Recent Accounting Issues - What is your bank worth?

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Discussion Topics

- Allowance for Loan and Lease Losses
- Troubled Debt Restructurings
- Transactions to Increase Capital
- FDIC Special Assessments
- Fair Value
- Other-than-temporary impairment
- FAS 166 and 167
- Deferred Income Taxes

Allowance for Loan and Lease Losses

Allowance for Loan and Lease Losses

- One of most significant accounting estimates for banks
- Maintain allowance for loan and lease losses (ALLL) at a level that is appropriate and determined in accordance with
  - GAAP (www.fasb.org)
    - FAS 114, Accounting by Creditors for Impairment of a Loan
    - FAS 5, Accounting for Contingencies
  - Bank's stated policies and procedures
  - Management's best judgment

Allowance for Loan and Lease Losses

- Relevant supervisory guidance (http://www.fdic.gov/regulations/laws/rules/5000-100.html; http://www.federalreserve.gov/boarddocs/srletters/)
  - 2006 Interagency Policy Statement on the ALLL
  - 2001 Interagency Policy Statement on ALLL Methodologies and Documentation
- Determination of appropriate level for the ALLL should be based on management's current judgments about loan credit quality, including consideration of all significant qualitative factors that affect collectibility

Allowance for Loan and Lease Losses

- Evaluate individual loans for impairment under FAS 114
  - Apply normal loan review procedures to identify loans for evaluation
  - Impairment represents a judgment about collectibility in accordance with loan terms, i.e., performance, not collateral
  - A real estate loan is not impaired solely because the fair value of the collateral is less than the loan's recorded investment

Allowance for Loan and Lease Losses

- An impaired real estate loan is not collateral dependent solely because the fair value of the collateral is less than loan's recorded investment
- An impaired loan is collateral dependent if repayment is expected to be provided solely by the underlying collateral
  - If there are other available and reliable sources of repayment besides the collateral, the loan is not collateral dependent
- Measure impairment on an individually impaired loan that is not collateral dependent based on present value of expected future cash flows discounted at loan's effective interest rate

Allowance for Loan and Lease Losses

- Agencies' policies require impairment of an individually impaired collateral dependent loan to be measured based on fair value of collateral (less costs to sell, if appropriate), even if foreclosure is not probable
  - Factors to consider when estimating fair value include, but are not limited to
    - Timing and reliability of appraisal or other valuation
    - Timing of most recent inspection of collateral
    - Historical losses on similar loans
  - Bank's estimate of fair value (less costs to sell) is subject to examiner review

Allowance for Loan and Lease Losses

- For all loans, other than individually evaluated and impaired loans, provide for estimated credit losses on groups of loans with similar risk characteristics by measuring the associated ALLL under FAS 5
  - Determine appropriate historical loss rate for each loan group
    - During periods of significant economic expansion or contraction, relevance of data that are several years old may be limited
    - Period used should be long enough to capture sufficient loss data

Allowance for Loan and Lease Losses

  - Consider current qualitative factors that are likely to cause estimated credit losses as of the evaluation date to differ from the group's historical loss experience
  - Banks typically reflect overall effect of relevant qualitative factors on a loan group as an adjustment to the group's historical loss rate

Allowance for Loan and Lease Losses

- Changes in an institution's ALLL level should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses, considering characteristics of portfolio
  - If declining credit quality trends relevant to an institution's portfolio are evident, the ALLL level as a percentage of loans should generally increase
  - If improving credit quality trends are evident, the ALLL level as a percentage of loans should generally decrease

Troubled Debt Restructurings

Troubled Debt Restructurings

- Applicable Accounting Standards
  - FAS 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings
  - FAS 114, Accounting by Creditors for Impairment of a Loan
  - EITF 02-4, Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15

Troubled Debt Restructurings

- Center for Audit Quality White Paper, Application of Statement 114 to Modifications of Residential Mortgage Loans that Qualify as Troubled Debt Restructurings
  - Issued December 2008
  - http://thecaq.org/newsroom/pdfs/FAS114_LoanModifications.pdf

Troubled Debt Restructurings

- A restructuring constitutes a “troubled debt restructuring” if the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would not otherwise consider
- A troubled debt restructuring may include
  - A transfer from the debtor to the creditor (including via foreclosure or repossession) of real estate or other assets,
  - A modification of the loan terms, or
  - A combination of the above

Troubled Debt Restructurings

- A modification of terms includes
  - Reduction of the contractual (stated) interest rate
  - Extension of the maturity date at a contractual interest rate lower than the current rate for new debt with similar risk
  - Reduction of the face amount of debt, i.e., forgiveness of a portion of principal
  - Reduction (forgiveness) of accrued interest

Troubled Debt Restructurings

- Not all modifications of terms are troubled debt restructurings
  - Is the debtor experiencing financial difficulty?
  - Has the creditor granted a concession?
- Even if a loan is current, a modification of terms would be a troubled debt restructuring if the preceding conditions are met

Troubled Debt Restructurings

- Creditor's accounting for a troubled debt restructuring involving a modification of terms on a loan held for investment
  - Loan is considered impaired and FAS 114 must be applied
  - Impairment (i.e., the FAS 114 allowance) on a loan modified in a troubled debt restructuring should normally be measured based on present value of expected future cash flows discounted at loan's original effective interest rate
  - Original effective interest rate is not the rate specified in the restructuring agreement or the original loan's starter, introductory, or teaser rate

Troubled Debt Restructurings

- Receipt of assets in full or partial satisfaction of a loan is a troubled debt restructuring
  - Assets received must be recorded at fair value
  - Example: Construction loan for a residential subdivision is troubled, so bank agrees to provide financing with more favorable than market terms to home purchasers to assist developer in selling homes
    - Record mortgage to a home purchaser, and credit construction loan, for the fair value of the mortgage
    - Mortgage will likely be booked at a discount

Transactions to Increase Capital

Transactions to Increase Capital

- EITF Issue No. 85-1, Classifying Notes Received for Capital Stock
  - http://www.fasb.org/pdf/abs85-1.pdf
  - Addresses whether an entity that receives a note, rather than cash, as a contribution to its equity capital should report the note receivable as a reduction of equity capital or as an asset
  - Transaction may be structured as a sale of capital stock or as contribution to paid-in capital (surplus)

Transactions to Increase Capital

- The SEC requires public companies to report notes received in payment for the company's stock as a deduction from stockholders' equity (i.e., netted against equity) unless such notes are collected in cash prior to issuance of the financial statements
  - If collected in cash prior to issuance, note may be reported as an asset
- Banking agencies have expected institutions to follow this SEC guidance
  - To reflect increase in capital at period-end, note should be collected in cash before Call Report is filed or by Call Report filing deadline, whichever is earlier

Transactions to Increase Capital

- For a note received as a contribution to equity capital to be reported in the Call Report, the note must meet the definition of an asset at period-end by satisfying the following criteria:
  - Written documentation shows that the note was contributed prior to period-end by those with the authority to make the capital contribution
  - The note represents a legally binding obligation to pay a specified amount by a specified date
  - The note is executed and enforceable prior to period-end

Transactions to Increase Capital

  - A holding company's general commitment or capital maintenance agreement to maintain a subsidiary institution's capital at a particular level is not in and of itself evidence of the existence of a note receivable at period-end
- If cash is received for a capital contribution after period-end, but a note receivable for the contribution did not exist at period-end, it would be inappropriate to report an increase in capital at period-end
  - Report increase in capital in period cash received

Transactions to Increase Capital

- Sales to insiders and related parties of problem loans
  - If loans held-for-investment are sold at "book value" or their face amount, but fair value of loans is a lower amount, bank must recognize a credit loss on the loans when the decision to sell is made
  - Credit loss is amount by which recorded investment in loans exceeds their fair value, which must be recognized as a charge-off against the loan loss allowance

Transactions to Increase Capital

  - Amount by which sales price of loans exceeds their fair value represents a capital contribution (typically a credit to surplus)
- Sales to insiders and related parties of charged-off loans
  - If charged-off loans are sold for their unpaid principal balance, amount by which sales price exceeds fair value represents a capital contribution, not a recovery to be credited to the ALLL

FDIC Special Assessment

FDIC Special Assessment

- FDIC Board adopted special assessment final rule on May 22, 2009
  - Amount is 5 basis points times institution's total assets minus Tier 1 capital as of June 30, 2009
  - Capped at 10 basis points times institution's domestic deposits as of June 30, 2009
  - Assessment payable on September 30, 2009
  - Accrue liability (accrued expense payable) and estimated loss (other noninterest expense) from this loss contingency in quarter ending June 30, 2009
  - http://www.fdic.gov/news/news/financial/2009/fil09023.html

Fair Value

FSP FAS 157-4

- Issued to provide further guidance on determining fair value in inactive markets
- Responsive to one of the recommendations in the SEC's MTM study
- The objective of fair value remains the same
- Fair value measurements require judgment, especially when market activity has significantly declined

FSP FAS 157-4

- Factors to help determine whether a decrease in volume and level of activity indicates that a market is inactive include:
  - Few recent transactions
  - Stale prices
  - Prices vary substantially over time or among market makers
  - Significant increase in implied liquidity risk premiums, yields, or performance indicators for prices
  - Wide or significant increase in the bid-ask spread
  - Significant decline or absence of a market for new issuances
  - Little information is released publicly (e.g., principle-to-principal market)

FSP FAS 157-4

- Transaction price/quote weight of evidence
  - Non-orderly transaction – little weight, if any
  - Orderly transaction – consider the transaction, weigh based on facts and circumstances, comparability, recency
  - Insufficient data to conclude whether orderly or not – consider the transaction, weigh based on facts and circumstances, transaction price may not be the primary basis of the valuation or market risk premium

FSP FAS 157-4

- If a transaction in an inactive market is not considered to be orderly
  - Significant adjustments may be needed
  - Valuation technique(s) may need to be changed
- Regardless of the valuation technique(s) used, the use of appropriate risk adjustments is required
- Effective for 2Q09 reporting, early adoption for 1Q09 reporting was permitted (provided the OTTI FSP was also early-adopted)

FSP FAS 157-4 Potential Impact

- Less reliance on the last transaction price for asset valuations in inactive markets which may result in
  - Higher valuations for certain valuations of financial instruments
  - Smaller impairments and, therefore, smaller OTTI write-downs based on the higher valuations
- Possible increased use of cash flow modeling for valuations
- Possible increase in "Level 3" valuations

Other-than-temporary Impairment

FSP FAS 115-2 & FAS 124-2

- Issued to make OTTI guidance for debt securities more operational
- Issued to improve the presentation and disclosure of OTTI in the financial statements
- Does not change the requirement to determine that an OTTI exists if management does not expect to recover the security's entire cost basis
- Does change the presentation of OTTI in the financial statements for certain securities under certain conditions

FSP FAS 115-2 & FAS 124-2

- Includes factors to consider in determining recoverability of a security's cost basis and the recovery period include:
  - Length and severity of the decline in fair value
  - Adverse change in the credit quality of the security, industry, or geographic area
  - Historical and implied volatility of the fair value of the security
  - Payment structure of the debt security and likelihood of the issuer being able to make payments that increase in the future
  - Failure of the issuer to make scheduled interest or principal payments
  - Any changes to security's rating by a rating agency
  - Recoveries or additional declines in fair value subsequent to the balance sheet date

FSP FAS 115-2 & FAS 124-2

- When management has an intent to sell or it is more likely than not it will be required to sell
  - The full OTTI amount is recorded in earnings
- When management has no intent to sell and it is more likely than not that it won't be required to sell, the presentation of the OTTI in the financial statement changes
  - Credit-related OTTI is recorded in earnings
  - Noncredit- related OTTI is recorded in other comprehensive income

FSP FAS 115-2 & FAS 124-2

- Determinations of credit-related loss
  - Based on institution management's best estimate of the amount of OTTI that relates to a decrease in cash flows expected to be collected from the debt security
  - One way of estimating the credit loss portion of an OTTI would be to consider the FAS 114 methodology of measuring impairment based on the present value of expected future cash flows

FSP FAS 115-2 & FAS 124-2

Disclosure requirements

- Expands and increases the frequency of certain existing disclosures
- Creates new disclosures of significant inputs used in determining a decrease in expected cash flows and a rollfoward of that amount each period

FSP FAS 115-2 & FAS 124-2

- Effective for 2Q09 reporting, early adoption for 1Q09 reporting was permitted (provided the Fair Value FSP was also early-adopted)
- True-up (cumulative effect) adjustment
  - Required to reclassify the noncredit component of a previously recognized OTTI from retained earnings to accumulated OCI if the institution does not have the intent to sell and it is more likely than not that it will not be required to sell before recovery

FSP FAS 115-2 & FAS 124-2 Potential Impact

- The amount of future impairment write-downs may be substantially reduced, improving earnings and regulatory capital
- The "one-time" true-up adjustment for previously recognized non-credit related OTTI may also significantly improve regulatory capital
- Potential increased use of cash flow modeling for valuations

Off Balance Sheet

FAS 166 Amending FAS 140
and
FAS 167 Amending FIN 46(R)

FAS 166
Transfers of Financial Assets

- Asset transfers can be sales or secured borrowings
  - Sales can achieve off-balance sheet treatment while borrowings are on-balance sheet
- The accounting principle for distinguishing sales from borrowings is control
- In general, a company that controls an asset should record the asset on its books
  - To get off-balance sheet treatment, must demonstrate that control has been transferred

Sale Accounting

- GAAP currently requires the following "FAS 140 Paragraph 9 conditions" to be met to record a transfer as a sale by demonstrating release of control
  - Assets must be isolated from the transferor – even in bankruptcy or other receivership
  - Investors must have the right to pledge or exchange investments received
  - Transferor must not maintain control over the assets through a call option or its equivalent
- Currently, second condition often is met using QSPE
  - This is especially true for securitizations
- FAS 166 eliminates the notion of a QSPE but permits looking through entities whose sole purpose is to engage in securitization or asset-backed financing activities

Key Differences between FAS 166 and FAS 140

- Demonstrating isolation (first condition prior slide)
  - Legal true sale and nonconsolidation opinions are basis for demonstrating isolation but may not be required if reasonable basis exists to conclude that they would be granted if requested
- Loan Participations
  - Can achieve partial sale accounting only if:
    - Each interest represents a pro rata ownership share
    - All cash flows are divided proportionately
    - All participants have same priority (i.e., no subordination)
  - LIFO participations do not qualify
  - Government guaranteed participations can qualify

Sale Transaction

- If release of control demonstrated, sale accounting:
  - Treat the assets securitized as if they have been sold
    - Remove assets from the Balance Sheet
    - Record cash received as proceeds
    - Record servicing asset or liability if retained
    - Record liability for any recourse provided for losses
    - Record I/O strip and other credit enhancers

Secured Borrowing Transaction

- If release of control not demonstrated, secured borrowing:
  - Leave the assets on the Balance Sheet
  - Record the borrowing transaction
    - Record cash received as borrowed money
    - Record payable to counterparty (i.e., securitization trust)

FAS 167

Consolidation of Special Purpose Entities

- Focus on Structure
  - Achieving a true sale under FAS 166 is useless if the transferor must consolidate the transferee
  - Elimination of intercompany transactions would bring assets back onto the balance sheet and eliminate gain on sale
  - Now we focus on other off-balance sheet structures (SPE)
- Accounting concern is to ensure that consolidation occurs where appropriate
  - Recall Enron – liabilities hidden in off-balance sheet SPEs
  - Banks often are affiliated with off-Balance Sheet SPEs of a different type – to remove assets from the balance sheet
    - Securitization trusts are an example

Special Purpose Entities

- Technical term is "Variable Interest Entity" (VIE)
    - The equity at risk is insufficient to finance activities
    - The equity investors lack power over the entity and/or do not absorb gains and losses produced by the entity
    - The equity investors have voting rights out of proportion with their economic interests
- Is the interest holder a Primary Beneficiary (PB)?
  - FIN 46(R) – Absorbs a majority of the expected losses or receives a majority of the expected residual returns
  - FAS 167 – **Power** to direct activities and the obligation to absorb losses/receive **benefits** of the entity

Examples of VIEs

- SPEs established to hold real estate or delinquent loans for banks
- Trust Preferred Security and Tender Option Bond trusts
- Asset-Backed Commercial Paper Conduits
- Structured Investment Vehicles
- CDOs and CLOs
- Almost any SPE that is not a QSPE

A Look Ahead

- High Risk of Consolidation
  - Revolving Securitization Structures (credit cards)
    - Ability to move accounts into and out of securitization trust and retention of subordinated position demonstrates **Power** and **Benefits**
  - ABCP Conduits
    - Ability to manage conduit's assets demonstrates **Power** and fees combined with ability to determine use of liquidity facilities demonstrate **Benefits**
- Moderate Risk – Almost any transaction in which the transferor retains servicing and provides credit or liquidity commitments

A Look Ahead

- Implementation date for FAS 166 and FAS 167 is 1/1/10 for calendar-year companies
  - More robust disclosures were required for public companies at year-end 2008 and will be required for all upon implementation
- Capital policy teams reviewing treatment
  - All agencies have teams dedicated to the effort of determining whether regulatory capital guidelines should be modified in response to accounting changes
  - Federal Reserve advised banks to perform capital planning assuming no change in regulatory capital rules

Deferred Income Taxes

Deferred Income Taxes

- Principal GAAP guidance is FASB Statement No. 109, *Accounting for Income Taxes*
  - http://www.fasb.org/pdf/aop_FAS109.pdf
- Call Report Glossary – Income Taxes
  - http://www.fdic.gov/regulations/resources/call/crinst/2009-03/309GLOSS%20033109.pdf

Deferred Income Taxes

- Temporary differences arise when events are recognized in one period on a bank's books but are recognized in another period on its tax return
  - In general, amount of temporary difference is a book-tax balance sheet difference
  - Results in reporting of income or expense in different periods in income statement and tax returns

Deferred Income Taxes

- **Temporary Differences** –
  - **Deductible temporary differences** reduce taxable income in future periods and create deferred tax assets
    - Example - the provision for loan and lease losses is expensed for financial reporting purposes in one period but losses may not be deducted for tax purposes until the loans are actually charged off, which may be in a subsequent period
  - Net operating loss carryforwards also create deferred tax assets
  - **Taxable temporary differences** result in additional taxable income in future periods and create deferred tax liabilities
    - Example – accelerated depreciation for tax purposes, straight line depreciation for book purposes

Deferred Income Taxes

- Calculate deferred tax assets and liabilities by multiplying applicable tax rate times amount of the temporary difference or carryforward
- The realizability of all deferred tax assets must be evaluated each period
  - Per FAS 109, a valuation allowance must be recorded, if needed, to reduce deferred tax assets to an amount that is more likely than not (greater than 50% likelihood) to be realized

Deferred Income Taxes

- Consider all available evidence, both positive and negative, in assessing the need for a valuation allowance
  - Realization of deferred tax assets depends on the existence of sufficient taxable income of the appropriate character in either the carryback or carryforward period
- On the balance sheet, report net amount of deferred tax assets (less any valuation allowance) and deferred tax liabilities separately for each tax jurisdiction (e.g., federal, state, and local)

Deferred Tax Assets

- Regulatory capital standards limit the amount of deferred tax assets that can be included in Tier 1 capital
  - Limit applies to deferred tax assets that are dependent on future taxable income:
    - Deferred tax assets arising from deductible temporary differences that exceed taxes previously paid that could be recovered through loss carrybacks if all temporary differences (both deductible and taxable) fully reverse at the report date
    - Deferred tax assets arising from operating loss and tax credit carryforwards

Deferred Tax Assets

- Determination of deferred tax assets "dependent on future taxable income"
  - May exclude deferred tax effects of unrealized holding gains and losses on available-for-sale debt securities
    - If excluded, follow this treatment consistently
  - For a bank subsidiary of a holding company, if parent does not have the financial capability to reimburse the bank for the tax benefit of the bank's carryback of net operating losses or tax credits, the bank should limit the carryback potential available for realization of its deferred tax assets to the amount which the bank could reasonably expect to have refunded by its parent

Deferred Tax Assets

- Deduct from Tier 1 capital the amount by which deferred tax assets dependent on future taxable income exceed the lesser of
  - Amount of deferred tax assets the bank expects to realize within one year based on projected future taxable income or
  - 10% of the bank's Tier 1 capital before deducting certain disallowed assets
- "Projected future taxable income"
  - Should not include net operating loss carryforwards to be used within one year or existing temporary differences expected to reverse within one year
  - May include estimated effect of tax planning strategies that are expected to be implemented to realize tax carryforwards that will otherwise expire during that year

Deferred Tax Assets

- Bank should calculate one overall limit on deferred tax assets that covers all tax jurisdictions rather than a separate limit for each tax jurisdiction
- See Call Report Schedule RC-R, item 9.b
  - Disallowed Deferred Tax Assets

Deferred Tax Assets

- For certain assets deducted from Tier 1 capital, deduction may be made net of associated deferred tax liability
  - Disallowed mortgage and nonmortgage servicing assets
  - Intangible assets acquired in nontaxable business combinations
  - Goodwill acquired in taxable business combinations
  - Disallowed credit-enhancing interest-only strips
  - Deducted nonfinancial equity investments
- Any deferred tax liability netted in this manner cannot also be netted against deferred tax assets when determining the amount of deferred tax assets dependent upon future taxable income and the disallowed amount of deferred tax assets, if any, for regulatory capital purposes

Disallowed Deferred Tax Assets Calculation

(a) Enter the amount from Schedule RC-R, item 8 ________

(b) Enter 10% of the amount in (a) above ________

(c) Enter the amount of deferred tax assets reported in Schedule RC-F, item 2 ________

(d) Enter the amount of taxes previously paid that the bank could recover through loss carrybacks if the bank's temporary differences (both deductible and taxable) fully reverse at the report date ________

(e) Amount of deferred tax assets that is dependent upon future taxable income: subtract (d) from (c); enter 0 if the result is a negative amount ________

(f) Enter the portion of (e) that the bank could realize within the next 12 months based on its projected future taxable income. (Future taxable income should not include net operating loss carryforwards to be used during the next 12 months or existing temporary differences that are expected to reverse over the next 12 months.) ________

(g) Enter the lesser of (b) and (f) ________

(h) Disallowed net deferred tax assets - subtract (g) from (e); enter 0 if the result is a negative amount ________

Deferred Tax Assets

- Deferred tax assets dependent upon future taxable income
  - Example:

    As of June 30, 2009:

    Estimated tax payments paid for 2009 = $10

    Taxes paid for 2008 = $40

    Taxes paid for 2007 = $30

    Total taxes paid that could be recovered = $80
  - If net deferred tax assets (Schedule RC-F, item 2) ≤ $80, then deferred tax assets dependent upon future taxable income = 0
  - If net deferred tax assets (Schedule RC-F, item 2) > $80, then deferred tax assets dependent upon future taxable income = Schedule RC-F, item 2, minus $80

Deferred Tax Assets

- In contrast, if bank is in a net operating loss carryforward position
  - Bank has no carryback potential, i.e., there are no taxes previously paid that are recoverable
  - Entire amount of deferred tax assets is dependent upon future taxable income
  - Exception: Bank has made estimated tax payments for the current year, which are recoverable

Deferred Tax Assets

- Deferred tax assets related to available-for-sale (AFS) debt securities
  - Net unrealized holding gains and losses on AFS debt securities
    - Reported in "accumulated other comprehensive income" component of equity capital
    - Excluded from regulatory capital
  - For deferred tax asset limitation purposes, a bank may, but is not required, to adjust its deferred tax assets for any deferred tax assets and liabilities related to AFS securities
    - Bank must consistently follow its chosen approach

Deferred Tax Assets

- Deferred tax assets related to available-for-sale (AFS) debt securities
  - Example 1:

Amortized cost of AFS debt securities	1,000
Fair value of AFS debt securities	880
Net unrealized loss on AFS securities	120*
Applicable tax rate (30%)	36**
Net unrealized loss, net of tax effect	84#

* Deductible temporary difference

** Deferred tax asset (assume no valuation allowance)

\# Amount included in AOCI

Deferred Tax Assets

- Example 1 (continued)
- Assume net deferred tax assets on balance sheet include the following components:

DTA – AFS debt securities	36
DTA – Other deductible temporary differences	124
DTL – All taxable temporary differences	(35)
Net deferred tax assets (Schedule RC-F, item 2)	125

If bank chooses to exclude the deferred tax effect of its net unrealized loss on AFS debt securities, the adjusted amount of deferred taxes to be reported on line (c) in the deferred tax assets calculation worksheet (slide 65) = 125 - 36 = 89

Deferred Tax Assets

- Deferred tax assets related to available-for-sale (AFS) debt securities
  - Example 2:

Fair value of AFS debt securities	1,080
Amortized cost of AFS debt securities	1,000
Net unrealized gain on AFS securities	80*
Applicable tax rate (30%)	24**
Net unrealized gain, net of tax effect	56#

* Taxable temporary difference

** Deferred tax liability

Amount included in AOCI

Deferred Tax Assets

- Example 2 (continued)
- Assume net deferred tax assets on balance sheet include the following components:

DTA – All deductible temporary differences	184
DTL – AFS debt securities	(24)
DTL – Other taxable temporary differences	(35)
Net deferred tax assets (Schedule RC-F, item 2)	125

If bank chooses to exclude the deferred tax effect of its net unrealized gain on AFS debt securities, the adjusted amount of deferred taxes to be reported on line (c) in the deferred tax assets calculation worksheet (slide 65) = 125 – (24) = 149

Deferred Tax Assets

- Assets deducted from regulatory capital net of associated deferred tax liability
  - Example – Goodwill acquired in a taxable purchase business combination
    - For financial reporting purposes, goodwill is not amortized, but must be tested for impairment at least annually
    - For tax purposes, goodwill is amortized on a straight-line basis over 15 years
    - Assume $300 in goodwill was recorded in a taxable purchase business four years ago
    - Goodwill on books remains $300 (no impairment has been recognized)

Deferred Tax Assets

- For taxes, goodwill has been amortized $20 per year for four years – goodwill on tax balance sheet is $220
- Taxable temporary difference for goodwill:
- Book balance sheet $300
- Tax balance sheet $220
- Temporary difference $80
- If applicable tax rate is 30%, deferred tax liability associated with the goodwill is $24

Deferred Tax Assets

- Goodwill example (continued)
- Assume net deferred tax assets on balance sheet include the following components:
  - DTA – All deductible temporary differences 152
  - DTL – Goodwill (24)
  - DTL – Other taxable temporary differences (30)
  - Net deferred tax assets (Schedule RC-F, item 2) 98
- If bank chooses to deduct goodwill ($300) from Tier 1 capital net of the associated deferred tax liability ($24), the adjusted amount of deferred taxes to be reported on line (c) in the deferred tax assets calculation worksheet (slide 65) = 98 – (24) = 122

Deferred Tax Assets

- Concluding example
  - Assume net deferred tax assets on balance sheet include the following components:
    - DTA – AFS debt securities 60
    - DTA – Other deductible temporary differences 314
    - DTL – Goodwill (24)
    - DTL – Other taxable temporary differences (10)
    - Net deferred tax assets (Schedule RC-F, item 2) 340
  - If bank chooses to exclude the deferred tax effect of its net unrealized loss on AFS debt securities and to net the deferred tax liability associated with goodwill, the adjusted amount of deferred taxes to be reported on line (c) in the deferred tax assets calculation worksheet (slide 65) = 340 - 60 - (24) = 304

Disallowed Deferred Tax Assets Calculation

Case I – Bank Uses Net Deferred Tax Assets as Reported in Schedule RC-F, item 2

(a) Enter the amount from Schedule RC-R, item 8	2,700
(b) Enter 10% of the amount in (a) above	270
(c) Enter the amount of deferred tax assets reported in Schedule RC-F, item 2	340
(d) Enter the amount of taxes previously paid that the bank could recover through loss carrybacks if the bank's temporary differences (both deductible and taxable) fully reverse at the report date	55
(e) Amount of deferred tax assets that is dependent upon future taxable income: subtract (d) from (c); enter 0 if the result is a negative amount	285
(f) Enter the portion of (e) that the bank could realize within the next 12 months based on its projected future taxable income.	260
(g) Enter the lesser of (b) and (f)	260
(h) Disallowed net deferred tax assets - subtract (g) from (e); enter 0 if the result is a negative amount	25

Disallowed Deferred Tax Assets Calculation

Case II – Bank Excludes DTA on AFS Securities and Nets DTL on Goodwill

(a) Enter the amount from Schedule RC-R, item 8 *	2,724
(b) Enter 10% of the amount in (a) above	272
(c) Enter the amount of deferred tax assets reported in Schedule RC-F, item 2 (as adjusted)	304
(d) Enter the amount of taxes previously paid that the bank could recover through loss carrybacks if the bank's temporary differences (both deductible and taxable) fully reverse at the report date	55
(e) Amount of deferred tax assets that is dependent upon future taxable income: subtract (d) from (c); enter 0 if the result is a negative amount	249
(f) Enter the portion of (e) that the bank could realize within the next 12 months based on its projected future taxable income.	260
(g) Enter the lesser of (b) and (f)	260
(h) Disallowed net deferred tax assets - subtract (g) from (e); enter 0 if the result is a negative amount	0

* Increased compared to Case I because goodwill was deducted net of DTL ($24)

Questions