obligation to make a payment to the customer or to a third party in the event the customer *fails to repay* an outstanding debt obligation or *fails to perform* a contractual obligation is treated, for risk-based capital purposes, as respectively, a financial guarantee standby letter of credit or a performance standby.

f. A loan commitment, on the other hand, involves an obligation (with or without a material adverse change or similar clause) of the banking organization to fund its customer *in the normal course* of business should the customer seek to draw down the commitment.

g. Sale and repurchase agreements and asset sales with recourse (to the extent not included on the balance sheet) and forward agreements also are converted at 100 percent.[48] So-called ''loan strips'' (that is, short-term advances sold under long-term commitments without direct recourse) are treated for risk-based capital purposes as assets sold with recourse and, accordingly, are also converted at 100 percent.

h. Forward agreements are legally binding contractual obligations to purchase assets with *certain* drawdown at a specified future date. Such obligations include forward purchases, forward forward deposits placed,[49] and partly-paid shares and securities; they do not include commitments to make residential mortgage loans or forward foreign exchange contracts.

i. Securities lent by a banking organization are treated in one of two ways, depending upon whether the lender is at risk of loss. If a banking organization, as agent for a customer, lends the customer's securities and does not indemnify the customer against loss, then the transaction is excluded from the risk-based capital calculation. If, alternatively, a banking organization lends its own securities or, acting as agent for a customer, lends the customer's securities and indemnifies the customer against loss, the transaction is converted at 100 percent and assigned to the risk weight category appropriate to the obligor, to any collateral delivered to the lending banking organization, or, if applicable, to the independent custodian acting on the lender's behalf. Where a banking organization is acting as agent for a customer in a transaction involving the lending or sale of securities that is collateralized by cash delivered to the banking organization, the transaction is deemed to be collateralized by cash on deposit in a subsidiary lending institution for purposes of determining the appropriate risk-weight category, provided that any indemnification is limited to no more than the difference between the market value of the securities and the cash collateral received and any reinvestment risk associated with that cash collateral is borne by the customer.

* * * * *

By order of the Board of Governors of the Federal By Reserve System, February 7, 1995.

William W. Wiles,

Secretary of the Board.

[FR Doc. 95–3469 Filed 2–10–95; 8:45 am]

BILLING CODE 6210–01–P

[48] In regulatory reports and under GAAP, bank holding companies are permitted to treat some asset sales with recourse as ''true'' sales. For risk-based capital purposes, however, such assets sold with recourse and reported as ''true'' sales by bank holding companies are converted at 100 percent and assigned to the risk category appropriate to the underlying obligor or, if relevant, the guarantor or nature of the collateral, provided that the transactions meet the definition of assets sold with recourse (including assets sold subject to pro rata and other loss sharing arrangements), that is contained in the instructions to the commercial bank Consolidated Reports of Condition and Income (Call Report). This treatment applies to any assets, including the sale of 1- to 4-family and multifamily residential mortgages, sold with recourse. Accordingly, the entire amount of any assets transferred with recourse that are not already included on the balance sheet, including pools of 1- to 4-family residential mortgages, are to be converted at 100 percent and assigned to the risk category appropriate to the obligor, or if relevant, the nature of any collateral or guarantees. The terms of a transfer of assets with recourse may contractually limit the amount of the institution's liability to an amount less than the effective risk-based capital requirement for the assets being transferred with recourse. If such a transaction is recognized as a sale under GAAP, the amount of total capital required is equal to the maximum amount of loss possible under the recourse provision, less any amount held in an associated non-capital liability account established pursuant to GAAP to cover estimated probable losses under the recourse provision.

[49] Forward forward deposits accepted are treated as interest rate contracts.

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 325

RIN 3064–AB20

Capital Maintenance

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Final rule.

SUMMARY: The FDIC is amending its capital standards for insured state nonmember banks to establish a limitation on the amount of certain deferred tax assets that may be included in (that is, not deducted from) Tier 1 capital for risk-based and leverage capital purposes. Under the final rule, deferred tax assets that can be realized through carrybacks to taxes paid on income earned in prior periods generally will not be subject to limitation for regulatory capital purposes. On the other hand, deferred tax assets that can only be realized if an institution earns sufficient taxable income in the future will be limited for regulatory capital purposes to the amount that the institution is expected to realize within one year of the most recent calendar quarter-end date, based on the institution's projection of taxable income for that year, or ten percent of Tier 1 capital, whichever is less. Deferred tax assets in excess of these limitations will be deducted from Tier 1 capital and from assets for purposes of calculating both the risk-based and leverage capital ratios.

This regulatory capital limit was developed on a consistent basis by the FDIC, the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) (hereafter, the federal banking agencies or the agencies) in response to the issuance by the Financial Accounting Standards Board (FASB) of Statement No. 109, ''Accounting for Income Taxes'' (FASB 109), in February 1992.

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.

EFFECTIVE DATE: April 1, 1995.

FOR FURTHER INFORMATION CONTACT: Robert F. Storch, Chief, Accounting Section, Division of Supervision, (202) 898–8906, or Joseph A. DiNuzzo, Counsel, Legal Division, (202) 898–7349, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION:

I. Background

Characteristics of Deferred Tax Assets

Deferred tax assets are assets that reflect, for financial reporting purposes, amounts that will be realized as reductions of future taxes or as future receivables from a taxing authority. Deferred tax assets may arise because of specific limitations under tax laws of different tax jurisdictions that require that certain net operating losses (*i.e.*, when, for tax purposes, expenses exceed revenues) or tax credits be carried forward if they cannot be used to recover taxes previously paid. These ''tax carryforwards'' are realized only if the institution generates sufficient future taxable income during the carryforward period.

Deferred tax assets may also arise from the tax effects of certain events that have been recognized in one period for financial statement purposes but will result in deductible amounts in a future period for tax purposes, *i.e.*, the tax effects of ''deductible temporary differences.'' For example, many depository institutions may report higher income to taxing authorities than they reflect in their regulatory reports[1] because their loan loss provisions are expensed for reporting purposes but are not deducted for tax purposes until the loans are charged off.

Deferred tax assets arising from an organization's deductible temporary differences may or may not exceed the amount of taxes previously paid that the organization could recover if the temporary differences fully reversed at the report date. Some of these deferred tax assets may theoretically be ''carried back'' and recovered from taxes previously paid. On the other hand, when deferred tax assets arising from deductible temporary differences exceed such previously paid tax amounts, they will be realized only if there is sufficient future taxable income during the carryforward period. Such deferred tax assets, and deferred tax assets arising from tax carryforwards, are hereafter referred to as ''deferred tax assets that are dependent upon future taxable income.''

FASB 109

In February 1992, the FASB issued Statement No. 109, which superseded Accounting Principles Board Opinion No. 11 (APB 11) and FASB Statement No. 96 (FASB 96), the previous standards governing accounting for income taxes. FASB 109 provides guidance on many aspects of accounting for income taxes, including the accounting for deferred tax assets. FASB 109 generally allows institutions to report certain deferred tax assets on their balance sheets that they could not recognize as assets under previous generally accepted accounting principles (GAAP) and the federal banking agencies' prior reporting policies.[2] Unlike the general practice under previous standards, FASB 109 permits the reporting of deferred tax assets that are dependent upon future taxable income. However, FASB 109 requires the establishment of a valuation allowance to reduce deferred tax assets to an amount that is more likely than not (*i.e.*, a greater than 50 percent likelihood) to be realized.

FASB 109 became effective for fiscal years beginning on or after December 15, 1992. The adoption of this standard has resulted in the reporting of additional deferred tax assets in Call Reports and TFRs that have directly increased institutions' undivided profits and Tier 1 capital.

Concerns Regarding Deferred Tax Assets That Are Dependent Upon Future Taxable Income

The FDIC has certain concerns about including in capital deferred tax assets that are dependent upon future taxable income. Realization of such assets depends on whether a bank has sufficient future taxable income during the carryforward period. Since a bank that is in a net operating loss carryforward position is often experiencing financial difficulties, its prospects for generating sufficient taxable income in the future are uncertain. In addition, the condition of and future prospects for an organization often can and do change very rapidly in the banking environment. This raises concerns about the realizability of deferred tax assets that are dependent upon future taxable income, even when a bank ostensibly appears to be sound and well-managed. Thus, for many banks, such deferred tax assets may not be realized and, for other banks, there is a high degree of subjectivity in determining the realizability of this asset. In this regard, many banks may be able to make reasonable projections of future taxable income for relatively short periods of time and actually realize the projected income, but beyond these short time periods, the reliability of the projections tends to decrease significantly. Furthermore, unlike many other assets, banks generally cannot realize the value of deferred tax assets by selling them.

In addition, as a bank's condition deteriorates, it is less likely that deferred tax assets that are dependent upon future taxable income will be realized. Therefore, the bank is required under FASB 109 to reduce its deferred tax assets through increases to the asset's valuation allowance. Additions to this allowance would reduce the bank's regulatory capital at precisely the time it needs capital support the most. Thus, the inclusion in a bank's reported capital of deferred tax assets that are dependent upon future taxable income raises supervisory concerns.

Because of these concerns, the agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), considered how the deferred tax assets of depository institutions should be treated for regulatory reporting and capital purposes. In August 1992, the FFIEC requested public comment on this matter (57 FR 34135, Aug. 3, 1992). After considering the comments received, the FFIEC decided in December 1992, that banks and savings associations should adopt FASB 109 for reporting purposes in Call Reports and Thrift Financial Reports (TFRs) beginning in the first quarter of 1993 (or the beginning of their first fiscal year thereafter, if later). Insured banks were notified by the FFIEC that they should report deferred tax assets in their Call Reports in accordance with FASB 109 in Financial Institutions Letter FIL–97–92 dated December 31, 1992. For insured state nonmember banks, this GAAP reporting standard has superseded the regulatory reporting limitation on deferred tax assets established by the FDIC in Bank Letter BL–36–85 dated October 4, 1985. As a consequence, this 1985 Bank Letter has been withdrawn.

II. Proposed Regulatory Capital Treatment of Deferred Tax Assets

The FFIEC, in reaching its decision on regulatory reporting, also recommended that each of the federal banking agencies should amend its regulatory capital standards to limit the amount of deferred tax assets that can be included in regulatory capital. In response to the FFIEC's recommendation, on May 5, 1993, the FDIC issued for public comment a proposal to adopt the recommendation of the FFIEC in full, as summarized below (58 FR 26701). The FFIEC recommended that the agencies limit the amount of deferred tax asset that are dependent upon future taxable income that an institution can include in regulatory capital to the lesser of:

(1) the amount of such deferred tax assets that 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 reversals of existing temporary differences) for that year, or

(2) ten percent of Tier 1 capital before deducting any disallowed purchased mortgage servicing rights, any disallowed purchased credit card

[1] Insured commercial banks and FDIC-supervised savings banks are required to file quarterly Consolidated Reports of Condition and Income (Call Reports) with their primary federal regulatory agency (the FDIC, the FRB, or the OCC, as appropriate). Insured savings associations file quarterly Thrift Financial Reports (TFRs) with the OTS.

[2] Prior reporting policies of the OCC and FDIC, as set forth in Banking Circular 202 dated July 2, 1985, and Bank Letter BL–36–85 dated October 4, 1985, respectively, limited the reporting of deferred tax assets in the regulatory reports filed by national banks and insured state nonmember banks to the amount of taxes previously paid which are potentially available through carryback of net operating losses. As such, the OCC and FDIC did not permit the reporting of deferred tax assets that are dependent upon future taxable income in the Call Reports filed by national and insured state nonmember banks. The FRB and OTS did not issue policies explicitly addressing the recognition of deferred tax assets. Consequently, state member banks and savings associations were able to report deferred tax assets in accordance with GAAP. Prior to FASB 109, GAAP, as set forth in APB 11 and FASB 96, also for the most part did not permit the reporting of deferred tax assets that are dependent upon future taxable income.

relationships, and any disallowed deferred tax assets.

When the recorded amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, exceeds this limitation, the excess amount would be deducted from Tier 1 capital and from assets in regulatory capital calculations. Deferred tax assets that can be realized from taxes paid in prior carryback years and from future reversals of existing taxable temporary differences generally would not be limited under the proposal.

III. Public Comments on the Proposal

The comment period for the FDIC's proposal closed on June 4, 1993. The FDIC received comment letters from 23 entities, 18 of which were banks or bank holding companies, four of which were bank trade associations, and one of which was an accounting firm (which submitted two comment letters). Only two commenters expressed support for or nonobjection to the proposed regulatory capital limitation, although each raised an implementation question about the limit. Two others favored the concept of a regulatory capital limitation on deferred taxes, but recommended that the limit be set in a different manner than was proposed. Three commenters seemed to suggest that deferred tax assets should not be included in regulatory capital at all. The remaining 16 commenters, including all of the larger banking organizations that commented, expressed a preference for placing no limit on the amount of deferred tax assets that can be included in regulatory capital. These commenters generally indicated that a regulatory capital limitation on deferred tax assets is unnecessary because FASB 109 contains sufficient safeguards to ensure that the amount of deferred tax assets carried on an institution's balance sheet is realizable. Instead, they supported the full adoption of FASB 109 for both regulatory reporting and regulatory capital purposes, indicating that such an approach would limit regulatory burden. Nevertheless, while preferring no capital limit on deferred tax assets, two commenters considered the agencies' decision to include some deferred tax assets that are dependent upon future taxable income in regulatory capital as a positive step compared to prior regulatory policies and proposals permitting little or no inclusion of such deferred tax assets in regulatory reports and regulatory capital.

Responses to the FDIC's Questions

The proposed rule requested specific comment on a number of questions.

Question (1): The FDIC's first question asked about the appropriateness of the proposed capital limit, particularly the ten percent of Tier 1 capital limitation. Eight commenters specifically responded to this question, while the views expressed by most of the remaining commenters could also be regarded as responsive to this question. In other words, because more than two-thirds of the commenters favored relying on the proper application of GAAP to the reporting of deferred tax assets over establishing a separate regulatory capital limit on such assets, these commenters generally considered the proposed limits to be inappropriate and unnecessary. Some of those who commented on this issue noted that any percentage of capital limit would be inappropriate because realizability is a function of an institution's ability to generate future taxable income. Thus, several letters described the proposed ten percent limit as arbitrary and too conservative.

One commenter noted that healthy banks typically earn in excess of ten percent of Tier 1 capital each year, thereby ensuring that this percentage limit will be the operative limit for such banks. This commenter suggested setting the percentage limitation for institutions that are deemed to be ''well-capitalized'' for prompt corrective action purposes at 20 percent of Tier 1 capital.

Another commenter likened deferred tax assets to the two identifiable intangible assets, purchased mortgage servicing rights (PMSRs) and purchased credit card relationships (PCCRs), that are included in Tier 1 capital. This commenter's recommendation was to apply the existing percentage limits for these two intangibles to deferred tax assets, *i.e.*, a 50 percent of Tier 1 capital limit for the total of PMSRs, PCCRs, and deferred tax assets along with 25 percent of Tier 1 capital sublimits for both PCCRs and deferred tax assets.

Question (2): The second question dealt with whether certain identifiable assets acquired in a nontaxable business combination accounted for as a purchase should be adjusted for the tax effect of the difference between the market or appraised value of the asset and its tax basis. Under FASB 109, this tax effect is recorded separately in a deferred tax liability account, whereas under previous GAAP, this tax effect reduced the amount of the intangible asset. This change in treatment could cause a large increase, *i.e.*, a ''gross-up,'' in the reported amount of certain identifiable intangible assets, such as core deposit intangibles, which are deducted for purposes of computing regulatory capital.

Six commenters indicated that institutions should be permitted to deduct the net after-tax amount of the intangible asset from capital, not the gross amount of the intangible asset. These commenters argued that FASB 109 will create artificially high carrying values for intangible assets and a related deferred tax liability when an institution acquires assets with a carryover basis for tax purposes but revalues the assets for financial reporting purposes. The commenters generally indicated that, under FASB 109, the balance sheet will not accurately reflect the value paid for the intangibles. Furthermore, commenters indicated that the increased carrying value of the intangible asset posed no risk to an institution, because a reduction in the value of the asset would effectively extinguish the related deferred tax liability.

On the other hand, one commenter indicated that deferred tax assets resulting from the gross-up effect in certain business combinations should not be treated differently from other deferred tax assets.

Question (3): The FDIC's third question inquired about (a) the potential burden associated with the proposal and whether a limitation based on projections of future taxable income would be difficult to implement and (b) the appropriateness of the separate entity method for determining the proposed limit on deferred tax assets and for tax sharing agreements in general.

Question (3)(a): The FDIC received seven comment letters specifically addressing the issue of potential burden and a limitation based on income projections.

Two commenters supported the use of income projections. The first one stated that capital limitations on deferred tax assets based on projected future taxable income should not be difficult to implement and should not impose an additional burden. This commenter noted that many institutions already forecast future taxable income in order to support the recognition of deferred tax assets on their balance sheets. The second commenter similarly observed that these taxable income projections must be evaluated by institutions' independent auditors and that the subjectivity and complexity involved in such projections are no greater than for the process of determining loan loss reserves. Another commenter added that these calculations should not pose any problems, provided they are done on a consolidated basis. One other commenter, who did not appear to oppose the concept of income projections, nevertheless reported that requiring banks to project their taxable income for the next year at the end of each interim quarter presents a potentially difficult burden to smaller banks.

In addition, one commenter who did not directly address the burden of income projections recommended that the FDIC clarify the term ''expected to be realized within one year.'' This commenter suggested that the term should mean the amount of deferred tax assets that could be absorbed by the expected amount of income taxes that would result from an institution's projected future taxable income for the next 12 months, and not the amount of deferred tax assets that actually will be used.

In contrast, three commenters specifically opposed an income approach, preferring that a limit be determined by other means. These commenters opposed the income approach because they believe that projecting future earnings involves either too much subjectivity or complexity. Instead, the three commenters expressed a preference for setting the regulatory capital limit for deferred tax assets solely as a percentage of capital. Two of these commenters suggested that the deferred tax asset limit should be a function of an institution's capital level for prompt corrective action purposes, with the highest limit for ''well capitalized'' banks. The other commenter recommended that the FDIC adopt percentage of capital limits consistent with those applicable to purchased mortgage servicing rights and purchased credit card receivables. On the other hand, one commenter specifically opposed the establishment of a capital limitation based upon the perceived ''health'' of an institution, stating that this method could lead to arbitrary and inconsistent measures of capital adequacy.

Question (3)(b): Seven commenters expressed opinions concerning the separate entity method. The FDIC's proposal stated that the capital limit for deferred tax assets would be determined on a separate entity basis for each insured state nonmember bank. Under this method, a bank (together with its consolidated subsidiaries) that is a subsidiary of a holding company is treated as a separate taxpayer rather than as part of a consolidated group.

All of these commenters opposed the separate entity approach, although one commenter appeared to support this approach for banks that do not have a ''strong'' holding company. Commenters argued that the separate entity approach is artificial and that tax-sharing agreements between financially capable bank holding companies and bank subsidiaries should be considered when evaluating the recognition of deferred tax assets for regulatory capital purposes. Commenters also stated that the separate entity method is unnecessarily restrictive and is contrary to bank tax management practices. It was suggested that any systematic and rational method that is in accordance with GAAP should be permitted for the calculation of the limitation for each bank.

One commenter's opposition to the separate entity approach was based on the view that the limitation is not consistent with the Federal Reserve Board's 1987 ''Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks'' and the FDIC's 1990 ''Statement of Policy Regarding Liability of Commonly Controlled Depository Institutions,'' which, in some respects, treat a controlled group as one entity. Another commenter contended that the effect of a separate entity calculation would be to reduce bank capital which is needed for future lending, an outcome that would be inconsistent with the objectives of the March 10, 1993, ''Interagency Policy Statement on Credit Availability.'' This same commenter as well as one other further noted that the required use of the separate entity method creates significant regulatory burden and adds to the cost and complexity of calculating deferred tax assets for both bankers and regulators.

Question (4): The FDIC's fourth question requested comment on the appropriateness of the provisions of the proposal that would (a) consider tax planning strategies as part of an institution's projections of taxable income for the next year and (b) assume that all temporary differences fully reverse at the report date.

Question (4)(a): The FDIC's proposal stated that the effect of tax planning strategies that are expected to be implemented to realize tax carryforwards that will otherwise expire during the next year should be included in taxable income projections. Five commenters addressed this issue. All of these commenters expressed support for including tax planning strategies in an institution's projection of taxable income. However, one commenter went on to state that the proposal should be modified to permit institutions to consider strategies that would ensure realization of deferred tax assets within the one-year time frame.

Question (4)(b): Six commenters specifically addressed the full reversal of temporary differences assumption and all but one agreed that this assumption is appropriate. One commenter observed that this assumption would eliminate the burden of scheduling the ''turnaround'' of temporary differences. In contrast, one commenter felt that this assumption was not realistic.

Question (5): The FDIC's final question asked whether the definition for the term ''deferred tax assets that are dependent upon future taxable income'' should appear in the rule, as proposed, or in the Call Report instructions. The only commenter who responded to this question indicated that the Call Report instructions should reference definitions in the tax rules and FASB 109.

IV. Final Rule

Limitation on Deferred Tax Assets

After considering the comments received on the proposed rule and consulting with the other federal banking agencies, the FDIC is limiting the amount of deferred tax assets that are dependent on future taxable income that can be included in Tier 1 capital for risk-based and leverage capital purposes. The limitation is consistent with both the FDIC's proposal and the recommendation of the FFIEC's Task Force on Supervision to the agencies as announced by the FFIEC on November 18, 1994. Under the final rule, for regulatory capital purposes, deferred tax assets that are dependent upon future taxable income are limited to the lesser of:

(1) the amount of such deferred tax assets that 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 reversals of existing temporary differences), or

(2) ten percent of Tier 1 capital before deducting any disallowed purchased mortgage servicing rights, any disallowed purchased credit card relationships, and any disallowed deferred tax assets.

Deferred tax assets that can be realized from taxes paid in prior carryback years and from the reversal of existing taxable temporary differences generally are not limited under the final rule. The reported amount of deferred tax assets, net of its valuation 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 be determined on a separate entity basis by each bank that was a subsidiary of a holding company. The use of a separate entity approach for income tax sharing agreements (including intercompany tax payments and current and deferred taxes) is generally required by the FDIC's 1978 Statement of Policy on Income Tax Remittance by Banks to Holding Company Affiliates, and similar policies are followed by the other federal banking agencies. Thus, any change to the separate entity approach for deferred tax assets would also need to consider changes to this policy statement, which is outside the scope of this rulemaking. The FDIC also notes that income tax data in bank regulatory reports generally are required to be prepared using a separate entity approach and consistency between these reports would be reduced if institutions were permitted to use other methods for calculating deferred tax assets in addition to a separate entity approach. Thus, while a number of the commenters suggested that the FDIC consider permitting other approaches, the FDIC has decided that the final rule should retain the separate entity approach.

The final rule departs from the separate entity approach in one situation. This situation arises when a bank's parent holding company, if any, does not have the financial capability to reimburse the bank for tax benefits derived from the bank's carryback of net operating losses or tax credits. If this occurs, the amount of carryback potential the bank may consider in calculating the amount of deferred tax assets that may be included in Tier 1 capital may not exceed the amount which the bank could reasonably expect to have refunded by its parent. This provision of the final rule is consistent with the proposed rule.

Gross-up of Intangibles: As noted above, the manner in which FASB 109 must be applied when accounting for purchase business combinations can lead to a large increase (*i.e.*, ''gross-up'') in the reported amount of certain intangible assets, such as core deposit intangibles, which are deducted for purposes of computing regulatory capital. Commenters stated that the increased carrying value of such an intangible posed no risk to an institution, because a reduction in the value of the asset would effectively extinguish the related deferred tax liability. The FDIC agrees with these commenters and, consequently, will permit, for capital adequacy purposes, the netting of deferred tax liabilities arising from this gross-up effect against related intangible assets. This will result in the same treatment for intangibles acquired in purchase business combinations as under the accounting standards in effect prior to FASB 109. However, a deferred tax liability netted in this manner may not also be netted against deferred tax assets when determining the amount of deferred tax assets that are dependent upon future taxable income. Netting will not be permitted against purchased mortgage servicing rights and purchased credit card relationships, since these intangible assets are deducted for capital adequacy purposes only if they exceed specified capital limits.

Leveraged Leases: While not expected to significantly affect many banks, one commenter stated that future net tax liabilities related to leveraged leases acquired in a purchase business combination are included in the value assigned to the leveraged leases and are not shown on the balance sheet as part of an institution's deferred taxes. This artificially increases the amount of deferred tax assets for those institutions that acquire leveraged leases. Thus, this commenter continued, the future taxes payable included in the valuation of a leveraged lease portfolio in a purchase business combination should be treated as a taxable temporary difference whose reversal would support the recognition of deferred tax assets, if applicable. The FDIC agrees with this commenter and, therefore, banks may use the deferred tax liabilities that are embedded in the carrying value of a leveraged lease to reduce the amount of deferred tax assets subject to the capital limit.

V. Regulatory Flexibility Act Analysis

The FDIC does not believe that the adoption of this final rule will have a significant economic impact on a substantial number of small business entities (in this case, small banks), in accordance with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). In this regard, the vast majority of small banks currently have very limited amounts of net deferred tax assets, which are the subject of this proposal, as a component of their capital structures. Furthermore, adoption of this final rule, in combination with the adoption of FASB 109 for regulatory reporting purposes, will allow many banks to increase the amount of deferred tax assets they include in regulatory capital.

VI. Paperwork Reduction Act

The FDIC has previously received approval from the Office of Management and Budget (OMB) to collect in the Reports of Condition and Income (Call Reports) information on the amount of deferred tax assets disallowed for regulatory capital purposes. (OMB Control Number 3064–0052.) Therefore, this final rule will not increase banks' existing regulatory paperwork burden.

List of Subjects in 12 CFR Part 325

Bank deposit insurance, Banks, banking, Capital adequacy, Reporting and recordkeeping requirements, Savings associations, State nonmember banks.

For the reasons set forth in the preamble, the Board of Directors of the Federal Deposit Insurance Corporation hereby amends part 325 of title 12 of the Code of Federal Regulations as follows:

PART 325—CAPITAL MAINTENANCE

1. The authority citation for Part 325 continues to read as follows:

Authority: 12 U.S.C. 1815(a), 1815(b), 1816, 1818(a), 1818(b), 1818(c), 1818(t), 1819(Tenth), 1828(c), 1828(d), 1828(i), 1828(n), 1828(o), 1831o, 3907, 3909; Pub. L. 102–233, 105 Stat. 1761, 1789, 1790 (12 U.S.C. 1831n note); Pub. L. 102–242, 105 Stat. 2236, 2355, 2386 (12 U.S.C. 1828 note).

§ 325.2 [Amended]

2. Section 325.2 is amended in paragraphs (t) and (v) by adding ''minus deferred tax assets in excess of the limit set forth in § 325.5(g),'' after ''12 CFR part 567),''.

3. Section 325.5 is amended:

a. In paragraphs (f)(3)(i) and (f)(4)(i), by removing the word ''and'', by adding a comma after ''rights'', and by adding '', and any disallowed deferred tax assets'' after ''relationships''; and

b. By adding a new paragraph (g) to read as follows:

§ 325.5 Miscellaneous.

* * * * *

(g) *Treatment of deferred tax assets.* For purposes of calculating Tier 1 capital under this part (but not for financial statement purposes), deferred tax assets are subject to the conditions, limitations, and restrictions described in this section.

(1) *Deferred tax assets that are dependent upon future taxable income.* These assets are:

(i) Deferred tax assets arising from deductible temporary differences that exceed the amount of taxes previously paid that could be recovered through loss carrybacks if existing temporary differences (both deductible and taxable and regardless of where the related deferred tax effects are reported on the balance sheet) fully reverse at the calendar quarter-end date; and

(ii) Deferred tax assets arising from operating loss and tax credit carryforwards.

(2) *Tier 1 capital limitations.* (i) The maximum allowable amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, will be limited to the lesser of:

(A) The amount of deferred tax assets that are dependent upon future taxable income that is expected to be realized within one year of the calendar quarter-end date, based on projected future taxable income for that year; or

(B) Ten percent of the amount of Tier 1 capital that exists before the deduction of any disallowed purchased mortgage servicing rights, any disallowed purchased credit card relationships, and any disallowed deferred tax assets.

(ii) For purposes of this limitation, all existing temporary differences should be assumed to fully reverse at the calendar quarter-end date. The recorded amount of deferred tax assets that are dependent upon future taxable income, net of any valuation allowance for deferred tax assets, in excess of this limitation will be deducted from assets and from equity capital for purposes of determining Tier 1 capital under this part. The amount of deferred tax assets that can be realized from taxes paid in prior carryback years and from the reversal of existing taxable temporary differences generally would not be deducted from assets and from equity capital. However, notwithstanding the above, the amount of carryback potential that may be considered in calculating the amount of deferred tax assets that a member of a consolidated group (for tax purposes) may include in Tier 1 capital may not exceed the amount which the member could reasonably expect to have refunded by its parent.

(3) *Projected future taxable income.* Projected future taxable income should not include net operating loss carryforwards to be used within one year of the most recent calendar quarter-end date or the amount of existing temporary differences expected to reverse within that year. Projected future taxable income should include the estimated effect of tax planning strategies that are expected to be implemented to realize tax carryforwards that will otherwise expire during that year. Future taxable income projections for the current fiscal year (adjusted for any significant changes that have occurred or are expected to occur) may be used when applying the capital limit at an interim calendar quarter-end date rather then preparing a new projection each quarter.

(4) *Unrealized holding gains and losses on available-for-sale debt securities.* The deferred tax effects of any unrealized holding gains and losses on available-for-sale debt securities may be excluded from the determination of the amount of deferred tax assets that are dependent upon future taxable income and the calculation of the maximum allowable amount of such assets. If these deferred tax effects are excluded, this treatment must be followed consistently over time.

(5) *Intangible assets acquired in nontaxable purchase business combinations.* A deferred tax liability that is specifically related to an intangible asset (other than purchased mortgage servicing rights and purchased credit card relationships) acquired in a nontaxable purchase business combination may be netted against this intangible asset. Only the net amount of the intangible asset must be deducted from Tier 1 capital. When a deferred tax liability is netted in this manner, the taxable temporary difference that gives rise to this deferred tax liability must be excluded from existing taxable temporary differences when determining the amount of deferred tax assets that are dependent upon future taxable income and calculating the maximum allowable amount of such assets.

4. Section I.A.1. of appendix A to part 325 is amended by revising the first paragraph following the definitions of Core capital elements to read as follows:

Appendix A to Part 325—Statement of Policy on Risk-Based Capital

* * * * *

I. * * *

A. * * *

1. * * *

At least 50 percent of the qualifying total capital base should consist of Tier 1 capital. *Core (Tier 1) capital* is defined as the sum of core capital elements[3] minus all intangible assets other than mortgage servicing rights and purchased credit card relationships[4] and minus any disallowed deferred tax assets.

* * * * *

5. Section I.B. of Appendix A to part 325 is amended by adding a new paragraph (5) immediately after paragraph (4) and preceding the final undesignated paragraph of Section I.B. to read as follows:

* * * * *

I. * * *

[3] In addition to the core capital elements, Tier 1 may also include certain supplementary capital elements during the transition period subject to certain limitations set forth in section III of this statement of policy.

[4] An exception is allowed for intangible assets that are explicitly approved by the FDIC as part of the bank's regulatory capital on a specific case basis. These intangibles will be included in capital for risk-based capital purposes under the terms and conditions that are specifically approved by the FDIC.

B. * * *

(5) *Deferred tax assets* in excess of the limit set forth in § 325.5(g). These disallowed deferred tax assets are deducted from the core capital (Tier 1) elements.

* * * * *

Appendix A to Part 325 [Amended]

6. Table I in Appendix A to part 325 is amended by redesignating footnote 3 as footnote 4, by adding a new entry at the end under ''Core Capital (Tier 1)'' and by adding a new footnote 3 to read as follows:

TABLE I.—DEFINITION OF QUALIFYING CAPITAL

[Note: See footnotes at end of table]

Components	Minimum requirements and limitations after transition period
Core Capital (Tier 1) * * *	
* * * * *	
Less: Certain deferred tax assers.[3]	
* * * * *	

[3] Deferred tax assets are subject to the capital limitations set forth in § 325.5(g).

* * * * *

By order of the Board of Directors.

Dated at Washington, D.C., this 31st day of January 1995.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Acting Executive Secretary.

[FR Doc. 95–3179 Filed 2–10–95; 8:45 am]

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CONSUMER PRODUCT SAFETY COMMISSION

16 CFR Part 1500

Statement of Policy or Interpretation; Enforcement Policy for Art Materials

AGENCY: Consumer Product Safety Commission.

ACTION: Final rule; statement of enforcement policy.

SUMMARY: In 1988, Congress enacted the Labeling of Hazardous Art Materials Act which mandated a labeling standard and certain other requirements for art materials. Based on its experience enforcing these requirements, the Commission is issuing a statement of enforcement policy to more clearly apprise the public of its intended enforcement focus.