

allowance, in excess of the limitation will be deducted from Tier 1 capital for purposes of calculating both the risk-based and leverage capital ratios. Banks should not include the amount of disallowed deferred tax assets in risk-weighted assets in the risk-based capital ratio and should deduct the amount of disallowed deferred tax assets from average total assets in the leverage capital ratio. Deferred tax assets included in capital continue to be assigned a risk weight of 100 percent.

To determine the limit, a bank should assume that all temporary differences fully reverse as of the report date. The amount of deferred tax assets that are dependent upon future taxable income that is expected to be realized within one year means the amount of such deferred tax assets that could be absorbed by the amount of income taxes that are expected to be payable based upon the bank's projected future taxable income for the next 12 months. Estimates of taxable income for the next year should include the effect of tax planning strategies that the bank is planning to implement to realize tax carryforwards that will otherwise expire during the year. Consistent with FASB 109, the FDIC believes tax planning strategies are carried out to prevent the expiration of such carryforwards. These provisions of the final rule are consistent with the proposed rule.

The capital limitation is intended to balance the FDIC's continued concerns about deferred tax assets that are dependent upon future taxable income against the fact that such assets will, in many cases, be realized. The limitation also ensures that state nonmember banks do not place excessive reliance on deferred tax assets to satisfy the minimum capital standards.

The final rule generally permits full inclusion of deferred tax assets potentially recoverable from carrybacks, since these amounts normally will be realized. The final rule also includes in Tier 1 capital those deferred tax assets that are dependent upon future taxable income, if they can be recovered from projected taxable income during the next year, provided this amount does not exceed ten percent of Tier 1 capital. The FDIC is limiting projections of future taxable income to one year because the FDIC believes that banks generally are capable of making taxable income projections for the following twelve month period that have a reasonably good probability of being achieved. However, the reliability of projections tends to decrease significantly beyond that time period. Deferred tax assets that are dependent upon future taxable income are also

limited to ten percent of Tier 1 capital, since the FDIC believes such assets should not comprise a large portion of a bank's capital base given the uncertainty of realization associated with these assets and the difficulty in selling these assets apart from the bank. Furthermore, a ten percent of capital limit also reduces the risk that an overly optimistic estimate of future taxable income will cause a bank to significantly overstate the allowable amount of deferred tax assets.

Banks are required to follow FASB 109 for regulatory reporting purposes and, accordingly, are already making projections of taxable income. The ten percent of Tier 1 capital calculation also is straightforward. In addition, banks have been reporting the amount of deferred tax assets that would be disallowed under the proposal in their Call Reports since the March 31, 1993, report date. Therefore, the FDIC believes that banks will not have significant difficulty in implementing this final rule. In this regard, as of the September 30, 1994, report date, more than one third of the 7,000 state nonmember banks carried no net deferred tax assets on their balance sheets. Fewer than 300 state nonmember banks with net deferred tax assets reported that any portion of this asset would have been disallowed under the proposal.

#### *Guidance on Specific Implementation Issues*

In response to the comments received and after discussions with the other federal banking agencies, the FDIC is providing the following additional guidance concerning the implementation of the limit.

**Projecting Future Taxable Income:** Banks may choose to use the future taxable income projections for their current fiscal year (adjusted for any significant changes that have occurred or are expected to occur) when applying the capital limit at an interim report date rather than preparing a new one-year projection each quarter. One commenter expressed concern about the potential burden and difficulty of preparing revised projections each quarter, particularly for smaller banks.

In addition, the final rule does not specify how originating temporary differences should be treated for purposes of projecting future taxable income for the next year. Each institution should decide whether to adjust its income projections for originating temporary differences and should follow a reasonable and consistent approach.

**Tax Jurisdictions:** Unlike the proposed rule, the final rule does not

require an institution to determine its limitation on deferred tax assets on a jurisdiction-by-jurisdiction basis. While an approach that looks at each jurisdiction separately theoretically may be more accurate, the FDIC does not believe the greater precision that would be achieved in mandating such an approach outweighs the complexities involved and its inherent cost to institutions. Therefore, to limit regulatory burden, a bank may calculate one overall limit on deferred tax assets that covers all tax jurisdictions in which the bank operates.

**Available-for-sale Securities:** Under FASB Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities" (FASB 115), "available-for-sale" securities are reported in regulatory reports at fair value, with unrealized holding gains and losses on such securities, net of tax effects, included in a separate component of stockholders equity. These tax effects may increase or decrease the reported amount of a bank's net deferred tax assets.

The FDIC has recently decided to exclude from regulatory capital the amount of net unrealized holding gains and losses on available-for-sale securities (except net unrealized holding losses of available-for-sale equity securities with readily determinable fair values) (59 FR 66662, Dec. 28, 1994). Therefore, it would be consistent to exclude the deferred tax effects relating to unrealized holding gains and losses on these available-for-sale securities from the calculation of the allowable amount of deferred tax assets for regulatory capital purposes. On the other hand, requiring the exclusion of such deferred tax effects would add significant complexity to the regulatory capital standards and in most cases would not have a significant impact on regulatory capital ratios.

Therefore, when determining the capital limit for deferred tax assets, the FDIC has decided to permit, but not require, institutions to adjust the reported amount of deferred tax assets for any deferred tax assets and liabilities arising from marking-to-market available-for-sale debt securities for regulatory reporting purposes. This choice will reduce implementation burden for institutions not wanting to contend with the complexity arising from such adjustments, while permitting those institutions that want to achieve greater precision to make such adjustments. Institutions must follow a consistent approach with respect to such adjustments.

**Separate Entity Method:** Under the proposed rule, the capital limit would