Evaluation of Accounting-Related Proposals in the Financial CHOICE Act

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Introduction

Passed in the wake of the financial crisis of 2007-2009, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) imposed many new regulations on insured depository institutions, bank holding companies, and certain nonbank financial institutions (hereafter referred to as banks, except where necessary to distinguish the different types of institutions). Republicans believe that Dodd-Frank, along with extensive preexisting regulations, saddles banks with an onerous and inefficient regulatory burden, and that this burden contributed to the relatively slow recovery of the economy from the recent financial crisis. They proposed the Financial CHOICE Act, which if adopted would eliminate much of this burden.

In this section, we explain how various proposals in the CHOICE Act depend on, provide incentives regarding, or influence the usefulness of banks' accounting numbers. Many of the effects of these proposals on banks' accounting numbers would flow through to banks' leverage and risk-based regulatory capital ratios, an important issue that the Act does not acknowledge or address. We evaluate the Act's proposals in the context of these accounting-related effects. The specific proposals we consider pertain to: (1) the use of a leverage ratio threshold to determine whether banks qualify for the Dodd-Frank "off-ramp;" (2) the interaction of securitization risk-retention requirements with on- versus off-balance sheet accounting treatment for securitizations and thus with the leverage ratio; (3) short-form regulatory call reports; and

(4) Congressional oversight of and restrictions on the Public Company Accounting Oversight Board (PCAOB).

The Leverage Ratio Threshold for the Dodd-Frank Off-Ramp

Background

A number of Dodd-Frank's regulations target very large bank holding companies (those with assets exceeding $50 billion or $10 billion, depending on the regulation) and similarly systematically risky nonbank financial institutions. These regulations aim to reduce the systemic risks that large banks impose on the financial system. These risks arise in part from the incentives of bank regulators to deem these institutions "too-big-to-fail," particularly during periods of high economic uncertainty. Title I of Dodd-Frank subjects (or allows the Board of Governors of the Federal Reserve to subject) these large banks to more stringent prudential standards, including risk-based capital and liquidity requirements, leverage and short-term debt limits, contingent capital requirements, credit exposure concentration limits and reporting requirements, periodic stress tests, requirements to plan for rapid and orderly resolution of the institution in the event of financial distress or failure, requirements to establish risk committees, and enhanced public disclosure requirements.[170]

Dodd-Frank also creates many new regulations for all banks. Compliance with these new regulations requires banks to incur sizable and partly fixed costs, which are particularly onerous for small and medium-sized community banks. A recent survey of over 200 community banks (defined as banks with assets less than $10 billion) reports that Dodd-Frank's creation of the Consumer Financial Protection Bureau (Title X) and mortgage regulations (Title XIV) are of greatest concern to these banks.

[170] Dodd-Frank, Title I, Section 165(b)-(e), (g), (h), (i), and (j).

The CHOICE Act Proposal

Any bank that qualifies based on criteria specified in Title I, Section 101 of the Act could elect the off-ramp, exempting the bank from certain of Dodd-Frank's and other regulations. Section 101 indicates that, to qualify for the off-ramp, banks must maintain average leverage ratios—defined as tangible equity divided by total assets (excluding any assets deducted from tier 1 capital) calculated in accordance with Generally Accepted Accounting Principles (GAAP)—of at least 10%.[171] This percentage is approximately double the current leverage ratio at which a bank is deemed well capitalized. Banks must also receive composite CAMELS ratings of 1 or 2.[172]

The CHOICE Act specifies that qualifying banks that elect the off-ramp would be exempt from the stringent prudential regulation in Dodd-Frank Title I described above. These banks would also be immune to regulatory objections to capital distributions and proposed mergers and acquisitions on grounds that these actions might compromise the stability of the U.S. financial system.[173]

Evaluation of the CHOICE Act Proposal

The Act would make the off-ramp available to all qualifying banks. As suggested in the comprehensive summary of the Act, however,

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[171] The CHOICE Act, Title I, Section 105(5) and (6).
[172] CAMELS ratings are supervisory ratings of banks' overall condition. CAMELS stands for capital adequacy, assets, management capability, earnings, liquidity, and sensitivity to market risk. A CAMELS rating of 1 (2) indicates strong (satisfactory) performance and risk management and thus minimal supervisory concern.
[173] The CHOICE Act, Title I, Section 102(a)-(d).

such regulatory relief is most necessary for community banks.[174] Inconsistent with this fact, the most onerous regulations from which qualifying banks would be exempted apply mostly or entirely to very large banks. For example, community banks are not subject to the more stringent prudential regulation in Dodd-Frank Title I, Section 165 described above, and they infrequently acquire other banks. In contrast, the off-ramp does not eliminate Dodd-Frank's creation of the Consumer Financial Protection Bureau (Title X) and mortgage regulations (Title XIV) that community banks find most onerous.

A large body of empirical research demonstrates that banks exercise discretion over accounting numbers, usually within the bounds of GAAP, to manage their regulatory capital ratios.[175] The reliance on accounting numbers to measure the leverage ratio would yield incentives for banks to exercise discretion over these numbers to increase the leverage ratio to qualify for the off-ramp. Most of these avenues for accounting discretion have similar effects of risk-based capital ratios. For example, banks could increase regulatory capital by delaying loan loss provisions or realizing gains on available-for-sale securities, or they could smooth regulatory capital by accelerating loan loss provisions in boom periods.[176]

[174] For example, the second bullet on page 2 of the comprehensive summary of the Act states "Dodd-Frank's particular brand of regulatory complexity and government micromanagement has made basic financial services less accessible to small businesses and lower-income Americans, by saddling America's small and medium-sized community financial institutions with a crushing regulatory burden."

[175] For summaries of this research, see Stephen Ryan, 2011, Financial Reporting for Financial Instruments, *Foundations and Trends in Accounting*; Anne Beatty and Scott Liao, 2014, Financial Accounting in the Banking Industry: A Review of the Empirical Literature, *Journal of Accounting and Economics*; Viral Acharya and Stephen Ryan, 2016, Banks' Financial Reporting and Financial System Stability, *Journal of Accounting Research*.

[176] Chi-Chun Liu and Stephen Ryan, 2016, Income Smoothing over the Business Cycle: Changes in Banks' Coordinated Management of Provisions for Loan Losses and Loan Charge-Offs from the Pre-1990 Bust to the 1990 Boom, *The Accounting Review*.

Other avenues have considerably stronger effects on the leverage ratio than on risk-based capital ratios. Most importantly, securitization and other transactions that keep economic leverage off-balance sheet typically reduce the leverage ratio far more than risk-based capital ratios, because risk-based capital rules require banks to hold capital against most types of off-balance sheet positions.

Post-financial crisis changes in accounting rules (discussed below) made off-balance sheet treatment somewhat more difficult to attain. Even so, empirical research finds that securitizations of most types of financial assets—including subprime and other types of residential mortgages, perceived culprits in the genesis of the financial crisis—continue to remain almost entirely off-balance-sheet.[177] Hence, were the CHOICE Act adopted, it could be expected that banks would engage in off-balance sheet securitizations and other transactions to qualify for off-ramp status. Very large banks are more likely than community banks to have the capability to engage in such transactions.

Summary and Recommendations

The CHOICE Act provides community banks with relatively little regulatory relief compared with that provided to very large banks. Granting banks with off-ramp status based on their leverage ratios is likely to encourage more off-balance sheet securitization and other transactions, particularly by very large banks.

To avoid providing accounting-related incentives, we recommend that the financial leverage embedded in banks' off-balance sheet positions (excepting those where risk has been completely transferred to unrelated third parties) be incorporated into the

[177] Board of Governors of the Federal Reserve System, 2010, Report to the Congress on Risk Retention; Yiwei Dou, Stephen Ryan, and Biqin Xie, 2016, The Real Effects of FAS 166 and FAS 167, Working Paper, New York University.

leverage ratio used to assess whether banks qualify for the off-ramp. This recommendation would retain most of the simplicity of the Act's approach, while increasing its robustness with regard to accounting-motivated transaction structuring.

Interaction of Risk-Retention Requirements with On- versus Off-Balance Sheet Treatment for Securitizations

Background

During the financial crisis, originators of securitized nontraditional (e.g., subprime) residential mortgages and some other types of financial assets (originators) and securitization sponsors and issuers (securitizers) bore sizable securitization-related losses through the provision of contractual or noncontractual credit enhancement and liquidity support, as well as through the repurchases of securitized assets due to actual or credibly alleged violations of representations and warranties. These losses suggest that originators and securitizers did not have adequate incentives to originate assets with sufficiently high credit quality and to make accurate representations and warranties about the credit-risk characteristics of those assets in securitization prospectuses. To provide such incentives, Dodd-Frank, Title IX, Subtitle D, Section 941 requires securitizers to retain at least 5% of the credit risk of securitized assets, exempting qualified (i.e., relatively low risk) residential mortgages,[178] without subsequently transferring or hedging that risk. The final rules became effective in December 2015, for securitizations involving residential mortgages, and in December

[178] The definition of "qualified residential mortgages" corresponds to the Consumer Financial Products Bureau's definition of "qualified mortgages," which involves any lien or property type, no negative amortization features, 30-year term or less, 43% total debt-to-income ratio or less, documented borrower income and assets, and with the underwriting decision based on a fully adjusted (non-teaser) interest rate.

2016, for securitizations involving other types of securitized assets.[179]

For securitizations of non-exempted types of financial assets, securitizers can satisfy the risk-retention requirements by holding: (1) vertical interests (i.e., a constant proportion of each tranche issued) in securitizations of at least 5%; (2) horizontal residual (i.e., first-loss-bearing) interests constituting at least 5% of the fair value of all the securitized assets; or (3) any combination of (1) and (2) totaling at least 5%. Option (2) involves far more risk retention than option (1) and thus at least somewhat more risk retention than option (3). Thus, securitizers that prefer to retain the minimum allowed level of risk will choose to hold vertical interests.[180]

The CHOICE Act Proposal

Republicans consider Dodd-Frank’s risk-retention requirements, which apply to all but one type of securitized financial assets, to be an overreaction to a problem that only affected securitization of certain nontraditional residential mortgage-related assets, and thus that it constitutes excessive governmental intrusion into capital markets. The Act’s Title IV, Subtitle B, Section 442 exempts securitizations of pools of financial assets that are not wholly residential mortgages from these requirements.

Evaluation of the CHOICE Act Proposal

In principle, the Act could completely sterilize Dodd-Frank’s risk-retention requirements, even for residential mortgage

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[179] Credit Risk Retention, Final Rule, Federal Register, December 24, 2014, pp. 77601-77766.

[180] For further discussion of the economic implications of and likely responses to Dodd-Frank’s risk retention rules, see Matthew Richardson, Joshua Ronen, and Marti Subrahmanyam, 2010, Chapter 16: Securitization Reform, in Regulating Wall Street: Dodd-Frank and the New Architecture of Global Finance, edited by Viral Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter.

securitizations, as a securitization with 99% residential mortgages would be exempt from those requirements. If this turned out to be the case, banks would retain risk only to the extent that market forces made it optimal from the banks' perspective.

A subtle accounting-related implication of Dodd-Frank's risk-retention requirements, and thus of the Act's proposal to eliminate these requirements, is that sufficient risk retention typically will cause securitizers to recognize securitizations on-balance sheet. On-balance sheet treatment reduces securitizing banks' leverage and other regulatory capital ratios, among other generally conservative accounting effects, compared with the transactions being off-balance sheet.

Specifically, under current GAAP, securitizers may account for securitizations on-balance sheet for two distinct reasons: First, securitizers may account for securitizations as secured borrowings rather than as sales under Accounting Standards Codification Topic 860, Transfers and Servicing (ASC 860). This rule requires secured borrowing accounting when securitizers retain control over the securitized assets. Retention of control is defined both legally (the assets are not isolated from securitizers) and effectively (securitizers retain effective control over the assets through contractual or noncontractual means). Second, securitizers may consolidate the securitization entities under Accounting Standards Codification Topic 810, Consolidation (ASC 810). This rule requires consolidation when securitizers retain control over the economically most significant activities of securitization entities, as well as the obligation to absorb a reasonable possibility of significant loss in the entities.

The more risk securitizers retain in securitization entities, the more they will desire to be able to manage this risk by retaining control over the entities. Sufficient risk retention thus will tend to be associated with retention of control. The retention of sufficient control and risk will lead to securitizers recognizing securitizations on-balance sheet. This treatment would be especially likely if securitizers retained 5% horizontal residual interests in securitizations. For many types of securitized financial assets, securitizers that bear the first 5% risk of loss on the assets likely bear most or even all of the risk of the assets, and so they will want to retain control over the assets.[181]

Summary and Recommendations

As written, the CHOICE Act proposal could sterilize Dodd-Frank's risk-retention requirements even for securitizations of residential mortgages. This aspect could easily be fixed, however, by exempting securitizations if they contained less than a threshold amount lower than 100% of residential mortgages.

The proposal might also contribute to more off-balance sheet accounting for securitizations. If so, it would increase securitizers' leverage and other regulatory capital ratios. In this respect, this proposal overlaps with the reliance on the leverage ratio in the Act's Dodd-Frank off-ramp proposal discussed earlier in this article.

[181] In the final rule of credit risk retention (https://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-29256.pdf), regulators acknowledged: "One commenter expressed opposition to any requirement for a minimum vertical or horizontal component, claiming that such a requirement would increase compliance costs and increase the risk that sponsors would, as a result of accounting standards, have to consolidate securitization entities into their financial statements… Two commenters asserted that, because of the flexibility of the proposed standard risk retention option, in and of itself, the option would not cause a sponsor to have to consolidate its securitization vehicles. One of these commenters observed that case-by-case analyses would be required and that the likelihood of consolidation would increase as a sponsor retains a greater portion of its required interest as a horizontal interest. Another commenter asserted that, if potential investors require the sponsor to hold a horizontal rather than a vertical interest, or a combination, the consolidation risk will increase."

We recommend that any proposal to reduce or eliminate Dodd-Frank's risk-retention requirements be considered in part based on its implications for off-balance sheet treatment for securitizations.

Short-Form Call Reports

Background

Every national bank, state member bank, insured state nonmember bank, and savings association must file quarterly Reports of Condition and Income (Call Reports) with the relevant bank regulatory agencies. Call Reports contain much more detailed and standardized quantitative balance sheet, income statement, and other data than exists in public banks' financial reports. The specific requirements depend on the size of the institution, the nature of its activities, and whether it has foreign offices. Unlike financial reports, Call Reports do not contain qualitative data or management discussion and analysis.

The Federal Deposit Insurance Corporation (FDIC) website describes the nature and uses of Call Report data as follows:

> *"Call Report data serve a regulatory and public policy purpose by assisting the agencies in fulfilling their missions of ensuring the safety and soundness of financial institutions and the financial system and the protection of consumer financial rights, as well as agency-specific missions affecting national and state-chartered institutions, e.g., monetary policy, financial stability, and deposit insurance...Call Report data are also used by the public, state banking authorities, researchers, bank rating agencies, and the academic community."*[182]

[182] https://www.fdic.gov/regulations/resources/call/index.html

The CHOICE Act Proposal

The CHOICE Act, Title XI, Subtitle N, Section 1166 would permit highly rated and well-capitalized (covered) insured depository institutions to file short-form Call Reports in the first and third quarters of each year.

Evaluation of the CHOICE Act Proposal

The ability to file short-form Call Reports in the first and third quarters likely would yield cost savings for community banks relative to preparing full reports in those quarters. The extent of these cost savings are unlikely to be large, however, as the reported data are standardized and entirely quantitative. Banks must record almost all of these data in their accounting systems at least quarterly. Hence, the primary costs are those involved in compiling these accounting records into standardized Call Reports.

Consistent with the FDIC description above, bank regulators indicate they use these reports to monitor banks between supervisory examinations, which occur only once every year or 18 months.[183] Moreover, empirical research shows that the highly standardized, and thus comparable, quarterly Call Reports provide more information to market participants than do far less easily analyzed quarterly financial reports.[184] Hence, even for small community banks, quarterly Call Reports likely provide significant benefits in terms of regulatory and market discipline, and these benefits very well may outweigh the likely modest cost savings.

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[183] Jessica Keeley, 2017, The Impact of Regulatory Enforcement Actions on Bank Risk, Working Paper, New York University.
[184] Brad Badertscher, Jeffrey Burks, and Peter Easton, 2016, Day 30: The Tacit Quarterly Information Event in the Banking Industry, Working Paper, University of Notre Dame.

Summary and Recommendation

Quarterly Call Reports yield benefits in regulatory and market discipline. We recommend that these benefits be weighed against the cost savings before passing the proposal to allow covered insured depository institutions to file short-form Call Reports.

Congressional Oversight of and Restrictions on the Public Company Accounting Oversight Board (PCAOB)

Background

In the wake of the revelation of numerous severe financial reporting failures by large publicly traded companies in 2001 and 2002 (e.g., Enron, WorldCom, Tyco, and Adelphia), as well as the demise of Enron's auditor, Arthur Andersen, the Sarbanes-Oxley Act (SOX) passed with almost unanimous bipartisan support. Among many other things, SOX created the PCAOB to supervise, investigate, and potentially sanction auditors of public companies. The PCAOB's activities effectively replaced auditors' prior self-regulatory practice of peer review of audits of these companies. SOX also vested auditing standard setting for these companies with the PCAOB, removing this responsibility from the Auditing Standards Board, a committee of the American Institute of Certified Public Accountants. Arguably, these changes diminished the professional status of auditors, possibly making auditing a less attractive career option.

SOX created the PCAOB as an independent nonprofit private corporation within the Securities and Exchange Commission, itself an independent federal agency. This, along with various other features of SOX, had the effect of providing the PCAOB with double insulation from both the executive and legislative branches of government. This insulation exists despite the PCAOB's *de facto* ability to act as an independent, and in some respects unusually powerful, federal agency. SOX also created the PCAOB to be independent of the auditing profession, most notably by limiting the number of certified public accountants on the five-member board to exactly two, and by not allowing the chairperson of the board to have been a practicing accountant for at least five years. The political insulation of the PCAOB and the limited auditing experience of its members involved various well-understood trade-offs (e.g., more independence from government and auditors, but less oversight and expertise) that Republican Senator Phil Gramm discusses in remarks supporting SOX reported in the Congressional Record.[185]

The CHOICE Act Proposals

The Act proposes two primary changes to SOX's provisions regarding the PCAOB. First, the CHOICE Act Title IV, Subtitle A, Section 425 requires the PCAOB to make information requested by specified Congressional committees available to them on a confidential basis. The comprehensive summary of the CHOICE Act indicates that this resolves "statutory ambiguity" regarding whether these committees can obtain this information. This ambiguity apparently results from SOX expressly allowing the SEC to receive such information, but not specifying whether the SEC can pass the information along to the committees on a confidential basis, despite Congressional oversight of the SEC.

Second, the CHOICE Act Title VI, Subtitle A, Section 620 requires the SEC to conduct a study within one year of the Act's enactment to set forth a plan to make the PCAOB subject to various provisions of this title. These provisions include requirements to: (1) conduct and explain, in notices of proposed rulemaking, quantitative and qualitative cost-benefit analyses for proposed new rules, both in isolation and relative to alternative approaches; (2) assess and explain who will bear the burden of the new rules; (3) consider comments on notices of proposed rulemaking; (4) predict changes

[185] Congressional Record, Vol. 148, No. 90, S6330-6340, July 8, 2002.

in market structure and behavior; (5) conduct retrospective regulatory impact analyses; and (6) enable adversely affected parties to bring actions in U.S. Appeals Court for judicial review of agency compliance with these requirements.

Evaluation of the Act's Proposals

We do not object to the Act's requirement that the PCAOB make information available on a confidential basis to specified Congressional committees. We raise a caution, however, about proceeding further down the slippery slope to political intrusion into the delicate and intertwined processes of setting, applying, and enforcing accounting and auditing standards. The history of such intrusions is deeply unfortunate, having consistently been driven by the political expediency of the moment to the detriment of the development of well-functioning and coherent processes.[186] Such development requires professional expertise and judgment, as well as a long-term perspective.

Relatedly, experience shows that auditors' reputations are easily lost but hard to regain (as noted above, Arthur Andersen's rapid demise after its Enron-related audit failures were factors contributing to the creation of the PCAOB). Moreover, auditors are subject to frequent and costly litigation, regardless of their culpability. These concerns are particularly salient given the highly concentrated audit market, in which very few firms (primarily the Big 4 auditors) are capable of auditing the largest and most far-flung companies. The loss of another auditor would raise significant competitive and practical problems.

[186] See discussion related to this point in Joshua Ronen and Stephen Ryan, Bank Regulators Should not Meddle in GAAP, Section 4 of Chapter 18, Accounting and Financial Reform, in Regulating Wall Street: Dodd-Frank and the New Architecture of Global Finance, edited by Viral Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter.

We believe these concerns require ongoing investigations of auditors to remain entirely confidential, whether or not information about the investigations is shared with Congressional committees. Many of the PCAOB's processes, and the ongoing improvement of auditing, require the cooperation of auditors. Such cooperation is less likely to be forthcoming if auditors cannot be sure that information provided is confidential prior to an evidence-based, reasoned, and fair determination of culpability.

We agree with the desire of the drafters of the CHOICE Act to deter the promulgation of rules for which the costs exceed the benefits. As a general rule, however, we do not believe that the costs and benefits of the PCAOB's oversight of auditors and setting of auditing standards are amenable to either quantification or judicial review. In most cases, these cost-benefit trade-offs are matters of professional judgment that must primarily be assessed qualitatively, and for which a certain amount of trial and error is inevitable.[187]

Summary and Recommendations

Sufficient time has passed since the creation of the PCAOB for the appropriate Congressional committees to evaluate whether and what extent this unusually powerful and politically insulated hybrid of nonprofit corporation and federal agency is serving its intended purposes, and whether and how these purposes can be better served. We believe it is critical to keep ongoing investigations of auditors confidential in order to avoid unnecessary loss of reputation and litigation costs.

More generally, we believe any Congressional oversight of the PCAOB's activities needs to be as nonpolitical as possible and to treat auditors as professionals and auditing as a profession. The best way for the profession to improve over time is to make it

[187] Mark Nelson, 2009, A Model and Literature Review of Professional Skepticism, *Auditing: A Journal of Practice & Theory*.

attractive to young people as they choose their careers. As Senator Gramm states in his remarks mentioned above, “if we don’t attract smart young people into accounting, people who understand it is not talent, it is not personality, it is not cool, it is character that ultimately counts, then none of these systems is going to work very well.”