



**Bank**

America's Most Convenient Bank®

October 22, 2012

Office of the Comptroller of the Currency  
250 E Street, Southwest  
Mail Stop 2-3,  
Washington, D.C. 20219

Jennifer J. Johnson, Secretary  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue, Northwest  
Washington, D.C. 20551

Robert E. Feldman, Executive Secretary  
Attention: Comments/Legal ESS  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, Northwest  
Washington, D.C. 20429

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum  
Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt  
Corrective Action, Docket ID OCC-2012-0008; Docket No. R-1442; RIN 3064-AD95 (the  
"Basel III NPR")

We appreciate the opportunity to respond to the Basel III NPR, which revises the risk-based and leverage capital requirements to be consistent with the agreements reached by the Basel Committee on Banking Supervision ("BCBS") in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" ("Basel III Rules Text").

TD Bank, America's Most Convenient Bank ("TD" or the "Bank"), is one of the 10 largest banks in the U.S., providing nearly 8 million customers with a full range of retail, small business, and commercial banking products and services at over 1,300 locations throughout the Northeast, Mid-Atlantic, Metro D.C., the Carolinas and Florida. TD is a member of TD Bank Group and a subsidiary of The Toronto-Dominion Bank of Toronto, Canada, a top 10 financial services company in North America.

### **Executive Summary**

This comment letter requests that the following modifications/clarifications be addressed in the final rules:

#### **I) Unrealized Gains and Losses on Certain Cash Flow Hedges**

The Bank respectfully requests that section 22(b)(1) of the final rules provide that unrealized gains and losses on cash flow hedges held by the Bank that give rise to "artificial volatility" in regulatory capital be excluded in the calculation of regulatory capital.

#### **II) Treatment of Unrealized Gains and Losses on AFS Debt Securities**

The Bank respectfully requests that, consistent with existing rules, Available for Sale ("AFS") debt securities continue to be filtered for regulatory capital purposes ("AOCI Filter for AFS Securities"). To the extent the AOCI Filter for AFS Securities is eliminated in the final rules, the Bank respectfully requests that section 22(b) be modified so that all unrealized gains and losses on AFS debt securities that are eligible for inclusion as assets in the proposed Basel III Liquidity Coverage Ratio test ("LCR") are excluded from regulatory capital.

### III) Adjustments Pertaining to Deferred Tax Assets ("DTA")

The Bank respectfully requests that the agencies' refine the following three aspects of the adjustments pertaining to DTAs (referenced in section 22(d)(1)(i) and section 22(e)).

- 1) In determining the amount that a bank can realize through Net Operating Loss ("NOL") carrybacks, the final rules should clarify that the relevant deferred taxes should be considered to reverse, in their entirety, as of the report date.
- 2) The final rules clarify that the DTA deduction calculation should exclude all DTAs and deferred tax liabilities ("DTL") related to unrealized gains and losses on cash flow hedges that are excluded from regulatory capital.
- 3) The final rules contain a simplifying assumption that allows state and local tax DTAs and DTLs to be aggregated in calculating the DTA deduction so that a blended tax rate can be applied to the timing difference that is calculated for federal tax purposes.

### Requested Modifications/Clarifications

#### I) Unrealized Gains and Losses on Certain Cash Flow Hedges

The Basel III NPR (Section 22(b)(1)) requires all unrealized gains and losses on cash flow hedges that relate to the hedging of items that are not recognized for accounting purposes at fair value on the balance sheet to be deducted from common equity tier 1 ("CET1"). We request that this section be modified as follows:

"Deduct any unrealized gain and add any unrealized loss on cash flow hedges included in accumulated other comprehensive income (AOCI), net of applicable taxes, that relate to the hedging of items that are not recognized at fair value on the balance sheet ~~give rise to artificial volatility in regulatory capital.~~"

Paragraph 72 of the Basel III Rules Text states that the cash flow hedge regulatory adjustment to CET1 is designed to "remove the element that gives rise to artificial volatility in common equity". While the Bank is in full agreement with this principle, it does not believe that derecognizing unrealized gains and losses on cash flow hedges related to the hedging of items that are not recognized at fair value on the balance sheet is always consistent with this principle.

The material in **Appendix A** illustrates that the Basel III NPR rule may in fact create the artificial volatility associated with cash flow hedges that the BCBS was seeking to avoid. At TD, "Receive Fixed, Pay Float" interest rate swaps ("**Receive Fixed Swaps**") are used to manage interest rate risk that can arise when stable, non-interest rate sensitive demand deposits are used to fund the floating interest rate securities held in the Bank's AFS securities investment portfolio. In order to qualify as a cash flow hedge relationship for accounting purposes, and thus avoid income statement earnings volatility, the Received Fixed Swaps must be assigned to the AFS floating interest rate security, rather than to the demand deposits. The Basel III NPR rule would include the unrealized gain or loss on the cash flow hedge in regulatory capital since the AFS security is not fair valued on the balance sheet. Artificial volatility in regulatory capital can result, since the value of the Receive Fixed Swap is highly sensitive to fluctuations in benchmark interest rates while the value of the AFS floating interest rate security is, by definition, not materially sensitive to such interest rate changes. Similar artificial volatility in regulatory capital can occur for banks that use floating interest rate debt to acquire fixed interest rate AFS securities and hedge the interest rate risk on the debt with a "Pay Fixed, Receive Float" interest rate swap. In this situation the debt is not fair valued for accounting purposes, therefore unrealized gains or losses on the hedge are not included in regulatory capital, whereas unrealized gains or losses on the AFS security are included, thus once again creating artificial volatility in CET1.

We believe that the issues described above should not be addressed by additional rules (e.g., deeming floating rate liabilities as being fair-valued, as proposed by Question #30 in the Basel III NPR). Since banks exercise different interest rate risk management practices, prescriptive rules, such as the one proposed in Question #30, would result in the elimination of capital volatility for



some bank practices but not for others, thus creating an unlevel competitive environment. Instead, we request that the principle espoused by the BCBS be reflected within the final rule, to ensure the regulatory intention is exercised in practice.

## **II) Treatment of Unrealized Gains and Losses on AFS Debt Securities**

The Basel III NPR requires Other Comprehensive Income ("OCI") related to unrealized gains and losses on securities to be included in regulatory capital without the accumulated other comprehensive income ("AOCI") filter (Section 20(b)(4) of Basel III NPR). This contrasts with the existing capital rules, under which these unrealized gains and losses on AFS debt securities are accounted for in AOCI but not taken into account for regulatory capital purposes.

The Bank believes that AFS debt securities should continue to be filtered for regulatory capital purposes (i.e., retain AOCI Filter for AFS Securities) for several reasons, as detailed in **Appendix B**. For example, the removal of the AOCI Filter for AFS Securities is not appropriate because a significant portion of the Bank's AFS debt securities are held for liquidity purposes and generally remain on the balance sheet until maturity. Removing the AOCI Filter for AFS Securities could thus create artificial changes in regulatory capital resulting from movements in interest rates. Further, if forced to push such AFS securities into the "Held-to-Maturity" accounting category, this would create significant liquidity management problems. In addition, the elimination of the AOCI Filter for AFS Securities can also create artificial volatility in regulatory capital when AFS debt securities are used to hedge liabilities that are recorded at amortized cost for accounting purposes. If the benchmark interest rates fluctuate, the change in value of the AFS debt securities will be reflected in regulatory capital but will not be materially offset by the items that are economically hedged by these securities.

**Appendix B** also addresses, in detail, the agencies' specific request for comments regarding the expected impact the removal of the AOCI Filter for AFS Securities would have on a bank's regulatory capital volatility, liquid asset levels, securities portfolio composition, and asset-liability management effectiveness (Question #15 in Basel III NPR). The removal of the AOCI Filter for AFS Securities is a significant concern to TD as it would result in excessive and undue volatility in the Bank's regulatory capital that could only be mitigated with solutions that would create either significant asset-liability or liquidity risk management challenges. Finally, **Appendix B** considers the pros and cons of permitting banks to exclude from regulatory capital (that is, retain the AOCI Filter for AFS Securities for) "unrealized gains and losses on debt securities whose changes in fair value are predominantly attributable to fluctuations in a benchmark interest rate (for example, U.S. government and agency obligations and U.S. GSE debt obligations)" (Question #16 in Basel III NPR). We strongly support and request that banks be permitted to exclude from regulatory capital unrealized gains and losses on debt securities whose changes in fair value are predominantly attributable to fluctuations in a benchmark interest rate and (assuming the AOCI Filter for AFS Securities is eliminated in the final rules) further request that the exclusion be extended to include all unrealized gains and losses on AFS debt securities that are eligible to be included as assets in the proposed Basel III LCR.

## **III) Adjustments Pertaining to DTAs**

The Bank requests that the following three aspects of the adjustments pertaining to DTAs be refined.

### **1) DTAs Considered to Reverse as of the Report Date**

The Basel III NPR permits the inclusion in regulatory capital of DTAs that could be realized through NOL carrybacks. To determine the amount that could be realized by NOL carrybacks, one must determine when the relevant deferred taxes reverse. Consistent with long-standing regulatory capital rules, we request the final rules clarify that the relevant deferred taxes should be considered to reverse, in their entirety, as of the report date ("**Report Date Reversal**").

In a financial stress scenario, banks typically realize sudden and large amounts of loan losses (often the major component of a bank's DTA). These losses typically give rise to NOL carrybacks, which in turn give rise to tax refunds, thus converting DTAs into cash. Because such DTAs are therefore loss absorbing, they should be included in capital. Further, the Report Date Reversal is



consistent with existing regulatory rules, in particular the Office of the Comptroller of the Currency rules (12 CFR 3 Appendix A)<sup>1</sup>, the Federal Deposit Insurance Corporation rules (12 CFR Part 325) and the Federal Reserve Board's Regulation Y (12 CFR Part 225). The rationale and merits for the Report Date Reversal have been considered in the past by the agencies and the reasons justifying its place in existing capital rules continue to be valid.

## **2) Double Counting of DTAs and DTLs Attributable to Cash Flow Hedges**

We request that the final rule make clear that a bank should adjust its balance sheet DTAs to reflect the removal of any DTAs attributable to unrealized losses on cash flow hedges. DTLs attributable to unrealized gains on cash flow hedges should similarly be removed.

Consistent with other adjustments to CET1 required by the Basel III NPR (e.g., goodwill and pension assets, etc.), the AOCI cash flow hedge regulatory adjustment in the Basel III NPR (Section 22(b)(1)) is made net of applicable tax effects. The material in **Appendix C**, however, illustrates that, unlike other adjustments, the accounting for AOCI cash flow hedges is unique, in that the tax benefit or cost associated with these hedges may be recorded, together with the pre-tax amount, thus presenting a net of tax figure in AOCI. This accounting is in contrast to that required for other adjustments, where the tax benefit or cost is recorded through the income statement and eventually resides in retained earnings, e.g., the balance of goodwill recorded on the balance sheet is the pre-tax, not the net of tax, amount. The result of this unique accounting can be the inappropriate double-counting of the DTA or DTL in the calculation of CET1.

## **3) State and Local Tax DTAs and DTLs**

Section 22(e)(3)(i) provides that "only the DTAs and DTLs that relate to taxes levied by the same taxation authority and that are eligible for offsetting by that authority may be offset for purposes of this deduction." This proposed rule appears to require that DTAs be netted by their proportionate allocation of DTLs, on a jurisdiction-by-jurisdiction basis. For banks operating in multiple states and cities, this requirement would pose a significant compliance burden, because, under existing practice, a large number of banks operating in multiple states and cities are permitted by their auditors to use simplifying assumptions in measuring state and local DTAs and DTLs. Under these assumptions, banks are permitted to apply a blended state and local tax rate to the federal tax timing differences for purposes of computing state and local tax DTAs and DTLs. These simplifying assumptions are also permitted under existing regulatory capital rules, where netting on a jurisdiction-by-jurisdiction basis is not required.

If these simplifying assumptions are not permitted, banks would be required to put new processes in place to perform state-by-state and city-by-city computations. Further, as illustrated in **Appendix D**, requiring detailed state-by-state and city-by-city computations may generate variations in the amount of DTAs and DTLs computed using the simplified approach permitted by auditors for financial statement purposes relative to the amounts that are computed using the state-by-state and city-by-city approach under the Basel III NPR. This raises questions about whether or not, and how, such variations must be taken into account in the computation of CET1.

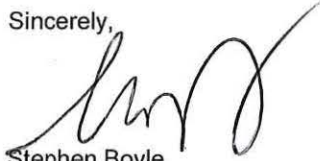
Thus, we respectfully request that the final rule permit banks to apply a blended state and local tax rate to the federal tax timing differences for purposes of computing state and local tax DTAs and DTLs. If the final rules do not permit banks to use this method, we request that the agencies explain how to treat the differences arising between the simplified approach used in financial reporting and the jurisdiction-by-jurisdiction approach suggested by the Basel III NPR.

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<sup>1</sup> In 1985, the Office of the Comptroller of the Currency ("OCC") issued Banking Circular 202 to limit the amount of DTAs that a bank could include in measuring regulatory capital. Under Banking Circular 202, which was replaced by the current OCC regulations, a bank was entitled to a Report Date Reversal and was permitted to include any DTAs that hypothetically could be carried back under the ten-year NOL carryback rule in place during that time period. Although the computation of DTA limitations evolved in 1995, with the issuance of the current OCC regulations, the Report Date Reversal remained in place and is articulated very clearly in the preamble to the OCC regulations. *See* 60 FR 7903 (February 10, 1995).

We thank you for taking our comments into consideration and for giving us the opportunity to share our views. Should you wish to discuss any of the above items in more detail, please feel free to contact either myself at (856) 874-2409 or [Stephen.J.Boyle@td.com](mailto:Stephen.J.Boyle@td.com) or Anand Borawake, our Head of Capital for the US bank at (856) 751-2727 or [Anand.Borawake@td.com](mailto:Anand.Borawake@td.com).

Sincerely,

A handwritten signature in black ink, appearing to read 'S. Boyle', with a stylized flourish at the end.

Stephen Boyle  
Chief Financial Officer  
TD Bank, America's Most Convenient Bank



## **Appendix A: Unrealized Gains and Losses on Certain Cash Flow Hedges**

While the Bank agrees with the BCBS's principle to remove elements that give rise to artificial volatility in common equity, it does not believe that derecognizing unrealized gains and losses on cash flow hedges related to the hedging of items that are not recognized at fair value on the balance sheet is always consistent with this principle.

### *Example 1*

Consider the case at TD where long-term, stable, non-interest rate sensitive demand deposits (e.g., non-interest bearing demand deposit account (DDA) balances) are used to fund the Bank's AFS securities investment portfolio. A well hedged portfolio would have fixed interest rate assets matched with fixed interest rate liabilities to avoid the income volatility that would result from a fixed interest rate/float interest rate mismatch. However, in reality, TD's investment portfolio typically comprises of numerous floating interest rate securities, which when funded by stable non-interest rate sensitive deposits, creates interest rate risk and earnings volatility if left unhedged. In order to eliminate this interest rate risk and earnings volatility, a Receive Fixed Swap is transacted and can be viewed as either:

- 1) transforming the fixed interest rate funding (the economic equivalent of stable fixed interest rate demand deposits), to floating interest rate funding; or
- 2) transforming the floating interest rate asset to a fixed interest rate asset.

Since hedge accounting principles prohibit assigning the Receive Fixed Swap to the demand deposits in a qualifying hedge accounting relationship, the Bank must assign the Receive Fixed Swap to the AFS floating interest rate security to establish a qualifying cash flow hedge accounting relationship. In the absence of this hedge accounting treatment, the Receive Fixed Swap is treated as a trading derivative for accounting purposes and results in the unrealized mark-to-market gains or losses being included in the income statement. Instead, the unrealized mark-to-market gains or losses on the Receive Fixed Swap are included in AOCI.

Since the AFS security is recognized for accounting purposes at fair value on the balance sheet, the Basel III NPR rule would include the unrealized gain or loss on the cash flow hedge in regulatory capital. However, the inclusion of this AOCI could introduce significant, one-sided regulatory capital volatility that arises due to a change in benchmark interest rates. Potential one-sided volatility can arise because, while the value of the Receive Fixed Swap is highly sensitive to fluctuations in benchmark interest rates, the value of the AFS floating interest rate security is not. Floating interest rate securities, by definition, do not exhibit material price sensitivity to changes in interest rates. From this perspective, as regards changes in interest rates, a floating interest rate security classified as AFS is no different than a floating interest rate loan recorded for accounting purposes at amortized cost. It should be noted that if the Receive Fixed Swap was used from an accounting perspective to hedge a floating interest rate loan (recorded for accounting purposes at amortized cost) instead of as a hedge of an AFS floating interest rate security, the Basel III NPR rule would not include the unrealized gains or losses on the cash flow hedge in regulatory capital and the capital volatility, described above, would not ensue from a change in benchmark interest rates. Thus, two situations that are equivalent from an economic hedge perspective have different impacts on capital, thereby highlighting, in our opinion, the need for the Basel III NPR rule to be enhanced.

Notwithstanding the potential volatility in capital, the Bank is economically hedged (i.e., it has a synthetic fixed interest rate asset - the AFS floating interest rate security combined with the Receive Fixed Swap - funded by a fixed interest rate liability) through the interest rate management strategy described above. For the reasons outlined above, this potential volatility may be viewed as

"artificial" and, in our opinion, is exactly the type of volatility the BCBS is seeking to avoid.

*Example 2*

Another example that illustrates how the proposed rule can give rise to artificial capital volatility is described in section III (B)(2) of the Supplementary Information section in the Basel III NPR. The example highlights a commonly used interest rate risk management practice where fixed interest rate securities in a bank's AFS investment portfolio are funded through the issuance of floating interest rate debt. In order to manage the interest rate risk of the AFS investment portfolio, the bank will hedge with a "Pay Fixed, Receive Float" interest rate swap ("**Pay Fixed Swap**") that is designated for accounting purposes in a cash flow hedge relationship with the floating interest rate debt. Since the floating interest rate debt is not fair valued for accounting purposes, the unrealized gains or losses on the cash flow hedge is not included in regulatory capital. The exclusion of these gains or losses from the computation of regulatory capital will introduce significant, one-sided, artificial capital volatility as the unrealized gains or losses on the cash flow hedge are meant to offset the unrealized gains or losses on the AFS investment portfolio.



## **Appendix B: Treatment of Unrealized Gains and Losses on AFS Debt Securities**

### *Reasons to Retain AOCI Filter for AFS Securities*

The Bank believes that AFS debt securities should continue to be filtered for regulatory capital purposes. The following reasons specifically address why the removal of the AOCI Filter for AFS Securities is not appropriate for the Bank:

1. A significant portion of the Bank's AFS debt securities are held for liquidity purposes and are expected to remain on balance sheet until maturity, i.e., the Bank did not enter into these positions with the intention to terminate them, nor would they plan to terminate them. As a result, recognizing unrealized gains in capital for these securities provides a capital benefit that is illusory. Conversely, recognizing unrealized losses in capital for these securities is overly punitive.
2. In many cases, the underlying economically hedged position of the Bank's AFS debt securities, such as preferred share equity or demand deposits, are recorded for accounting purposes at amortized cost. As a result, if benchmark interest rates fluctuate, the change in fair value of the hedging item (i.e., AFS debt securities) is recorded in OCI, thus creating "artificial" volatility in OCI (and by extension, in regulatory capital), since there will be no material offset for accounting purposes (in either the income statement or OCI) from the economically hedged items. The ensuing volatility in regulatory capital that can result from the reporting of valuation mismatches between hedging assets and hedged liabilities is, in our opinion, exactly the type of "artificial" volatility that the BCBS (per paragraph 72 of the Basel III Rules Text) is attempting to avoid.
3. The Bank has an Other-Than-Temporary Credit Impairment ("OTTI") process in place that is designed to capture changes due to credit deterioration in AFS debt securities. OTTI on AFS debt securities is recorded to the income statement for accounting purposes and so the retention of the AOCI Filter for AFS Securities will not exclude the impact of OTTI in the computation of regulatory capital.

We also note that during the finalization of the Basel III Rules Text, the BCBS acknowledged (footnote #10 in Basel III Rules Text) the need to continue to review the treatment of unrealized gains or losses, taking into account the evolution of the accounting framework and to make any changes as required. At the time (i.e., 2009/2010), the expectation was that new international accounting rules would value AFS debt securities at amortized cost on the balance sheet (i.e., resulting in no volatility in regulatory capital). Since then, the effective date of the new international accounting rules have been postponed (to beyond the start of Basel III implementation) and recent International Accounting Standards Board ("IASB") staff papers/comments have suggested that unrealized gains and losses on these securities will be measured at fair value through OCI, thereby potentially creating volatility in regulatory capital. Given the significant regulatory capital implications of this potential change in international accounting rules, we believe that it is prudent for all regulators (both U.S. and international) to revisit the treatment of AFS debt securities and we request that either the AOCI Filter for AFS Securities be retained or that, at the very least, all unrealized gains and losses on AFS debt securities that are eligible for inclusion in the proposed Basel III LCR as assets be excluded in the computation of regulatory capital.

### *Response to Question #15 in Basel III NPR*

The agencies have asked for comment regarding the expected impact the removal of the AOCI Filter for AFS Securities would have on a bank's regulatory capital volatility, liquid asset levels, securities portfolio composition, and asset-liability management effectiveness. The following illustrates the impact to TD:

The removal of the AOCI Filter for AFS Securities is a significant concern to TD as it would result in excessive and undue volatility in regulatory capital. Indeed, we estimate that based on our current AFS securities portfolio, a 100 bps instantaneous increase in interest rates would result in an approximately 70 bps negative impact to the Bank's Tier 1 capital ratio<sup>2</sup>. This level of volatility is

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<sup>2</sup> Assuming Risk Weighted Assets are calculated based on the current risk-based capital requirements (i.e., Basel I).



material and could not be addressed economically with a buffer. As a result, we would be left with three options, each involving either significant asset-liability or liquidity risk management challenges:

- (i) Purchase only float interest rate securities and expose the Bank to the income volatility (and resultant volatility in regulatory capital) that would result from the unhedged position of a non-interest rate sensitive deposit funding a float interest rate investment.
- (ii) Increase the use of interest rate swaps resulting in added complexity and potential ineffectiveness of hedges for accounting purposes, given limited capacity for purposes of hedge accounting rules.
- (iii) Increase the use of the "Held-to-Maturity" designation, which results in a loss of flexibility and, by extension, reduces the proportion of securities that can be used for liquidity risk management purposes.

Further, bank holdings of AFS debt securities may increase in the future, once the agencies announce their proposed rules for liquidity management, given the narrow scope of securities that are eligible to be included in the proposed liquidity ratios. Hence, the volatility in regulatory capital caused by the removal of the AOCI Filter for AFS Securities may be further amplified going forward.

*Response to Question #16 in Basel III NPR*

The Agencies have also asked for comment concerning the pros and cons of permitting banks to exclude from regulatory capital (that is, retain the AOCI Filter for AFS Securities for) "unrealized gains and losses on debt securities whose changes in fair value are predominantly attributable to fluctuations in a benchmark interest rate (for example, U.S. government and agency obligations and U.S. GSE debt obligations)". TD strongly supports permitting banks to exclude unrealized gains and losses on those securities from regulatory capital and (assuming the AOCI Filter for AFS Securities is eliminated in the final rules) further requests that the exclusion be extended to include a wider range of High Credit Quality ("HCQ") securities such as HCQ foreign sovereign debt. Specifically, the Bank requests that the term "HCQ" be defined to include all securities that are eligible to be included as assets in the proposed Basel III LCR. The Bank does not feel it is appropriate for the AOCI Filter for AFS Securities to be applied only to certain HCQ securities (e.g., U.S. government and agency securities) as it unjustifiably discriminates against holdings of other HCQ instruments. As such, we strongly encourage and request that the agencies apply the AOCI Filter for AFS Securities to all securities eligible to be included as assets in the proposed Basel III LCR and not just to U.S. government/agency securities and sovereign debt obligations that would qualify for a zero risk-weight under the proposed standardized approach.

**Appendix C: Double Counting of DTAs and DTLs Attributable to Cash Flow Hedges - Examples**

US GAAP generally requires banks to account for unrealized gains and losses on cash flow hedges on a net-of-tax basis. For example, assuming a 40% tax rate, and a \$100 loss on a cash flow hedge, a bank would record the following journal entry:

Dr. AOCI	\$60	
Dr. DTA (B/S)	\$40	
Cr. Cash flow hedge liability (B/S)		\$100

Thus, in the case of the above journal entry, a bank would suffer a \$60 reduction in book equity as a result of its \$100 unrealized loss. However, because this unrealized loss is largely a temporary condition that self-cures as a hedge position nears maturity (e.g., a fixed-for-floating interest rate swap contract), the reduction to book equity may be viewed as somewhat artificial to the extent a bank holds the cash flow hedge to maturity. For this reason, Regulation Y requires that loss to be added back, effectively neutralizing the mark-to-market accounting required under US GAAP.

The existing regulations, however, do not specify whether a bank or a bank holding company must adjust its balance sheet DTAs for cash flow hedge amounts. The form instructions for FR Y-9c or FFIEC 031 also do not address this issue. However, we have been informed that the federal agencies have advised other U.S. banks that they may choose whether or not to eliminate the DTAs and DTLs related to cash flow hedge items prior to performing the limitation testing on DTAs as long as such choice is made consistently in future periods. Thus, in the foregoing example, a bank would reduce its balance sheet DTA by \$40 prior to measuring any limitations on DTAs. Otherwise, a bank could end up effectively subtracting the same DTA twice.

Other rules in the Basel III NPR support the principle that deferred tax items should not be double-counted. Section 22(e)(1) explains that "[a] DTL can only be netted against a single asset." This rule implies that if a DTL has been netted against an unrealized gain (as in the example below), that DTL cannot also reduce the bank's DTAs subject to any of the DTA limitations. However, there is no similar rule that applies to DTAs. Consequently, if a bank has unrealized losses on cash flow hedges, the bank may be required to effectively subtract the same DTA twice, as illustrated in Example 1, below.

*Example 1*

At December 31, 2012, a bank holding company ("BHC") marks-to-market its cash flow hedge and records a \$100 pre-tax unrealized loss, resulting in a debit to AOCI of \$60 and a debit to DTAs of \$40 (assuming a 40% tax rate). At the end of the year, BHC's total equity, including AOCI, is \$940 (\$1,000 excluding AOCI) and its total DTAs, including the DTA related to cash flow hedges, is \$140. Under the existing version of Regulation Y, BHC computes Tier 1 capital starting with book equity of \$940, then adds back the \$60 loss (which is already presented net of \$40 of tax) in AOCI attributable to its mark-to-market adjustment on cash flow hedges. As a result, prior to computing any DTA limitation, BHC's Tier 1 capital is \$1,000. Further assume that BHC cannot hypothetically carryback any of its DTAs. If BHC does not adjust its balance sheet DTA to remove the tax benefit related to the unrealized loss on cash flow hedges, then it will suffer a \$40 subtraction from Tier 1 capital for its excess DTAs [\$140 DTA - \$100 (being (\$1,000 Tier 1 capital before adjustments for DTAs x 10% threshold deduction percentage))]. This would reduce Tier 1 capital from \$1,000 down to \$960, effectively resulting in a double deduction of the same tax benefit amount.

Book Equity	\$ 940
Add: pre-tax unrealized loss	+ 100
Subtract: tax benefit recorded to AOCI	< 40>
Subtract: excess DTA	< 40>
Tier 1 capital	<u>\$ 960</u>



If a pre-tax amount of AOCI was added back (i.e., \$100), the DTA associated with the unrealized loss (i.e., \$40) would be eliminated by way of the excess DTA computation, thus resulting in \$1,000 of Tier 1 capital (which is the correct end result). However, by adding back a net-of-tax AOCI amount (i.e., \$60), and subjecting DTAs to limitation, the DTA of \$40 is effectively subtracted twice (once because it is not added to capital and once as an excess DTA deduction).

As the foregoing example demonstrates, it is essential that a bank adjust its balance sheet DTAs to reflect the removal of any DTAs attributable to unrealized losses on cash flow hedges in order to avoid a double deduction of such DTAs. Similarly, in the case of an unrealized gain, it is essential that a bank reduce its balance sheet DTLs to avoid an unwarranted benefit, as shown in the example below.

*Example 2*

Assume the same facts as Example 1, except that BHC has an unrealized pre-tax gain of \$100 (\$60 net of tax) on its cash flow hedge position (instead of an unrealized loss of \$100) and instead of \$100 of DTAs, BHC's DTAs are \$140 and its DTAs, net of DTLs of \$40 related to the unrealized gain on cash flow hedges, is \$100. The following tables illustrate the results on BHC's Tier 1 capital depending on whether it chooses to adjust its balance sheet DTLs to reflect the elimination of the deferred tax effects of the unrealized gain.

		Without Adjustment	With
<u>Adjustment</u>			
Book Equity		\$1,060	\$1,060
Subtract: pre-tax unrealized gain		< 100>	<
100>			
Add: tax benefit recorded to AOCI	+ 40	+ 40	
Subtotal	1,000	1,000	
DTA balance		100	140
10% Limitation (\$1,000 x 10%)		< 100>	≤
100>			
Subtract: excess DTA		0	40
Tier 1 capital		<u>\$1,000</u>	<u>\$ 960</u>

In this fact pattern, BHC's DTLs related to the unrealized gain on the cash flow hedge are able to shield \$40 of BHC's DTAs from the limitation that would otherwise apply. Therefore, if BHC is not required to remove the DTL associated with cash flow hedges, BHC will obtain a double benefit for the DTL – once by way of the AOCI adjustment and again by way of shielding DTAs from limitation.

## Appendix D: State and Local Tax DTAs and DTLs - Examples

### Example 1

BHC and its 100% owned subsidiary ("Subsidiary") join in the filing of a consolidated federal tax return. BHC has federal deductible temporary differences of \$100. Subsidiary has federal taxable temporary differences of \$80. Thus, for financial reporting purposes, BHC and Subsidiary together have a net federal DTA of \$7 (\$20 x 35% tax rate).

Additionally, BHC and Subsidiary operate in two states, State A and State B. In State A, Subsidiary is required to file a separate return from BHC. In State B, BHC and Subsidiary file a consolidated return. State A has a tax rate of 4% and State B has a tax rate of 6%. In the past two years, approximately 50% of BHC's federal taxable income was apportioned to State A and approximately 50% of to State B. This would suggest a blended rate of approximately 5%. However, because of state-level adjustments to federal taxable income, e.g., municipal bond interest and depreciation, the total taxes paid in State A and State B divided by federal taxable income has yielded a blended state rate of approximately 6%, computed as follows:

	<u>Total</u>	<u>State A</u>
<u>State B</u>		
Federal taxable income		\$ 50
\$ 100		
State addbacks		<u>10</u>
<u>20</u>		
State taxable income		\$ 60
\$ 120		
Apportionment percentage	<u>100%</u>	<u>50%</u>
Apportioned state taxable income	\$ 60	\$ 60
State tax rate		<u>4%</u>
<u>6%</u>		
Current state tax expense	\$ 6.00	\$ 2.40
		\$ 3.60

BHC reached an agreement with its external financial statement auditor that for purposes of computing current and deferred state tax expense, BHC may assume a blended rate of 6% and ignore any variation in the composition of temporary differences between the state and federal jurisdictions. As a result, BHC and Subsidiary have a consolidated state DTA of \$1.20 (\$20 x 6%).

Further, as shown in Example 2 below, a detailed, state-by-state computation will likely generate variations in the amount of DTAs and DTLs rendered using a simplified approach, raising questions about whether or not that variation in amount must be taken into account in determining the DTA adjustment to CET1.

### Example 2

Assume the same facts as Example 1, except that BHC determines its state tax DTAs and DTLs on an entity-by-entity, state-by-state basis, as follows:

	<u>State A</u>	<u>State B</u>
<u>Total</u>		
BHC timing differences	N/A	\$ 150
Subsidiary timing differences	<u>&lt; 40&gt;</u>	<u>&lt; 40&gt;</u>



Total timing differences for state	\$ < 40 >	\$ 110
State apportionment percentage (A)	100%	50%
Statutory rate (B)	4%	6%
Effective state tax rate (C) = (A) x (B)	<u>4%</u>	<u>3%</u>
DTA/<DTL>	\$ < 1.60 >	\$ 3.30
DTA per example 1		\$ 1.70
<u>1.20</u>		
Differential		
	\$ < 0.50 >	

By performing this analysis, BHC discovers its combined DTAs computed with the simplified approach, permitted by its auditors for financial reporting purposes, are \$0.50 less than the amount determined using the detailed state-by-state and entity-by-entity approach that the Basel III NPR seems to require. There are numerous reasons for this differential arising, including the fact that the state-by-state analysis does not permit the offsetting of DTLs in State A against the DTAs in State B, a result which may occur using a simplified approach. However, given that the overall state DTA would be \$0.50 larger than the amount recorded for financial statement purposes (which is the starting point for measuring regulatory capital), it is not clear how BHC should treat this amount under the Basel III NPR. Perhaps BHC should be entitled to reduce its State B DTA by the full amount of the net \$0.50 differential, resulting in a state DTA of \$2.80 (\$3.30 - \$0.50). The analysis and issues outlined above are equally applicable in the context of local taxes.

Ultimately, should the Basel III NPR impose a higher standard in terms of computing DTAs and DTLs than is required for financial statement purposes, the latter of which embraces the concept of the materiality, which concept seeks to balance perfection with the tangible impact to a financial statement user? Would the additional work effort required to produce such granular level of data create a bank holding company that is a significantly better source of strength or provide noticeably better protection for deposit holders? We believe the response to both these questions to be 'no'.