expected to be implemented during that year, or

(2) 10 percent of Tier 1 capital net of goodwill and other disallowed intangible assets.

Banks have been calculating and reporting the amount of "Deferred tax assets disallowed for regulatory capital purposes" in the Call Reports since March 31, 1993.

Comments Received on the Proposed Rule—The comment period for the OCC's proposed rule closed on January 24, 1994. The OCC received a total of 17 comments on the proposed rule. The commenters consisted of 13 banks, three trade groups, and one public accounting firm.

All but one commenter expressed opposition to some portion or all of the proposed rule. Eleven of the commenters indicated that a limit on the amount of deferred tax assets included in regulatory capital was unnecessary. However, six commenters agreed that some form of limit on deferred tax assets was appropriate.

The primary concern of the commenters is that the adoption of a deferred tax limit could increase regulatory burden because regulatory capital policy would be more restrictive than GAAP. Several commenters indicated that no limit on deferred tax assets is necessary because FAS 109 only permits the reporting of deferred tax assets that have a better than 50% probability of being realized. Other commenters indicated that the proposed one year limit was too restrictive because there is a 15-year carryforward period in which a bank could realize the deferred tax assets.

After carefully considering the comments, the OCC believes that a limit on deferred tax assets is necessary. Estimates of future taxable income are very subjective. If a bank does not realize these estimates, the bank insurance fund is exposed to losses because bank capital would be overstated. Moreover, unlike certain types of intangible assets that a bank can include in regulatory capital at a higher allowable percentage, a bank cannot sell deferred tax assets.

The GAAP standard allows a bank to record deferred tax assets that they may not realize for up to 15 years. The OCC believes that allowing deferred tax assets to constitute a significant portion of a bank's capital is inappropriate, since deferred tax assets may have only a slightly better than 50% possibility of realization. Furthermore, other than the likelihood of realization, there is no specific limit under GAAP on the amount of deferred tax assets that a bank can record. Without a limit on deferred tax assets, a bank could include significant amounts of deferred tax assets in capital.

In addition, the OCC believes that GAAP should guide rather than establish regulatory capital policy. When formulating GAAP, the accounting policy makers do not consider the safety and soundness objectives of the capital standards applicable to banks. Therefore, differences between the GAAP and regulatory capital definitions are justified.

Final Rule

The OCC believes that since banks can only realize deferred tax assets that are dependent upon future taxable income when they achieve positive taxable earnings, a limit based on estimated future earnings is rational. In general, a bank's projections up to 12 months into the future are reliable. However, the OCC believes the reliability of such projections decreases significantly for periods further in the future. Therefore, having a one year cutoff reduces the risk of a bank misstating its deferred tax assets because its estimate of future income is inaccurate. Furthermore, the one year cutoff increases the likelihood of a bank achieving the earnings required to realize the recorded deferred tax asset.

The OCC believes that this final rule will ensure that such deferred tax assets do not make up an unduly large portion of a bank's regulatory capital base. The upper limit of 10 percent of Tier 1 capital provides a "backstop" that addresses this concern. This requirement also reduces the risk that an overly optimistic estimate of future taxable income will cause the bank to significantly misstate the deferred tax asset.

The OCC believes that the combination of the one year future income approach and the 10% of Tier 1 capital approach will provide an effective and efficient limit on deferred tax assets. Consequently, under the final rule, the amount of deferred tax assets that are dependent upon future taxable income that a bank may include in its regulatory capital is limited to the lesser of:

(1) The amount of deferred tax assets the institution expects to realize within one year of the quarter-end report date, based on its projection of future taxable income (exclusive of tax carryforwards and reversal of existing temporary differences for that year), or

(2) 10 percent of Tier 1 capital, net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships, and before any disallowed deferred tax assets are deducted.

Banks should note that under this final rule there is no limit on deferred tax assets that a bank can realize from taxes paid in prior carryback years and from reversals of existing taxable temporary differences. In addition, to determine the limit on deferred tax assets, a bank should assume that all temporary differences fully reverse as of the report date. Also, estimates of future taxable income should include the effect of tax planning strategies the bank is planning to implement within one year of the quarter-end report date to realize net operating loss or tax credit carryforwards that will otherwise expire during the year. With respect to the Call Reports, banks will continue to report deferred tax assets according to GAAP.

The OCC believes that the limit on deferred tax assets will pose little or no additional burden on banks. Banks already follow FAS 109 for Call Report purposes and already are making projections of taxable income. Additionally, the OCC has revised the 10 percent Tier 1 capital calculation to be more straightforward and less burdensome. Under the proposed rule, the 10 percent of Tier 1 capital calculation is based on Tier 1 capital net of goodwill and other disallowed intangible assets. As proposed, the 10 percent of Tier 1 capital calculation would have required banks to first determine the amount of disallowed intangible assets. After consideration of this matter, the OCC believes that this additional computation is not necessary. Consequently, the final rule requires that the 10 percent of Tier 1 capital calculation be based on Tier 1 capital net of goodwill and all identifiable intangible assets other than purchased mortgage servicing rights and purchased credit card relationships, and before any disallowed deferred tax assets are deducted. While this calculation may result in a slightly higher Tier 1 capital base, the OCC believes that this calculation is simpler and imposes less burden on banks.

In response to the comments received, the OCC has decided to incorporate the following additional provisions to reduce the regulatory burden of this final rule.

Method of Estimating Future Income—In Banking Bulletin 93–15, Supplement 1 (BB 93–15), the OCC specified a method of estimating future taxable income. BB 93–15 provided a specific method for treating originating and reversing tax timing differences in the calculation of one year's future taxable income. Several commenters