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Washington, DC 20036

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Robert R. Davis
Executive Vice President
Mortgage Markets,
Financial Management
& Public Policy
Tel: 202-663-5588
rdavis@aba.com

August 7, 2009

Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Honorable John C. Dugan
Office of the Comptroller of the Currency
Independence Square, 250 E Street, S.W.
Washington, DC 20219

Honorable John Bowman
Acting Director
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

The Honorable Elizabeth A. Duke
Governor
Board of Governors of the Federal Reserve System
20th and C Streets, NW, (Mail Stop 54)
Washington, DC 20551

RE: *Capital Adequacy Guidelines; Deduction of Goodwill Net of Associated
Deferred Tax Liability*

Dear Sirs/Madams:

This letter concerns the Agencies' final rule on the above-captioned issue published in the Federal Register on December 30, 2008. The American Bankers Association (ABA)¹ has identified a problem in the application of the rule, which stems from some confusion relating to the example provided in the proposed rule and language in the final rule. The lack of clarity in the application of the rule has resulted in taxpayers applying the rule differently. The difference in application varies from taxpayer to taxpayer depending on whether or not goodwill is impaired and also depending on a taxpayer's interpretation of the rule. We believe that it is not the intent of the Agencies to issue a rule that would yield this type of disparate treatment

¹ ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than \$125 million in assets – represent over 95 percent of the industry's \$13.6 trillion in assets and employ over 2 million men and women.

that is based on whether or not goodwill is impaired or how a taxpayer decides to interpret the rule. Thus, we respectfully request that the Agencies issue guidance that would clarify that the rule permits “***a banking organization to reduce the amount of goodwill it must deduct from tier 1 capital by the amount of any associated deferred tax liability, that is, the amount that reflects the banking organization’s maximum exposure to loss if such goodwill becomes impaired or derecognized under GAAP***”.

The Proposed Rule

On September 30, 2008, in response to industry requests that the Agencies address the issue of deducting goodwill net of tax from Tier 1 Capital, the Agencies published a notice of proposed rulemaking (NPR). The NPR stated that a banking organization is permitted “to reduce the amount of goodwill arising from a taxable business combination that it must deduct from tier 1 capital by the amount of any deferred tax liability associated with that goodwill.” The Agencies requested comment(s) on all aspects of the proposal. . We have determined that the example that was provided in the proposed rule to illustrate its application is one of the sources of the problem relating to the rule. Specifically, the example provides both the total deduction of goodwill from capital at the end of the first year (\$8,820) and the total deduction of goodwill from capital at the end of the 15-year amortization period (\$6,300). The ABA suggests that, rather than have the bank perform a year by year calculation as indicated in the example, the bank should calculate the total amount of the deduction for the amortization period and deduct such an amount from tier one capital. Thus, there would be no need for the first part of the calculation in the example. Based on this suggestion, a banking organization, regardless of whether or not its goodwill is impaired, would be able to deduct the entire amount of deferred tax liability associated with goodwill that must be deducted from Tier 1 capital in Year 1 (before the end of the 15-year amortization period), which will help boost the banking organization’s capital position.

The process of doing a year-by-year calculation is what yields the disparate results. A year-by-year calculation would allow a bank whose goodwill becomes impaired before the end of the 15-year amortization period to write off the entire amount of the goodwill and record a deferred tax asset (the full tax effect of the write off), which is includable in Tier 1 Capital, whereas, a bank whose goodwill is not impaired must wait until the end of the 15-year amortization period to receive the full value of the deferred tax liability associated with the goodwill.

The Problem

The different applications that depend on whether or not goodwill is impaired can best be explained using the following example:

- Bank A and Bank B each record goodwill of \$1,000,000 in separate but similar taxable business combinations.
- Assume a 40% tax rate.

- For each bank, at the end of the first year, the amount of goodwill deducted from Tier 1 Capital under the rule would be \$973,334 (the total goodwill less the deferred tax liability of \$26,666
 - The deferred tax liability resulting from the \$1,000,000 of goodwill is \$400,000 ($\$1,000,000 \times 40\%$). This amount is realized over 15 years. Thus, the annual deferred tax liability amount to be deducted from goodwill would be 26,666).
- At the end of the first year, Bank B's goodwill becomes impaired. Bank A's goodwill is not impaired.
- As a result of the impairment, Bank B is required to write off the entire amount of the goodwill (\$1,000,000) which was recorded through the income and expense statement. For book purposes, the write off results in the deferred tax liability of \$26,666 being reversed and a deferred tax asset of \$373,334 being recorded and included in Tier 1 Capital (assumes no valuation reserve under FASB #109).
- This results in Bank B obtaining a higher level of Tier 1 capital since its Tier 1 capital increased by \$400,000 (the \$26,666 recognized in Year 1 and the future tax benefits of \$373,334) as a result of the write-off of the \$1,000,000 in goodwill.
- Because Bank A's goodwill is not impaired, it gets the benefit of the \$26,666 deferred tax liability, but is not allowed to count the future tax benefits of \$373,334, and does not get the capital boost that Bank B gets.
- Therefore, the bank that experienced the impairment is in a favorable capital position as a result of the write-off.

The different applications of the rule that stem from different taxpayer interpretations of the rule is a result of some conflicting Agencies' comments that were included in the "Supplementary Information" section of the final rule published on December 30, 2009 in the Federal Register. While some of the comments provide a clear explanation of the Agencies' intent in the application of the rule, some did not. Specifically, the following two paragraphs have generated some confusion:

1. *One commenter disagreed with the calculation of the maximum capital reduction that could occur as a result of the impairment of goodwill in the NPR. This commenter asserted that the maximum capital reduction under GAAP should be equal to the carrying value of goodwill less the sum of tax benefits recognized as of the date of impairment and those tax benefits to be realized in future periods. The Agencies believe that current rules adequately address the treatment of deferred tax assets for regulatory capital purposes and that deferred tax assets that may be created for tax benefits to be realized in the future are beyond the scope of this NPR.*

This paragraph implies that a banking organization may only include in capital the tax benefits associated with goodwill that is recognized each year, and not the future tax benefits. If goodwill becomes impaired, the entity would only include in capital the tax benefits associated with goodwill as of the date of impairment and not those to be realized in the future. This suggests that the rule requires a year by year

calculation of the associated deferred tax liability that will reduce the amount of goodwill which is deducted from tier 1 capital.

Under this interpretation, in the example above, both Bank A and B would be permitted to include only \$26,666 in capital - the amount of the deferred tax assets that was created for the tax benefits recognized in year 1 relating to the goodwill. Bank A would not be permitted to include the future tax benefit of \$373,334 in capital.

2. *As several commenters stated, if goodwill becomes impaired or is derecognized under GAAP, a banking organization's maximum exposure to loss is equal to the carrying value of the goodwill less any associated deferred tax liability...[t]he **Agencies believe that it is appropriate to permit a banking organization to reduce the amount of goodwill it must deduct from tier 1 capital by the amount of any associated deferred tax liability, that is, the amount that reflects the banking organization's maximum exposure to loss if such goodwill becomes impaired or derecognized under GAAP.***” Emphasis added.

The underlined statement in this paragraph seems to suggest, and has been interpreted by some taxpayers to say, that a banking organization is permitted to include the entire associated deferred tax liability amount (\$400,000 in the example above) in capital up front, regardless of whether goodwill becomes impaired. This will result in the same treatment for all banking organizations without consideration of whether goodwill is impaired. Some taxpayers have also interpreted the statement to mean that only banking organizations that have impaired goodwill are permitted to include the entire associated deferred tax liability in capital. Under the former interpretation, the result in the example above would be incorrect – Bank A would not be in a better capital position because its goodwill becomes impaired. Rather, both Bank A and Bank B would receive the same level of capital boost – each would be permitted in year 1 to **reduce the amount of goodwill it must deduct from tier 1 capital by the amount of any associated deferred tax liability**, in this case, \$40,000, which is the amount that would be included in capital. Under the latter interpretation, the result in the example would be accurate. The two banks would be treated differently under the rule because of the existence of goodwill impairment.

We believe that the former interpretation is the correct one because it provides the same treatment for Bank A and Bank B – each bank would reduce goodwill that is deducted from Tier 1 Capital by the amount that “reflects the banking organizations’ maximum exposure to loss if such goodwill becomes impaired or derecognized under GAAP” – in this case, \$400,000. This interpretation can be applied quite simply by using our suggested approach, i.e., in Year 1, the banking organization deducts \$400,000 (entire amount of associated deferred tax liability) from goodwill (\$1,000,000), and the \$400,000 will be included in Tier 1 capital.

However, because of the example in the NPR which requires a year-by-year calculation of the associated deferred tax liability and the comment in the first

paragraph above, there is some confusion in both the interpretation and application of the rule, which creates varied results.

Recommendation

We believe that the Agencies did not intend that the rule be unclear or generate confusion within the industry. However, the lack of clarity and the application that seems to provide a more favorable result for taxpayers whose goodwill is impaired have created a need for guidance. Moreover, under the status quo, a taxpayer might be more inclined to determine goodwill to be impaired in order to obtain the more favorable application of the rule.

Our suggestion above would allow all banking organizations to apply the rule on a uniform basis – i.e., all banking organizations would be permitted to deduct from goodwill in Year 1 the total tax benefits to be realized over the 15-year period without regard to whether such goodwill becomes impaired at anytime during the 15-year period. This will bring conformity to the Tier 1 Capital calculation and remove the disparity that could be caused by some banks recognizing a goodwill impairment charge during the 15-year period. In other words, if the deferred tax benefit associated with the carrying value of goodwill is deducted from goodwill upfront, if a bank's goodwill becomes impaired subsequently, it will not yield a different or better result for such bank.

The ABA appreciates and commends your staffs on the excellent work that they have done so far on the issue. ABA supports the intent of the rule and your willingness to address this issue. Please contact Fran Mordi at 2020.663.5317 (fmordi@aba.com) or me at anytime if you would like us to answer any questions you may have or provide information or clarification relating to this issue.

Thank you

Sincerely,

A handwritten signature in black ink that reads "Robert R. Davis". The signature is written in a cursive, flowing style.

Robert R. Davis

cc: Charles Holm
Chief Accountant
Federal Reserve Board
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Norah M. Barger
Deputy Director
Federal Reserve Board
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Jeffrey Geer
Chief Accountant
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

Kevin J. Bailey
Deputy Comptroller, Capital and Regulatory Policy
Office of the Comptroller of the Currency
Independence Square, 250 E Street, S.W.
Washington, DC 20219

Robert F. Storch
Chief Accountant
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

George E. French
Special Adviser to the Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Mr. Amrit Sekhon
Director, Capital Policy
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219