From: John M Taylor [mailto:John.Taylor1@ey.com]
Sent: Friday, October 03, 2014 3:31 PM
To: Marroquin, Juan J; Call Reports Task Force
Cc: Michael V Seminatore; Trey Spiece
Subject: "Residual Goodwill" risk-weighting

Mr. Marroquin, et. al.:

I appreciate your taking my call yesterday. As I explained, there is strange quirk in the risk-weighting of goodwill if it has been reduced by "DTL-netting." This has become a topic of intense discussion at a number of my clients. Below is my attempt to articulate the issue.

1. **Genesis.** Since the origins of purchase accounting, goodwill has been subtracted from bank balance sheets for purposes of measuring capital ratios (a rule dating back hundreds of years). The same rule applies to intangibles, such as core deposits. In 1993, FAS 109 changed the rules for accounting for deferred taxes on intangible assets. Prior to FAS 109, any DTL related to core deposit intangibles was netted against the core deposit intangible directly and not separately reported on the GAAP balance sheet. FAS 109 forced this separation, causing the core deposit intangibles to be recorded at their pre-tax or "grossed-up" amounts. From a regulatory capital standpoint this raised the question: would the new accounting rule apply for "RAP" purposes, thereby causing banks to lose capital as a result of having to subtract the larger pre-tax intangible asset balances. The industry wailed and moaned (so to speak), and the banking agencies responded with an optional DTL netting rule that would allow a bank, solely for purposes of computing regulatory capital, to subtracted the net-of-tax intangible balance consistent with prior year measurements of regulatory capital.

2. **The Goodwill Netting Election of 2008.** In 2008, a number of banks petitioned the federal banking agencies to provide a similar rule for goodwill-related DTLs and the federal banking agencies responded favorably (see attached regulation implementing the goodwill DTL netting change for reference). This rule, very simply, provides that any DTLs relating to goodwill can be netted against the GAAP goodwill balance for purposes of determining how much goodwill is subtracted in measuring Tier 1 capital. Note, goodwill is an item which very often produces DTLs. If goodwill is recorded in connection with a taxable acquisition, the tax law allows that goodwill to be amortized over 15 years, whereas FAS 141 and 142 preserve the goodwill on the balance sheet, potentially forever, provided there is no impairment to its putative value. Thus, under the 2008 rule change, if a bank possessed $100 of goodwill that was fully amortized for tax purposes, such a bank would only subtract $60 of that goodwill in computing regulatory capital (i.e., $100 of goodwill minus $40 of DTLs, assuming a simple 40% tax rate). In order to make this "entry" balance, the regulations made it clear – if you elected to net-down your goodwill for this purpose, you could not also "count" that same DTL in measuring the quantum of DTAs subject to the DTA limitations. In other words, if a $40 goodwill DTL was netted against goodwill, that same $40 DTL would have to be removed from the net GAAP DTA balance (i.e., in the parallel universe of regulatory capital accounting, Dr. DTA $40, Cr. Goodwill $40).

3. **Enter Basel III.** From its inception in BCBS 189, the Basel III rules have stated the same DTL netting rule would apply: goodwill would be subtracted in measuring common equity tier 1 (and every other measure of capital), and would be subtracted on an elective net-of-tax basis. In the US, this principle has been enshrined in 12 CFR secs. 217.22(a)(1) and .22(e)(5). (I reference the

BHC section of the rules, but of course the ".22" rules apply equally to each banking agency sections throughout Title 12 of the CFR). So far, so good? I believe this treatment is clear to everyone in the industry, clear in the amended FFIEC 031/041 forms, clear in the FR Y-9C, clear enough on FR Y-14A, and I suspect you agree. Thus, if a bank has $100 of goodwill and elects to "net" DTLs, it can subtract $60 of goodwill (again, let me assume the goodwill has been fully amortized for tax purposes so as not to muddle the example and miss the point) but it would pay the price in the form of having to take that same $40 DTL out of the determination of the "net" DTAs subject to the DTA limitation rules, thereby causing the net DTAs subject to DTA limitations to grow by a like amount. This is clarified in Basel III section .22(e), which states that a DTL can only be used one time. Stated differently, the DTL relating to goodwill cannot be netted against attribute DTAs or temporary difference DTAs under section .22(e)(3) if the bank has elected to net that particular DTL against goodwill.

4. **Enter the risk-weighting rules.** Here, the clear path becomes foggy. The regulations themselves do not provide a clear explanation – section 32, et. seq. of the US Basel III regulations imply that you start with GAAP balances and subtract the amounts that have been disallowed and risk-weight the difference. In June 2014, the banking agencies proposed draft new forms and instructions, see 79 FR 35634 (June 23, 2014) and http://www.ffiec.gov/forms041.htm, where the rubber of the risk-weighting rules meet the form-filing road. These newly forms and instructions create a new Schedule RC-R, Part II, which provides a matrix whereby assets can be divvied up into all the new standardized risk-weight categories. Line 8 of this matrix is where "other assets" such as goodwill and DTAs are handled. The form and instructions both follow the logic of the regulations: GAAP minus disallowed amounts equals risk weighted basis, subject to one of the various coefficients of risk (in Columns C through Q).

5. **Consider a simple example.** Before going too deep into an explanation of the form instructions, let me lay out a simple example. Suppose a bank has $100 of goodwill and a net GAAP DTA of $100, all of which are temporary difference items, but included in this net GAAP DTA are $40 of DTLs related to the $100 of goodwill. As a result, in determining regulatory capital, the bank elects to net the $40 DTL against goodwill and thereby only subtracts $60 of net-of-tax goodwill in measuring CET1. Likewise, the bank "grosses up" its net GAAP DTA to $140, resulting in a pool of $140 of temporary difference DTAs subject to the threshold limits under section .22(d)(1)(i). Assume the bank possessed a combination of NOL carryback capacity and CET1 such that the regulatory-adjusted DTA balance of $140 was fully allowed in measuring CET1.

6. **New proposed form instructions.** In measuring RWA, the line 8 instructions provide that this example bank must report $200 in column A, i.e., $100 of goodwill reported on Schedule RC line 10a and $100 of DTA reported on Schedule RC line 11 (and RC-F line 2). In column B, the form instructions state very clearly to input the amount of goodwill disallowed on RC-R, Part I, line 6, which is the net-of-DTL amount of $60 (see instructions p. 31). If one imagines a sub-line relating to goodwill, this produces a $40 "dangling debit" for goodwill and leaves the $100 of GAAP DTA intact. At this point, consider page 38 of the proposed FFIEC Form 031/041 instructions, which provides that the amounts in column A must equal the sum of the amounts in columns B through Q; this makes perfect sense, the GAAP amounts in Column A must equal the amount of assets that are either removed from the numerator and denominator plus the residual amount of assets that are risk-weighted in one of the 15 categories (columns C through Q). Returning to the imaginary "goodwill line" inside of Line 8 of RC-R, Part II, we have $100 in column A, $60 in Column B, therefore $40 must be input into columns C through Q. But where?

7. **An inter-related DTA risk weighting question.** Before answering the question of where the $40 "dangling" balance of goodwill should be input, consider the fact that the DTAs subject to the threshold limitation totaled $140, not the $100 GAAP balance embedded in Schedule RC line 11 (and RC-F line 2). Thus, the question that might emerge is whether the $40 dangling goodwill balance is, in essence, the DTA that emerges from the grossing-up process required by section .22(e)(1). In other words, if goodwill and DTA are "fused together" in Line 8, Column A, then the $200 GAAP balance will be reduced to $140 of combined risk-weighted eligible basis, which is precisely the temporary difference DTA amount subjected to the threshold limitation of section .22(d)(1)(i), and therefore, that $140 of DTA should be risk-weighted at either 100% or 250% depending on the bank's ability to carryback DTAs (note: there is a special risk-weighting rule in section .22(d)(1)(i) that permits DTAs to be assigned a 100% risk weight to the extent of the bank's carryback capacity).

8. **Pause: a quick note is in order.** When speaking of a "grossed up" DTA, what is really meant is that the net GAAP DTA balance likely consists of a large number of temporary difference DTAs and a variety of DTLs, one of which is the $40 DTL related to the goodwill basis difference, and when that DTL related to goodwill is "stripped away" by virtue of the DTL netting election, the remaining DTLs will be netted against the gross temporary difference DTAs and the net result, after applying section .22(e)(3), will be a net temporary difference DTA of $140. This is true whether the bank possesses $500 of gross DTAs and $400 of gross DTLs, including the $40 goodwill DTL, or if the bank possesses gross DTAs of $140 and its only DTL is the $40 goodwill-related DTL.

9. **Back to the proposed form instructions.** On page 32, the instructions state that, in 2018, DTAs not disallowed under .22(d)(1) will be risk-weighted in Column K – the 250% "bucket." So let me stick with a fully-phased-in analysis of Basel III, lest the issue becomes too entangled with Basel III transition rules. If the $40 "dangling" balance in the imaginary goodwill line within RC-R Part II Line 8 is, really, in essence, a DTA, then it would seem Column K is the right place to balance things. This answer emerges if the balances in goodwill and DTA are "fused" and the imagining of separate sub-lines within Line 8 is discarded as an idea altogether. However, if the imaginary sub-lines within Line 8 are regarded, and logic is applied thenceforth, the instructions on page 32 might be read to imply that the $40 "dangling debit" in the imaginary goodwill line might belong in Column I – the 100% risk bucket. The instructions state that this Column I ought to include "[t]he amount of all other assets reported in column A that is not included in columns B through Q." And since there are no instructions as to what goes into Column K, one might argue that Column I is the only answer that can be derived absent better form instructions applicable to Line 8, Column K. One could also argue that the $40 "dangling debit" balance in the imaginary goodwill sub-line is a "nothing" – we can all likely agree that there is no "goodwill" left in the regulatory-capital-parallel-universe-balance-sheet, and, therefore, nothing should be risk-weighted; stated differently, the $40 "dangling debit" is simply not an asset, it is a regulatory-capital-chimera that should be banished to Column C – the zero risk-weight bucket.

10. **Back to the example.** Adding a few more features, the example is illustrated below (note, some DTA is 100% RWA as a result of NOL carryback potential).

"Residual Goodwill" Risk-Weighting Under Basel III Proposed Form Changes

DTA Scenario

GAAP Balances	
Goodwill (RC line 10a)	100
Net DTA (RC-F line 2)	100
Book equity	1,000

DTA Profile	
Gross temp DTAs	200
NOL/credit DTAs	-
Goodwill DTLs	(40)
Other DTLs	(60)
Net GAAP DTA	100

Reg Cap DTA Calc	
GAAP DTA	100
Plus: GW DTL	40
Reg Cap DTA	140
Carryback potential	(50)
Threshold DTAs	90
Book equity	1,000
Less: goodwill, net	(60)
CET1, pre-threshold	940
CET1*10%	94
Excess DTAs	-

Risk Weighting Alternatives on Proposed Schedule RC-R Part II Line 8

Alternative #1	*Column A*	*Column B*	*Column C*	*Column I*	*Column K*
Goodwill	100	60	-	40	-
DTAs	100	-	-	50	50
Total	200	60	-	90	50
RWA %s			0%	100%	250%
RWA			-	90	125
				215	

Alternative #2	*Column A*	*Column B*	*Column C*	*Column I*	*Column K*
Goodwill	100	60	40	-	-
DTAs	100	-	-	50	50
Total	200	60	40	50	50
RWA %s			0%	100%	250%
RWA			-	50	125
				175	

Alternative #3	*Column A*	*Column B*	*Column C*	*Column I*	*Column K*
Goodwill	100	100	-	-	-
DTAs	100	(40)	-	50	90
Total	200	60	-	50	90
RWA %s			0%	100%	250%
RWA			-	50	225
				275	

11. **A few notes on these alternatives**. Alternative #1 reflects the "plain reading" of the instructions, whereby the $40 dangling balance for goodwill is required to be placed into Column I. Alternative #2 reflects a view that the residual $40 amount is not an asset and should be risk weighted at 0%. Finally, Alternative #3 reflects the view that the $40 difference is in essence the gross-up of the DTA; in this case the gross-up to the DTA is presented by subtracting the pre-tax amount of goodwill embedded in the Part I, line 6 deduction and recording a negative amount in Column B with respect to the DTA, to create the gross-up effect; note, the separate lines for goodwill and DTA under line 8 would never appear on the call report, these two lines are "imaginary" and are only presented so as to help illustrate the rationale.

12. **What about banks with net DTLs?** There are plenty of banks that have large net DTL balances where the same logic would not apply. Consider the same example but assume the bank possessed a net GAAP DTL of $100. Upon netting the $40 DTL related to goodwill, the bank's regulatory-adjusted net DTL would still be $60, therefore even if the bank constructed a parallel-universe-regulatory-capital-balance-sheet, its net DTA would still be zero and there could not possibly be any DTA to subject to risk weighting. As a result, there can only be two alternatives: zero or 100% risk-weighting for the $40 "dangling debit." The question is whether Alternative #3 is a valid way of presenting the information. In other words, if the "imaginary" goodwill line within Line 8 were adjusted from $100 down to zero and the net GAAP DTL adjusted from $100 to $60, the $40 adjustment to the net GAAP DTL would not emerge on line 8 because the DTL is not included in the asset section of the balance sheet.

"Residual Goodwill" Risk-Weighting Under Basel III Proposed Form Changes

DTL Scenario

GAAP Balances	
Goodwill (RC line 10a)	100
Net DTL (RC-G line 2)	(100)
Book equity	1,000

DTA Profile	
Gross temp DTAs	100
NOL/credit DTAs	-
Goodwill DTLs	(40)
Other DTLs	(160)
Net GAAP DTA	(100)

Reg Cap DTA Calc	
GAAP DTA	(100)
Plus: GW DTL	40
Reg Cap DTA	(60)
Carryback potential	(50)
Threshold DTAs	-
Book equity	1,000
Less: goodwill, net	(60)
CET1, pre-threshold	940
CET1*10%	94
Excess DTAs	-

Risk Weighting Alternatives on Proposed Schedule RC-R Part II Line 8

Alternative #1	*Column A*	*Column B*	*Column C*	*Column I*	*Column K*
Goodwill	100	60	-	40	-
DTAs	-	-	-	-	-
Total	100	60	-	40	-
RWA %s			0%	100%	250%
RWA			-	40	-
				40	

Alternative #2	*Column A*	*Column B*	*Column C*	*Column I*	*Column K*
Goodwill	100	60	40	-	-
DTAs	-	-	-	-	-
Total	100	60	40	-	-
RWA %s			0%	100%	250%
RWA			-	-	-
				-	

Alternative #3	*Column A*	*Column B**	*Column C*	*Column I*	*Column K*
Goodwill	100	100	-	-	-
DTAs	-	-	-	-	-
Total	100	100	-	-	-
RWA %s			0%	100%	250%
RWA			-	-	-
				-	

** Because the "reg-adjusted" deferred taxes still possess a credit balance of $60, no DTA "emerges."*

13. **My request.** As these examples illustrate, it is presently unclear how to risk-weight the arithmetical difference between the GAAP goodwill balance and the net-of-tax goodwill subtracted on RC-R, Part I, line 6. To our knowledge, practice in the industry is varied and, by and large, most banking organizations would prefer clarity over a specific outcome. My request is that you consider correcting the form instructions to clarify which treatment ought to apply (#1, #2, #3, or maybe another variation I overlooked).

14. **Parting thought**. There are other aspects that will likely factor into your decision. First, it should be noted that goodwill is not the only item that presents this risk-weighting conundrum. MSRs, intangibles, investments in nonconsolidated financial entities subject to threshold limitations – pretty much all regulatory adjustments with a potential DTL-netting feature pose the same problem of the "residual" or "dangling debit" that needs to be evaluated and entered into the RWA grid somewhere between Columns C and Q. The question in each of these scenarios will be the same: which Column? This becomes more complex if you consider the fact that banks often possess DTAs in one jurisdiction and DTLs in another jurisdiction and may simultaneously need to contend with both of the foregoing variations to this problem. Furthermore, some clients will possess net GAAP DTLs in a particular jurisdiction that are less than the DTLs in that jurisdiction related to goodwill (or other regulatory adjustments),

in which case a more complex variety emerges (where part of the “dangling debit” might be described as DTA and part-something-else). If you would like to explore further, I am happy to help.

Regards,

John M. Taylor
Ernst & Young LLP | Financial Services Office | Tax Partner
Office: 602.322.3643 | Cell: 602.882.9582 | john.taylor1@ey.com
Assistant: Susan Renner | Office: 602.322.3395 | susan.renner@ey.com