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May 7, 2009

The Honorable John C. Dugan
Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable John Bowman
Acting Director
Office of Thrift Supervision
1700 G Street, NW
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

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

Re: Regulatory Capital Limits on Deferred Tax Assets

Ladies and Gentlemen:

We are writing to you about some concerns of the American Bankers Association (ABA) relating to the current regulatory capital rule that limits the amount of deferred tax assets (DTAs) that can count towards capital. The rule limits the amount of DTAs that a bank may include in Tier 1 Capital to the lesser of (i) 10 percent of Tier 1 Capital or (ii) the amount of DTAs that the bank expects to realize within one year of the calendar quarter-end date based on projections of future taxable income for that year ("look-forward period"). Our purpose in writing is to

request that you reexamine this rule and consider revising it to better reflect the amount of DTAs that will be realized and can be included in Tier 1 Capital.

In applying the current rule, banks and thrifts are generally not allowed to include in their capital calculations the DTAs resulting from book vs. tax income/expense recognition items that cannot be absorbed by a carry back to cash taxes paid in the prior two years or the estimated tax liability over the next twelve-month period from the date of the calculation. It is important to note that this limitation on DTAs exists irrespective of the limitation imposed on DTAs under Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. Therefore, a financial institution must project that it will earn profits within the next year to offset the DTAs in order to include the DTAs in its capital calculation.

Some financial institutions are feeling the negative impact of the current financial crisis, and thus, are generating more losses than income. Under the current loss carry back and carry forward rules, most banks are able to carry losses back only 2 years and forward 20 years.[1] In these times of lowered bank profitability, losses in the last few years have made it impossible for many banks to be able to carry back DTAs to prior tax periods; thus, many banks are in a loss carry forward position.

Some institutions are unable to project that they will generate income within a year under the current economic conditions. The result is that the one year carry forward period is unnecessarily limiting the amount of DTAs that are included in Tier 1 Capital. It is our understanding that the one year limitation was relatively arbitrary at the time it was put in place. Additionally, the limitations were established at a time when the concepts of SFAS 109 were entirely new and untested. Significant amounts of accounting experience have been gained since the issuance of SFAS 109, and the audit process has become significantly more stringent since inception. Thus, what may have seemed a conservative approach at the time of issuance is now outdated.

It should be noted that the accounting rules for recognizing deferred tax assets under SFAS 109 require reporting entities to assert that it is "more likely than not" the DTAs will be realized. The accounting rules take into account, among other factors, recent earnings history and the probability of future profits over a horizon of more than one year, including whether a carry forward period is so brief as to preclude the use of the loss. In the case of federal NOLs, the carry forward period is 20 years. If the "more likely than not" test is not met, a reserve must be posted in the form of a valuation allowance against the DTA. Because of the discipline surrounding the determination of the amount of the DTA that is realizable, the strict two-year back/one-year forward limitation does not seem justified.

We believe that the regulatory rules should be amended to eliminate the regulatory DTA limitations. This is because the years of experience with SFAS 109, the heightened level of controls, the heightened level of external audit attention, and the

[1] The American Recovery and Reinvestment Act of 2009 includes a provision that would allow loss carry back of 2008 loss for up to 5 years for "small businesses." The application of this provision generally excludes most banks.

refinements to the valuation allowance have led to improvements in these calculations. It is our understanding that some in the agencies are not willing to eliminate the book and regulatory differences, and, if that is the case, then we ask that the one year look forward rule be extended and the 10 percent limit be increased.

The fact that the tax law allows a 20 year carry forward (note that a 15 year carry forward period existed for NOL's for tax years beginning before August 6, 1997) for losses helps provide a reasonable basis for amending the one year look forward rule. For tax purposes, if an institution does not generate enough income within a year to absorb its losses, it has ample opportunity to absorb the losses with income generated for the next 19 years. A longer look forward period for regulatory purposes is complemented by the tax law that allows a 20-year loss carry forward period. It is reasonable to expect that the losses will be fully used at some point within the next 20 years for tax purposes.

Furthermore, we believe that the current capital rule places duplicative restrictions on the amount of DTAs that can be included in Tier 1 Capital. Under the rule, if a bank's DTAs are dependent on future income (e.g., can't be realized through carry back to taxes paid in prior years), then the amount that may be included in Tier 1 Capital is limited to what can be realized within a year. However, even if the entire DTAs can be realized within that year, the rule further restricts the amount of DTAs that can be included in Tier 1 Capital to 10%. Thus, the rule provides a limitation regardless of the ability to realize the DTAs.

Recommendation

We believe that the rule should be amended to allow a longer look forward period and an increased percentage limitation provision. Such changes would better reflect the amount of DTAs to be realized and, in the current economic environment, it could be helpful toward recovery in the markets, as it can help prevent some banks from shrinking their balance sheets (and, therefore, curtailing new lending). We recommend that the agencies consider increasing the amount of DTAs that a financial institution may count towards Tier 1 Capital by changing the look forward period from one to four years and increasing the 10% limitation to 25%.

Thank you for considering our request. Please contact Fran Mordi, ABA's Tax Counsel (202- 663-5317 or fmordi@aba.com), or me if you have any questions or would like to discuss this in greater detail.

Sincerely,

Robert R. Davis

Cc: Ms. Norah M. Barger
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Mr. Amrit Sekhon
Director, Capital Policy
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