August 26, 2008

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson
Director

SUBJECT: Interagency Notice of Proposed Rulemaking on Capital Maintenance: Deduction of Goodwill Net of Associated Deferred Tax Liabilities

SUMMARY

Proposal: That the Board of Directors (Board) of the Federal Deposit Insurance Corporation (FDIC) approve the publication of the attached Notice of Proposed Rulemaking (NPR) on *Capital Maintenance: Deduction of Goodwill Net of Associated Deferred Tax Liability* for public comment. If approved, the NPR 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).

Under the Agencies' existing capital rules, a bank must deduct goodwill from its tier 1 capital. The proposed rule would revise the capital rules to permit a bank to deduct goodwill acquired in a taxable purchase business combination net of any associated deferred tax liability, thus effectively reducing the amount of goodwill a bank must deduct from tier 1 capital. The proposed rule would be consistent with the capital treatment provided for certain other intangible assets. Staff believes that the capital treatment provided in this NPR reflects a bank’s maximum exposure to loss in the event goodwill is either impaired or derecognized for financial reporting purposes.

The NPR solicits comment on all aspects of the proposed rule, and also on whether the Agencies should permit banks to extend the capital treatment provided in the NPR to other intangible assets.

Recommendation: That the Board approve publication of this NPR for a public comment period of 30 days.

Concur:

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Sara A. Kelsey
General Counsel

Discussion

Background

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

Under the Agencies' existing risk-based capital rules, a banking organization must deduct from tier 1 capital the full or gross carrying amount of goodwill acquired in business combinations. However, a banking organization may deduct certain other intangible assets from tier 1 capital net of associated deferred tax liabilities. The ability to deduct an asset net of any associated deferred tax liability has the effect of increasing a banking organization's tier 1 capital.

Deferred tax liabilities arise when certain events are recognized differently under the applicable tax rules and the generally accepted accounting principles (GAAP) used for financial reporting. Generally, under the Internal Revenue Code (IRC), a banking organization may amortize goodwill. Under GAAP, however, 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, the proposed treatment of goodwill in the NPR does not present safety and soundness concerns.

Proposed Rule

This NPR would revise the treatment of goodwill provided under the Agencies' existing capital rules to allow the amount of goodwill acquired in a taxable purchase business combination that must be deducted from tier 1 capital to be deducted net of any associated deferred tax liability. The net goodwill amount that would be deducted reflects a bank's actual maximum exposure to loss in the event such goodwill is impaired or derecognized for financial reporting purposes. This treatment would be similar to other provisions in the Agencies' risk-based capital rules, for example, the provision that permits a bank to deduct from tier 1 capital disallowed mortgage servicing assets net of any associated deferred tax liability. The NPR would also solicit comment on all aspects of the proposal, and on whether the Agencies should provide similar capital treatment to other intangible assets.

RECOMMENDATION

Staff recommends that the Board of Directors of the Federal Deposit Insurance Corporation approve the publication of the attached Interagency Notice of Proposed Rulemaking on *Capital Maintenance: Deduction of Goodwill Net of Associated Deferred Tax Liability* in the *Federal Register* for a public comment period of 30 days.

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