November 25, 2008

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson
Director

SUBJECT: Interagency Final Rule on Capital Maintenance: Deduction of Goodwill Net of Associated Deferred Tax Liability

SUMMARY

Proposal: That the Board of Directors (Board) of the Federal Deposit Insurance Corporation (FDIC) approve for publication the attached final rule titled, *Capital Maintenance: Deduction of Goodwill Net of Associated Deferred Tax Liability*. If approved, the final rule would be published in the *Federal Register* on an interagency basis by the FDIC, the Board of Governors of the Federal Reserve System, the Office of Thrift Supervision, and the Office of the Comptroller of the Currency (together, the Agencies).

On September 16, 2008, the Board approved for publication in the *Federal Register* a joint Notice of Proposed Rulemaking that would amend the Agencies' existing risk-based capital rules to permit a bank to reduce the amount of goodwill that must be deducted from tier 1 capital by the amount of any deferred tax liability associated with such goodwill (NPR or proposal). The NPR proposed that a bank would continue to deduct goodwill from tier 1 capital, but would permit the bank to reduce the amount of goodwill deducted to reflect its maximum exposure to loss if such goodwill is fully impaired or derecognized under generally accepted accounting principles (GAAP).

The NPR solicited comment on all aspects of the proposal and, specifically, on whether to extend the proposed capital treatment for goodwill to other intangible assets. The Agencies received 13 public comments, most of which supported the proposal and asked the Agencies to make the final rule applicable for the regulatory reporting period ending on December 31, 2008. Several commenters requested that the proposed capital treatment for goodwill be extended to other intangible assets but did not provide any data to support their request.

This final rule adopts the proposal without change and clarifies in the preamble that a bank must continue to deduct goodwill from tier 1 capital. If approved, the final rule would be effective 30 days after publication in the *Federal Register*; however, banks may elect to apply the final rule for purposes of the regulatory reporting period ending on December 31, 2008.

Recommendation: That the Board approve publication of this final rule in the *Federal Register*.

Concur:

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John V. Thomas
Acting General Counsel

Discussion

Background

Early in 2008, the banking industry renewed its call for the Agencies to change their existing capital rules to permit the required deduction from tier 1 capital of goodwill acquired in a taxable purchase business combination to be net of any associated deferred tax liability.

A deferred tax liability arises when certain events are recognized differently under the applicable tax rules and the GAAP-based rules used for financial reporting. Generally, under the Internal Revenue Code (IRC), a bank may amortize goodwill. However, under GAAP goodwill may not be amortized; instead, it is tested for impairment at least annually and is subject to an impairment charge if certain conditions are met. Recognition of amortization as an expense for tax purposes lowers a bank's taxable income and, thus, its tax liability during the life of the asset. To reconcile the differences in the amount of goodwill on a bank's balance sheets for tax purposes under the IRC and for financial reporting purposes under GAAP, the GAAP-based accounting rules provide for the recognition of the tax effect of this difference through a deferred tax liability, which is reported on a bank's balance sheet for financial reporting purposes. The deferred tax liability associated with goodwill does not represent an actual tax liability of the reporting institution (that is, money owed) for IRC purposes.

Thus, even if the GAAP-based accounting rules required a bank to remove the entire amount of its goodwill from its balance sheet for financial reporting purposes in response to an impairment loss on or disposal of the goodwill, the maximum reduction in the bank's tier 1 capital would not exceed the amount of the goodwill less the amount of any associated deferred tax liability. Accordingly, any change to the existing capital rules that would permit a bank to deduct goodwill from tier 1 net of any associated deferred tax liability would not present safety-and-soundness concerns.

On September 30, 2008, the Agencies published an NPR in the *Federal Register* that would permit a bank to reduce the amount of goodwill it must deduct from tier 1 capital by the amount of any deferred tax liability associated with such goodwill.[1] The NPR solicited comment on all aspects of the proposal and, specifically, on whether the Agencies should provide similar capital treatment to other intangible assets acquired in a taxable business combination. The Agencies also requested quantitative information on the potential capital impact of extending the proposal to these other intangible assets.

Public Comments and Final Rule

The Agencies received 13 public comments on the proposal from banks, trade and industry groups, and certain individuals. Most of the commenters supported the proposal and asked the Agencies to make the final rule applicable for purposes of the regulatory reporting period ending on December 31, 2008. Some of these commenters also urged the Agencies to extend the capital treatment proposed for goodwill to other intangible assets acquired in a taxable business combination. Two commenters generally opposed the proposal, and two commenters

[1] 73 Fed. Reg. 56756.

inaccurately described the proposal as permitting a bank to include goodwill in regulatory capital.

After reviewing the comments, the Agencies' staffs agreed to recommend adopting the proposal without change. Under the final rule, a bank may reduce the amount of goodwill it must deduct from tier 1 capital by the amount of any deferred tax liability associated with that goodwill. For these banks, the amount of goodwill deducted from tier 1 capital will reflect each organization's maximum exposure to loss in the event that the entire amount of goodwill is impaired or derecognized for financial reporting purposes. However, a bank that reduces the amount of goodwill deducted from tier 1 capital by the amount of the deferred tax liability is not permitted to net this deferred tax liability against deferred tax assets when determining regulatory capital limitations on deferred tax assets. The Agencies have also clarified in the preamble that, consistent with the proposal, the final rule preserves the statutory prohibition on including goodwill in regulatory capital.[2]

The final rule applies only to a deferred tax liability associated with goodwill. The capital treatment provided in the final rule does not apply other intangible assets acquired in a taxable business combination because the commenters did not provide quantitative information to support broadening the scope of the proposal. Finally, in light of requests from several commenters, the Agencies would permit banks to elect to apply the final rule for the regulatory reporting period ending on December 31, 2008.

RECOMMENDATION

Staff recommends that the Board of Directors of the Federal Deposit Insurance Corporation approves the publication of the attached interagency final rule on *Capital Maintenance: Deduction of Goodwill Net of Associated Deferred Tax Liability* in the *Federal Register*.

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[2] 12 U.S.C. 1828(n).