January 16, 2024

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

James P. Sheesley
Assistant Executive Secretary
Attention: Comments/Legal OES (RIN 3064-AF29)
Federal Deposit Insurance Corporation
550 17th St. NW
Washington, DC 20429

Chief Counsel's Office
Attention: Comment Processing
Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, DC 20219

Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity (OCC Docket ID OCC–2023–0008; Federal Reserve Docket No. R–1813, RIN 7100–AG64; FDIC RIN 3064–AF29)

Dear Sirs and Madams:

Synchrony Financial, Discover Financial Services, and Capital One Financial Corporation (collectively, the "Banks" or "we") appreciate the opportunity to comment on the notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (the "Agencies") to amend the U.S. Basel III capital rules on July 27, 2023 (the "Proposal")[1]. We are a coalition of financial institutions writing to recommend that the Agencies retain the deduction threshold for temporary difference deferred tax assets ("DTAs") at 25 percent.

We are leading providers of credit to consumers in the United States. Collectively, we provide consumers with a broad range of financial products, including credit cards, short- and long-term installment loans, retail banking, and other consumer banking products. Our coalition includes some of the smallest institutions that would be subject to the Proposal's changes to the regulatory capital framework.

We urge the agencies not to lower for Category III and IV institutions the 25 percent threshold for the deduction of temporary difference DTAs that applies under the existing capital rules. The 25 percent deduction framework was adopted in the Agencies' 2019 Capital Simplification Rule[2], a product of the Agencies' multi-year review to simplify the capital framework. Many of the factors cited in the Capital Simplification Rule remain true and valid (in fact, more relevant since 2019), and the Proposal did not offer any explanation as to why the 25

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1 Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, 88 Fed. Reg. 64028 (Sept. 18, 2023).

2 Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, 84 Fed. Reg. 35234, 35234 (July 22, 2019).

percent threshold is no longer appropriate. In addition, maintaining the 25 percent deduction threshold would help ensure that the final rule is appropriately tailored as required by S. 2155 because the final rule would distinguish between Category III and IV institutions, on the one hand, and the largest and most complex banking organizations subject to the more rigid 10 percent deduction threshold, on the other. As further discussed below, maintaining the 25 percent deduction threshold would (i) help mitigate the impact from CECL adoption, (ii) be consistent with historical experience that DTAs are highly realizable, and (iii) mitigate procyclical effects.

If the agencies do not maintain the 25 percent deduction threshold for Category III and IV institutions, the agencies should at least increase the individual and aggregate deduction thresholds to 15%/20% respectively to account for the CECL impact. Alternatively, the agencies could allow an exception to a lower deduction threshold for a special subset of temporary difference DTAs known as "Allowance for Credit Losses" or "ACL" DTAs, which have significantly increased since the agencies originally calibrated the deduction threshold as a result of changes to accounting standards.[3]

In addition to adopting our recommendations regarding the deduction threshold, the agencies should allow for banks in their stress tests to assume that a two-year Federal net operating loss ("NOL") carryback will be available to offset temporary difference DTAs.

Below we provide background on temporary difference DTAs and discuss the reasons the agencies should adopt the recommendations described above.

I. Background on Temporary Difference DTAs and Their Regulatory Capital Treatment

Temporary difference DTAs arise when there are differences regarding the timing of when a bank recognizes an expense or loss for accounting purposes and when it recognizes the expense or loss for tax purposes, and the difference will be recognized or eliminated over time. There are different types of temporary difference DTAs, but one major source of temporary difference DTAs for financial institutions that do a significant amount of consumer lending is the allowance for credit losses, which has generally grown under the recent current expected credit losses ("CECL") accounting standard. These temporary difference DTAs are known as "ACL DTAs." Banks that make credit card loans recognize especially high levels of ACL DTAs because these loans have no defined maturity and are unsecured. Another source of temporary difference DTAs is unrealized losses on available-for-sale debt securities.

U.S. Generally Accepted Accounting Principles ("GAAP") only allows the recognition of a temporary difference DTA if the DTA is "more-likely-than-not" to be realizable. Specifically, ASC 740 requires that in each reported period, a bank evaluate all positive and negative evidence, including the prospect of future taxable income, and charge off to equity via a valuation allowance any DTAs that are *not* "more-likely-than-not" to be realized. An institution's temporary difference DTA on its balance sheet, both in baseline and in stress scenarios, reflects this GAAP

[3] Provision for credit losses is the expense related to maintaining the allowance for credit losses at an appropriate level to absorb the expected credit losses for the life of the loan balance.

assessment and conclusion that it is already "more-likely-than-not" realizable and that such DTAs are valuable.

Under the existing regulatory capital rules, a non-advanced approaches institution must deduct from its common equity Tier 1 capital the amount of temporary difference DTAs that exceeds 25 percent of the institution's common equity Tier 1 capital. The amount of temporary difference DTAs that is not deducted from the institution's capital is included in the institution's risk-weighted assets, with a 250 percent risk weight. Advanced approaches institutions are subject to similar requirements, but with a much lower deduction threshold of 10 percent.

II. Reasons Why the 25 Percent Deduction Threshold Should Be Maintained

The 25 percent deduction threshold that currently applies to non-advanced approaches banking organizations is already too conservative, and the agencies should not lower that threshold. This is the case for several reasons.

A. The 25 Percent Threshold Was Calibrated Prior to CECL

First, the agencies set the 25 percent deduction threshold for non-advanced approaches banking organizations and the 10 percent deduction threshold for advanced approaches banking organizations several years before events significantly increased the amount of temporary difference DTAs that banks have been forced to recognize. Most notably, as a result of the adoption of the CECL accounting framework, banking organizations have higher allowances for credit losses. Higher allowances for credit losses, in turn, increase temporary difference DTAs. Unrealized losses on available-for-sale debt securities also increase temporary difference DTAs. The current macroeconomic environment has led to significant unrealized losses, and therefore, many banks have had a significant increase in the amount of temporary difference DTAs with little to no increase to risk from those DTAs.

Thus, due to changes in accounting standards, banking organizations currently have significantly higher DTAs than when the agencies calibrated the deduction thresholds in the existing capital rules. As a consequence, the deduction thresholds are far more binding in today's world than we believe the agencies ever intended.

B. Temporary Difference DTAs are Highly Realizable

Second, the existing capital rules require banking organizations to deduct temporary difference DTAs exceeding the relevant threshold from their capital based on a false premise: that banks are unlikely to be able to realize temporary difference DTAs. The agencies have stated:

> Temporary difference DTAs are assets from which banking organizations may not be able to realize value, especially under adverse financial conditions. A banking organization's ability to realize its temporary difference DTAs is dependent on future taxable income; thus, the revised deduction threshold, together with a 250 percent risk weight for non-deducted temporary difference DTAs, will continue to protect banking organization

> capital against the possibility that the banking organization would need to establish or increase valuation allowances for DTAs during periods of financial stress.[4]

Importantly, however, banks ***are*** able to realize temporary difference DTAs over time, and often on an immediate basis during periods of stress as well. As the agencies have recognized, a bank will realize ACL DTAs over time by recognizing interest and fees (and the resulting taxable income) on the loans, including when borrowers repay their loans, which most borrowers do. Moreover, the capital rules are largely premised upon banking organizations as going concerns, not failed entities,[5] and therefore the agencies' concern that future taxable income would not exist against which DTAs could be used or realized should not be a driving consideration, particularly with respect to DTAs arising from timing differences.

In addition, DTAs on an institution's balance sheet are already subject to a "more-likely-than-not" to be realized valuation standard under U.S. GAAP. Experience has shown that valuation allowances have been established with appropriate conservatism such that DTAs are valuable assets that should be capable of being included in regulatory capital. We therefore submit that further limiting the recognition of DTAs in regulatory capital is unwarranted and overly punitive.

A bank can also realize temporary difference DTAs on an immediate basis by offsetting them with the amount of taxes previously paid that an institution can recover through NOL carrybacks.[6] The U.S. Congress generally eliminated NOL carrybacks in 2017.[7] But Congress frequently reinstates NOL carrybacks during stress scenarios in order to stimulate the economy, avoid a reduction in the banking sector's ability to provide credit to consumers, and thus stave off a recession. Congress has consistently done so during economic downturns, even in times of divided government. Examples include the following:

- **The COVID-19 pandemic.** In response to the COVID-19 pandemic, Congress enacted the CARES Act, which, among other things, allowed firms to carry back losses in tax years covering 2018, 2019, and 2020 for up to five years and provided that NOL carrybacks could offset 100 percent of taxable income (*i.e.*, rather than 80 percent).[8]

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4 84 Fed. Reg. 35,234, 35,239 (July 22, 2019).

5 82 Fed. Reg. 8,266, 8,267 (Jan. 24, 2017) (Federal Reserve stating that "regulatory capital requirements are intended to ensure that a banking organization has sufficient capital to remain a going concern"); Basel Committee on Banking Supervision, Basel III Definition of Capital, Definition of Eligible Capital, available at https://www.bis.org/basel_framework/chapter/CAP/10.htm?inforce=20191215&published=20200605 (June 5, 2020) (describing Tier 1 capital – the dominant form of capital and the type of capital from which temporary difference DTAs are applied – as "going-concern" capital).

6 When temporary difference DTAs can be realized through NOL carrybacks, the capital rules do not require such DTAs to be deducted from capital. *See* 12 C.F.R. 217.22(d)(1); 12 C.F.R. 324.22(d)(1); 12 C.F.R. 3.22(d)(1).

7 *See* Tax Cut and Jobs Act, Pub. L. No. 115-97 (Dec. 22, 2017).

8 *See* CARES Act, Pub. L. No. 116-136, 134 Stat. 281 (Mar. 27, 2020).

- **The 2008-09 financial crisis.** In 2009, Congress created a temporary extension to the NOL carryback rule. This extension allowed taxpayers to elect to carry back certain losses occurring in 2008 and 2009 for three, four, or five years, rather than the two-year period that generally applied at the time.[9]

- **The 2001 Dot-com crash and 9/11.** Similarly, in 2002, in response to recessionary conditions, Congress extended the NOL carryback period to five years.[10]

And importantly, as described above, accounting rules only allow the recognition of a temporary difference DTA in the first place if the DTA is "more-likely-than-not" to be realizable.

Thus, temporary difference DTAs – especially ACL DTAs – are highly realizable, including in times of stress.

C. Deductions of Temporary Difference DTAs Have Pro-Cyclical Effects

Third, the requirement to deduct additional temporary difference DTAs from capital would have unnecessarily pro-cyclical impacts on institutions' capital, which could lead institutions subject to these additional deductions to scale back their lending to avoid threatening their safety and soundness. These impacts are particularly large for banking organizations with significant consumer financing and credit card businesses, and the capital strain caused by the proposed changes could reduce their ability to provide credit, especially during periods of stress.

Temporary difference DTAs typically increase when a banking organization recognizes significant loan loss provision expenses, which can occur during stressed conditions. Those conditions that result in significant increases in loan loss reserves also may create stress on capital levels. Due to the unduly restrictive deduction thresholds, downward pressure on capital while temporary difference DTAs are increasing would reduce the amount of such DTAs that can be included in capital. This procyclicality arises not only in an actual downturn, but impacts capital levels at institutions during normal economic times through application of stress scenarios in the Federal Reserve's stress testing and capital planning processes.

III. Conclusion

For the foregoing reasons, when finalizing the Proposal, the Agencies should make the following changes to the framework for calculating capital:

- Maintain the 25 percent deduction threshold that applies to Category III and IV institutions – or, at the very least, increase the proposed individual and aggregate thresholds to 15%/20% to account for CECL adoption or allow an exception for ACL DTAs; and

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9 *See* Worker, Homeownership, and Business Assistance Act of 2009, P.L. 111-92 (Nov. 6, 2009).

10 *See* Job Creation and Worker Assistance Act of 2002, Pub. L. 107-147 (Mar. 9, 2002).

- Allow for banks in their stress tests to assume that a NOL carryback will be available to offset temporary difference DTAs, as it has been in every significant economic downturn of the last 20 years.

These changes will improve the risk sensitivity of the final rule and ensure that the regulatory capital framework is appropriately tailored as required by law.

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We thank the agencies for considering the recommendations set forth in this letter. If you have any questions, you can contact our individual firms using the contact information provided below.

Respectfully Submitted,

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