or periods. For example, when a bank's tax deductions exceed its tax revenues, the result is a net operating loss. Such losses may be used to recover taxes paid in prior years (the carryback period) or may be carried forward to reduce a bank's taxable income in a future period. The situation is similar for some tax credits that a bank cannot use in the current tax period. The bank will realize the benefit of deferred tax assets arising from tax carryforwards if it generates sufficient taxable income in the permissible carryforward period.

Temporary differences arise when a bank records financial events or transactions in one period on the bank's books and recognizes them in another period, or periods, on its tax return. There are two types of temporary differences—deductible and taxable. Deductible temporary differences reduce a bank's future taxable income. When a bank records an addition to its allowance for loan and lease losses, it records that amount as an expense on its books. However, the bank may be unable to take the tax deductions for such losses until it charges off the loans and realizes the losses. The chargeoffs typically occur in subsequent periods. Thus, a bank creates a deferred tax asset when it adds an amount to the allowance on the books, but charges it off in a future period.

Taxable temporary differences produce additional taxable income in future periods. For example, a bank may depreciate its bank building using an accelerated depreciation method on its tax return but may use a straight-line method when recording depreciation on its books. As a result, the bank's tax depreciation will be less than its book depreciation in certain future periods. This taxable temporary difference will cause the bank to have higher taxable income in those future periods.

A bank may only realize deferred tax assets arising from deductible temporary differences by: (1) Recovering taxes paid in prior years, (2) offsetting taxable temporary differences, or (3) earning sufficient future taxable income. Consequently, if deferred tax assets arise from deductible temporary differences and exceed the amount of recoverable taxes paid in prior years plus offsetting taxable temporary differences, the bank will only realize such deferred tax assets if it generates sufficient taxable income in the carryforward period. Hereafter, these deferred tax assets, and deferred tax assets arising from tax carryforwards, will be called ''deferred tax assets that are dependent upon future taxable income.''

FAS 109 allows a bank to record deferred tax assets that are dependent upon future taxable income. However, the bank must establish a reserve to adjust the recorded deferred tax asset to the amount that it is more likely than not (i.e., likelihood of more than 50 percent) to realize. A bank assesses the probability of realization based on its prospects of earning taxable income in the future. The statutory carryforward period of 15 years provides a limit on the amount of the assessment.

Supervisory Concerns Regarding Deferred Tax Assets

Before adoption of FAS 109, regulatory policy generally limited the recognition of net deferred tax assets to the bank's potential tax carryback amount. In other words, a bank could only record an asset to the extent it potentially could file for a tax refund if all book and tax timing differences reversed at the report date.

Because FAS 109 allows a bank to record a greater amount of deferred tax assets than under previous policy, the OCC and the other banking agencies were concerned about the effect of the accounting standard on bank capital adequacy. Specifically, the OCC was concerned that FAS 109 would allow banks to include excessive amounts of deferred tax assets that are dependent upon future taxable income as part of regulatory capital.

Whether a bank can realize such assets depends on whether it generates enough taxable income during the carryforward period. As new products evolve and market conditions change, a bank's current financial condition and outlook for future income can change rapidly. Such changes make predicting future taxable income more difficult. For many banks, including sound and well-managed banks, the judgment about the likelihood that the bank will realize deferred tax assets that are dependent upon future taxable income is highly subjective. Inaccurate estimates could cause a bank to overstate its deferred tax assets and its capital position. Therefore, allowing banks to recognize significant amounts of assets based on subjective estimates could pose a risk to the deposit insurance funds.

Additionally, the OCC is concerned about the effect of these changes on a bank that is experiencing financial difficulty. Such banks often have net operating loss carryforwards. As a result, these troubled institutions potentially could record deferred tax assets under FAS 109, even though their realistic prospects for generating sufficient future taxable income are uncertain. As a troubled bank's condition deteriorates, it is less likely to realize the financial benefit of deferred tax assets that are dependent upon future taxable income. In such instances, FAS 109 generally requires the bank to reduce its recorded net deferred tax asset by increasing the asset's valuation allowance. The result is a charge to earnings that will reduce the bank's regulatory capital at precisely the time it needs capital the most.

To address these concerns, on August 3, 1992, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), the OCC, along with the other banking agencies requested public comment (57 FR 34135) on alternative approaches for the regulatory capital and reporting treatment of deferred tax assets. Based on the comments received, the FFIEC agreed to adopt FAS 109 for regulatory reporting effective January 1, 1993.

After discussing the comments and suggestions received, the OCC and the other banking agencies remained concerned about the impact of deferred tax assets that are dependent upon future taxable income on regulatory capital. The OCC believes that many financially sound banks will have net deferred tax assets arising from deductible temporary differences that exceed their taxable temporary differences and the bank's carryback potential. Since many of these deferred tax assets will be realized, the OCC agreed that banks should recognize some amount of these assets in regulatory capital. The OCC and the other banking agencies concluded they could adequately address their supervisory concerns by placing a limit on the amount of such assets that a bank could include in regulatory capital. This approach maintained consistency between generally accepted accounting principles (GAAP) and regulatory reporting.

Proposed Rule—In December 1993, the OCC issued a proposed rule to amend its capital adequacy rules with respect to deferred tax assets (58 FR 68065, December 23, 1993). The FRB (58 FR 8007, February 11, 1993), and the FDIC (58 FR 26701, May 5, 1993) published similar proposed rules.

The OCC proposed to limit the amount of deferred tax assets that are dependent upon future taxable income that a bank may include in regulatory capital to the lesser of:

(1) The amount of deferred tax assets expected to be realized within one year of the quarter-end report date, based on a bank's projection of future taxable income (exclusive of tax carryforwards and reversals of existing temporary differences) for that year, including the effect of tax-planning strategies