impacts on business strategy, asset quality, earnings, and capital. It will challenge the investment community, which evaluates and forecasts bank performance, credit quality, and the ability to distribute dividends, and it will challenge your agency's ability to likewise evaluate not only a bank's financial condition, but also overall soundness, as indicated in the CAMELS ratings.

Tax Reform Affects Long Term Bank Management and Asset Quality

While the overall impacts will likely not be known for years, specific aspects of the law are likely to have profound effects on the industry. For example, limitations on the deductibility of interest will normally be expected to suppress loan demand and collateral values. On the other hand, lower corporate income tax rates are generally believed to encourage economic growth, which would be positive for both loan demand and the credit quality of the related borrowers. We believe that the banking industry, as a whole, will be stronger in the long-run due to tax reform. However, impacts to individual banks are

[1] The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.

largely unknown and little strategic assessment has likely been performed by most. In a time when banks are preparing to estimate credit losses under CECL based on forecasts of collateral prices and the economy in general, tax reform promises to put banks to the test. With this in mind, bank examiners will need to be flexible in their upcoming reviews of bank management and asset quality.

Tax Reform Affects Short Term Net Income, Regulatory Capital, and Capital Management

Despite what we see as significant net long-term gain for the industry (and for the U.S. economy as a whole), short-term pain will be experienced on bank financial statements as a result of tax reform, due to the requirement in generally accepted accounting principles (GAAP) to immediately[2] revalue deferred tax assets and liabilities (DTAs and DTLs) and other tax-sensitive assets. As banks of all sizes are generally in a net deferred tax asset position, this will normally result in significant downward adjustments to earnings and may even result in operating losses being reported during the fourth quarter call reports. For example, while we expect a relatively small number of banks to be in danger of "prompt corrective action" due to revaluing DTAs, we estimate that close to 600 banks will record adjustments to DTAs that effectively erase over 50% of their net income as of September 2017. We believe that the safety and soundness of the individual banks, and the industry as a whole, have not changed due to these downward adjustments.

Additionally, tax reform's impact on a bank's regulatory capital may, in the near-term, often be adverse, due to certain risk-weighting rules and limitations on DTAs, mortgage servicing assets, and other items. Due to the complexity of both the tax reform law and the regulatory capital rules, many institutions are currently challenged to estimate the ultimate impact of the law without significant detailed analysis. It is possible that dividend distributions, many approved prior to the signing of the new law, could exceed full year net income and even occur when losses are reported or overall regulatory capital levels have declined from the prior year. In a normal year, this might be subject to criticism during a bank examination. Tax reform is, thus, a unique event with capital planning challenges in both the long and the short terms. With that in mind, regulatory guidance is needed so that bankers have the confidence as to whether to proceed with dividend and capital management plans, including what analyses would be expected under these unusual circumstances and any transition periods in which regulatory capital levels would be expected to return to normal.

Unexpected Regulatory Capital Impact from Items in AOCI

Further complicating this is the FASB standard on accounting for income taxes that requires the related changes in DTAs and DTLs to be to be presented in net income from continuing operations, even when the corresponding deferred taxes relate to items presented in accumulated other comprehensive income (AOCI). As noted in the attached letter ABA sent to FASB, for banks under $250 billion in assets, the change in rates will have a regulatory capital impact where one would never be expected. The effect of adjustments in DTAs and DTLs from items such as unrealized capital gains/losses of available for sale

[2] GAAP requires the effects of a change in income tax rates to be recorded as of the date of enactment. Therefore, since the new law was enacted on December 22, it will be reported and reflected in the 2017 financial statements.

securities and pension adjustments can vary between banks and can both increase and decrease regulatory capital levels. We expect a relatively small number of institutions to be at risk of falling under levels that would require prompt corrective action and that many banks could actually increase regulatory capital levels as a result of the adjustment. However, the impacts, when combined with those above, could also be significant to net income, which many banks use as a basis for dividends.

Whatever the effect on regulatory capital on individual banks, the changes from AOCI-related DTAs/DTLs will be not only unplanned, but also burdensome from a reporting perspective (explaining to investors and board members) and a planning perspective (forecasting the ongoing impact as the related securities are paid down). As a result, both processes are challenging from an operational accounting perspective and we believe are the unnecessary result of an accounting standard that never foresaw the large regulatory capital implications. Considering bank examiners and auditors will need to be trained to evaluate bank accounting processes related to this unnecessary requirement, we urge you to consider contacting FASB to change this requirement for the year-end financial reporting season.[3]

Tax Reform Puts a Strain on Internal Controls over Financial Reporting

The implications of tax reform on net income and regulatory capital levels, given the short time that banks will have to digest the many aspects of the new law, creates a financial reporting environment where the difference between an accounting “change in estimate” and a “correction of an error” may be severely diminished. With this in mind, the timely issuance of guidance provided by the staff of the SEC Office of the Chief Accountant and Division of Corporation Finance (namely, Staff Accounting Bulletin No. 118 and Compliance and Disclosure Interpretation 110.02) is much appreciated and we believe they go a long way toward setting common expectations related to the necessary internal controls for SEC registrants and non-registrants alike. The banking industry is firmly committed to maintaining appropriate internal controls over financial reporting. However, some bankers foresee that increased audit emphasis over the past several years on attaining and assessing documentation over accounting estimates could potentially slow a company’s tax reform analysis to a crawl. There has been little substantive guidance, for example, provided by auditing firms related to expectations on the level of detail a company’s analysis of the new tax law must be in order for any subsequent adjustment to their estimate to avoid the status of correction and requiring restatement of financial statements.

It is foreseeable that the effects of tax reform could have many unintended consequences to many companies. With this in mind, the banking industry – indeed, companies in all industries – need guidance on the reporting and documentation expectations as they head into this financial reporting year-end. This guidance should not be limited to tax reform’s direct impact on DTAs and DTLs.

[3] This issue is not specific to the banking industry, but for any company with significant items in AOCI. Property/casualty insurance companies and life insurance companies, for example, will be subject to the same reporting burdens.

With all this in mind, we recommend that guidance be issued publicly to address the capital management and internal control documentation issues just noted. We believe coordinated efforts of the agencies with FASB and the PCAOB are necessary to convey expectations during this unique financial reporting season to avoid a flood of unnecessary restatements, criticized audits, and regulatory matters requiring attention.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) or Josh Stein (jstein@aba.com; 202-663-5318) if you would like to discuss this in more detail.

Sincerely,

Michael L. Gullette

American Bankers Association
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Michael L. Gulllette
Vice President – Accounting and Financial Management
202-663-4986

December 13, 2017

Russell G. Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Via email: director@fasb.org

RE: Accounting for the Income Tax Rate Changes of Tax Reform

Dear Chairman Golden:

The American Bankers Association[1] (ABA) wishes to express concerns regarding the accounting for changes to income tax rates within Accounting Standards Codification Topic 740, *Income Taxes* (ASC 740). Of course, this concern has arisen in light of the recent tax reform efforts in the U.S. and the likely occurrence that a material change in the U.S. Federal corporate income tax rate will result. While financial statement preparers in all industries will be challenged to account for a new tax law[2], we believe board members, investors, and regulators will be unnecessarily challenged by the accounting for items currently presented in accumulated other comprehensive income (AOCI).

Specifically, ASC 740-10-45-15 requires deferred tax assets (DTAs) and liabilities (DTLs) to be adjusted upon enactment of the new tax law and their changes to be presented in net income from continuing operations, even when the corresponding deferred taxes relate to items presented in AOCI. As a result, the remaining DTAs and DTLs within AOCI are nowhere near reflecting the appropriate tax rates of the corresponding items within AOCI. This will be confusing to financial statement users, particularly for the banking industry:

- First, adjustments recorded though net income often have different regulatory capital impacts than those recorded in AOCI. Regulatory capital in the banking industry often excludes amounts in AOCI and is normally the basis to determine capital available for dividends and other key items to investors.

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[2] Per ASC 740-10-25-47, the effect of changes in tax rates is recognized at the date of the enactment of the law. Further, ASC 740-10-30-9 notes that the adjustment of deferred tax assets and liabilities requires knowledge about when they will be realized. These requirements, which ABA does not question, present significant challenges to financial statement preparers, especially considering the possibility that decreases to corporate income tax rates occur in 2019, while other aspects of the bill are effective in 2018.

- On an ongoing basis, the inability to immediately release the residual DTA/DTL amounts caught in AOCI will require reconciliation and potentially burdensome tracking on the part of the preparer or the investor. This is especially true in accounting DTAs and DTLs related to the unrealized capital gains and losses of Available For Sale (AFS) debt securities.

To illustrate the issue, here is an example of the accounting entries under the current standard using unrealized gains on an AFS security:

Entry	Dr	Cr	AOCI[3]	Total Equity		Regulatory Capital[4]
To record an unrealized gain on an AFS security (35% tax rate):						
AFS Security	100					
Unrealized Gain/Loss		100	100	100		
Unrealized Gain/Loss	35		65	65		
Deferred Tax Liability		35				
To record the change in the tax rate (to 20% tax rate):						
Deferred Tax Liability	15					
Income Tax Expense		15		80		15

In this example, a gain of 15 has been recognized in current period net income for a security that has historically been and continues to be marked to fair value through OCI. This results in a mismatch (highlighted in yellow in the table above) between total equity and AOCI for the same security (65 vs 80). Institutions under $250 billion in assets exclude AOCI from regulatory capital and, therefore, this mismatch affects regulatory capital (highlighted in blue in the table above). We acknowledge that total equity is accurate. However, investors and bank board members analyzing and forecasting regulatory capital will observe that the effective tax rate for unrealized capital gains in AOCI (which remains at 35%) and that for those unrealized capital gains reported through net income are both individually misleading. Further analysis and disclosure that would be unnecessary if the impact was presented in OCI will be required.

Further, the difference will need to be tracked and will only release when the security is disposed. As principal on debt securities is paid down over time and the security is often subject to prepayment, forecasting and communicating the impact on an ongoing basis will be challenging. This appears to be an unintended consequence of the current standard, uncovered only by the potential magnitude of the current tax reform efforts.

[3] AOCI is generally excluded from regulatory capital for banks under $250 billion in assets.

[4] This example reflects the Common Equity Tier 1 regulatory capital impact for banks under $250 billion in assets.

Similar mismatches resulting from other items presented in AOCI include:

- Foreign currency translation adjustments
- Certain pension adjustments
- Gains/Losses on cash flow hedges
- Other-Than-Temporary Impairment related to Held-To-Maturity securities
- Credit risk portion of own debt using the Fair Value Option

As we noted, the timing of this tax reform will create considerable burden on preparers and investors to calculate and process the impacts. This requirement in the standard will significantly add to this burden and obfuscate the resulting financial statements. We believe a change is needed before this year-end reporting season gets underway.

ABA supports allowing an option to use "backwards tracing", a requirement in International Financial Reporting Standards, which would result in the related items to be reflected within OCI (and AOCI). This should enable most companies to apply the income tax rate change to their DTAs and DTLs without significant additional documentation.

There is a high level of detail needed to track the timing of recognition of specific DTAs and DTLs (whether in AOCI or not) caused by the change in income tax rates. Such work should not then result in confusion for investors. While we realize that time is not our friend given the calendar, we highlight the Board's ability to take swift action and correct the Other-Than-Temporary Impairment issue in less than a month back in 2009.[5] Therefore, we strongly urge you to make an immediate technical correction to mitigate this important issue.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) or Josh Stein (jstein@aba.com; 202-663-5318) if you would like to discuss this in more detail.

Sincerely,

Michael L. Gullette

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[5] The exposure draft for FASB Staff Position No. FAS 115-2 and FAS 124-2 was released on March 17, 2009 and a final standard was issued April 9, 2009.