

June 22, 2004

Financial Services Agency

**Report of the Second Sub-Committee of the Financial System Council regarding  
Regulatory Treatment of Deferred Tax Assets in Calculating Capital Adequacy  
Ratios and Other Issues related to Capital Adequacy of Banks  
(Outline)  
[Provisional Translation]**

In the “Program for Financial Revival,” it was stated that the issue on proper regulatory treatment of deferred tax assets (DTAs) in calculating capital adequacy ratios (CARs) should be examined promptly in the Financial System Council.

Against this background, fifteen meetings of the Working Group on Regulation of Capital Adequacy Ratio (WG) under the Council were held since February 2003. A progress report was published in July, 2003.

The attachment is the outline of the final report of the WG.

(Attachment)

## **Outline of “Regulatory treatment of deferred tax assets in calculating capital adequacy ratios and other issues related to capital adequacy of banks”**

**June, 2004**

### **1. Summary of the progress report**

In the progress report, there was a broad agreement on the vulnerability of deferred tax assets (DTAs) for the reasons that their characteristic as an asset depends on future taxable income and that they will become valueless when banks fail. There was also a broad agreement that the ratio of DTAs to capital should be lowered in the future.

The progress report requested the implementation of effective measures to enhance disclosure concerning DTAs. (The disclosure has been enhanced since September 2003.)

### **2. Basic thoughts on the regulatory treatment of DTAs**

#### **(1) DTAs’ characteristic as an asset and protection of depositors**

From the viewpoint of protection of depositors, among others, the supervisory authority should make utmost efforts to ensure the soundness of banks by setting supervisory standards that could be different from accounting standards.

Based upon the current situation of Japanese major banks, whose ratios of DTAs to their regulatory capitals are considerably high, the vulnerability of DTAs, which will become valueless when banks fail, cannot be ignored.

Therefore, it is appropriate for the authority to require banks to reduce DTAs by applying a supervisory standard that is different from an accounting standard.

#### **(2) Business conditions of banks and the vulnerability of DTAs**

Since DTAs’ characteristic as an asset depends on future taxable income, rigorous treatment of DTAs when booking is critical.

From the viewpoint of protection of depositors, the vulnerability of DTAs matters more seriously for those banks whose business conditions are worsening, as the risk of DTAs’ becoming valueless is higher for those banks.

(3) Vulnerability (instability) of DTAs and effectiveness of supervisory measures

It is pointed out that, when a bank has a high ratio of DTAs to regulatory capital, capital adequacy ratio (CAR) will not serve well as a trigger of prompt corrective actions (PCAs).

If so, it is worth considering to modify the regulatory treatment of DTAs in calculating CARs so that they can serve well as triggers for PCAs.

(4) Necessity of modifying the regulatory treatment of DTAs in calculating CARs

With the points raised above, there was a broad support for the idea that, as the vulnerability of DTAs cannot be ignored from the viewpoint of protection of depositors and as it is important to make CARs serve well as triggers of PCAs, proper regulatory treatment of DTAs in calculating CARs should be introduced.

This does not preclude the authority's taking early warning measures to urge banks to improve their businesses before PCAs kick in.

**3. Points to be considered in modifying the regulatory treatment of DTAs in calculating CARs**

(1) Impact on financial system and consistency with macroeconomic policy

Modification of the regulatory treatment of DTAs in calculating CARs should be consistent with the original purpose of the regulation, which is to require banks to take actions to improve their businesses, the government's policy to ensure the stability of financial system, and the government's objective of macroeconomic policy, which is to overcome deflation.

(2) Consistency with the objective of disposal of Non Performing Loans (NPLs)

The Japanese major banks are currently trying to improve their soundness through achieving the objective to halve the ratio of NPLs by end-March, 2005.

In view of the consistency with this objective, the regulatory treatment of DTAs should be modified after the major banks achieve this objective. In addition, the consistency with the macroeconomic policy objective mentioned above should be also taken into account.

### (3) Relation with tax system

DTAs are accumulated due to the difference between corporate accounting and tax accounting. A major cause of the accumulation of DTAs is that write-offs and provisions tended to be recognized as losses only in later years due to the limited scope for tax-deductible write-offs and provisions.

When comparing with other countries where write-offs and provisions are more widely treated as tax-deductible, it is natural that the scale of DTAs is larger in Japan.

The major cause of DTAs above (the difference of tax systems) should be fully taken into account in modifying the regulatory treatment of DTAs.

## **4. Double-Gearing**

With regard to the issue of double-gearing between banks and insurance companies, there was a broad agreement that additional regulations are not needed because investments in insurance subsidiaries and affiliates are already treated to be deducted from regulatory capital in accordance with the discussions on Basel II.

## **5. Conclusions**

This report presents basic thoughts on the regulatory treatment of DTAs.

As for the concrete measures regarding the regulatory treatment of DTAs in calculating CARs, the supervisory authority should further examine and make a decision based upon this report.