American Bankers Association

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American Bankers Association
Preliminary Analysis Tax Reform Accounting and Capital Challenges

December 4, 2017

(NOTE: This analysis is based on ABA's understanding of each of the approved bills as of the date noted and can change significantly, based on specific terms within subsequent bills and the final law.)

1. Timing of Law: Immediate Impact to Capital
(Both House and Senate)

- Timing matters as to *when* the impact is recognized – The effects of the changes in tax rates and laws on deferred tax assets and liabilities are recognized in the period the law is enacted, even if substantially all the provisions are not effective until 2018 or 2019 (depending on the version). If signed in December, the law will have an immediate impact to 2017 earnings and capital (ASCs 740-10-35-4, 740-10-25-47, 740-10-45-15).
- Timing matters as to *the amount* of the impact – If there is a phased-in change in corporate tax rates (as in the Senate bill), the amount of change in deferred tax will vary, based on the specific year the items are settled and realized. For example, 2018 charge-offs related to credit loss allowances recorded in 2017 could apply a different tax rate, compared to comparable 2019 charge-offs (ASC 740-10-30-9).
- SEC registrants should refer to Form 8-K requirements, considering material impairment of assets, such as deferred tax assets and holdings in tax-advantaged investments.

2. Decreased Business Tax Rates: Deferred Tax Adjustments and Mortgage Servicing
(Both House and Senate)

- Immediate Impact: Income tax assets and liabilities (including deferred tax assets and liabilities) are immediately reduced to reflect the new rates.
    - Many banks have net deferred tax assets (DTAs). Required revaluation of DTAs decreases capital.
    - Banks with Mortgage Servicing Assets (MSAs) are currently able to offset related deferred tax liabilities (DTLs) against MSAs. A decrease in related DTLs may cause a bank to exceed the 10% (individual)/15% (combined) thresholds for inclusion in regulatory capital. The 250% risk weighting of additional net MSAs also decreases the capital of "advanced approach" banks (those with over $250B in assets) that are within the threshold amounts.[1]
- Immediate Impact: FASB requires the rate change to be recorded through earnings, even though the related DTAs/DTLs are not in capital (such as for those related to unrealized

[1]ABA expects that the currently outstanding regulatory "simplification" proposal that raises the threshold for inclusion of MSAs, DTAs, and certain investments to 25% for non-advance approach banks will, nevertheless, subject MSAs at these banks to 250% risk weighting at the time of final issuance.

gains/losses on AFS securities – ASC 740-10-45-15). The adjustment could provide for a surprise reduction in capital and be difficult to explain to investors on an ongoing basis. ABA has engaged FASB to evaluate this treatment. FASB appears willing to move quickly on making specific changes. However, the late timing of any signed law puts a timely change in doubt. ABA has notified the banking agencies about this and will be engaging them for any needed capital guidance if a timely FASB change is not possible.

3. Net Operating Loss Carrybacks are Eliminated: Capital Treatment of Deferred Taxes
(Both House and Senate)

- Immediate Impact: DTAs currently mitigated in capital calculations due to NOL carrybacks will increase from 100% to 250% risk weighting of capital for advanced approach banks. In addition, this change may cause any bank to exceed 10%/15% threshold limits (which is expected to increase to 25% for non-approach banks under the current regulatory "simplification" proposal – see footnote 1). This will decrease capital.

4. Interest Expense Deductibility Reduced for Both Businesses and Individuals
(Both House and Senate)

- Immediate Impact: Leveraged leases will need to be reevaluated, with cash flows reassessed (ASC 840-30-35-41). Banks with leasing company subsidiaries may impair their net investment balance. This would decrease capital and may lower future income.
- Immediate and Ongoing Impact: Banks will need to assess underwriting/risk ratings on new cash flow assumptions. Collateral values may decrease, due to reduced deductibility of interest.
- Temporary Ongoing Impact: Increased loan modification activity may occur in anticipation of enactment. This can accelerate recognition of loan fees, increasing capital (ASC 310-20-35-9).
- Ongoing Impact: This is likely to decrease loan demand over the longer term.

5. Tax Accounting: Front Loading of Taxes on Credit Card Fees
(Senate Only)

- Immediate Impact: For tax purposes, credit card fee income will be recognized based on timing of receipts. This increases current taxes paid, potentially decreasing capital due to a decrease in DTLs.
- Ongoing Timing: Front-loading taxes on credit card revenue may cause pricing issues going forward.

6. **International Taxation/Tax Credits: Base Erosion to Tax Regular Intra-Bank Activities**
(House and Senate)

- Ongoing Impact: "Base erosion minimum tax" will affect international banks, not only in payments to/from concerns, but also in potentially limiting the benefits of tax credits received for LIHTC, New Markets, and Historic investments.
- Ongoing Impact: There may be changes required or additional costs associated with existing business models and products. It may also affect tax credit markets, due to the Erosion formula.

7. Tax Credit Investments to be Limited, LIHTC Valuations may be impaired
(House: New Markets and Historic tax credits eliminated; Senate: Only certain Historic credits remain; plus Alternative Minimum Tax)

- Immediate Impact: Lower tax benefits could impair the valuations for certain banks, depending on accounting method used (ASC 323-10-35-32, ASC 323-740-35-6).
- Alternative Minimum Tax may diminish use of related tax credits.
- Ongoing Impact: Investments in affected investments will be limited.

8. **FDIC Premiums to be Non-Deductible**
(Both House and Senate)

- Ongoing Impact: Deduction for FDIC premiums is phased out for banks $10B to $50B in assets, with deductibility eliminated for those banks with over $50B.

9. Municipal Securities Income Tax Exemption to be Limited
(Private activity: only House; Advance refunding bonds: House and Senate)

- Immediate Impact: Due to decreased after-tax returns, overall market prices may decline. When held as securities, Other Than Temporary Impairment (OTTI) analysis for these and other municipal securities will likely be necessary. Any OTTI will decrease capital.
- Ongoing Impact: Reduced liquidity in market.