Evaluation of Accounting-Related Proposals in the Financial CHOICE Act
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1. Introduction

Passed in the wake of the recent financial crisis, 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 non-bank financial institutions (hereafter "banks", except where necessary to distinguish the different types of institutions). 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.¹

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 non-bank 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.²

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 ("FCA"), which if adopted would eliminate much of this burden.

In this section, we explain how various proposals in FCA depend on and/or provide incentives regarding banks’ accounting numbers. We evaluate these proposals in the context of these accounting-related effects. The specific proposals we consider pertain to: (1) the Dodd-Frank “off ramp” for qualifying banks, (2) securitization risk-retention requirements, (3) short-form regulatory call reports, and (4) the Public Company Accounting Oversight Board (“PCAOB”).

¹ Patrick McLaughlin and Robert Greene, 2013, Did Deregulation Cause the Financial Crisis? Examining a Common Justification for Dodd-Frank, working paper, George Mason University.
² Dodd-Frank, Title I, Section 165(b)-(e), (g), (h), (i), and (j).
2. The Dodd-Frank Off Ramp

2.A. FCA Proposal

Any bank that qualifies based on criteria specified in FCA Title I, Section 101 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—of at least 10%. 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.

FCA specifies that qualifying banks that elect the off ramp would be exempt from all risk-based capital requirements, liquidity requirements, and stress tests. 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.

2.B. Evaluation of FCA Proposal

The FCA would make the off ramp available to all qualifying banks. As suggested in the comprehensive summary of the FCA, however, such regulatory relief is most necessary for community banks. Inconsistent with this fact, the most onerous regulations from which off ramp 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 to manage their regulatory capital ratios. The reliance on accounting numbers to measure the leverage ratio will yield incentives for banks to exercise discretion to increase that

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3 FCA, Title I, Section 105(5) and (6).

4 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.

5 FCA, Title I, Section 102(a)-(d).

6 For example, the second bullet on page 2 of the comprehensive summary of FCA 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.”

ratio to qualify for the off ramp. Some of these avenues of discretion could equally well be used to risk-based capital ratios; for example, banks could increase regulatory capital by reducing loan loss provisions or realizing gains on available-for-sale securities. 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 positions.

Post-financial crisis changes in accounting rules discussed in Section 3.3 below made off-balance sheet treatment somewhat more difficult to attain. Despite this fact, empirical research finds that securitizations of most types of financial assets—including all types of mortgages, including subprime residential mortgages, perceived culprits in the genesis of the financial crisis—continue to remain almost entirely off-balance-sheet. 8 Hence, were the FCA 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.

2.C. Summary and Recommendations

FCA provides community banks with relatively little regulatory relief compared to 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 leverage ratio used to assess whether banks qualify for the off ramp. This recommendation would retain most of the simplicity of the FCA’s approach while increasing the robustness of the approach to accounting-motivated transaction structuring. If desired, the threshold for these grossed-up leverage ratios could be reduced below 10% to yield the same average stringency as in the FCA proposal.

3. Risk-Retention Requirements

3.1. Background

During the financial crisis, originators of securitized non-traditional (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 non-contractual 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, without subsequently transferring or hedging that risk. The final rules became effective in December 2015 for securitizations involving residential mortgages and in December 2016 for securitizations involving other types of securitized assets.

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 chose to hold vertical interests.

3.2. FCA Proposal

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

3.3 Evaluation of FCA Proposal

In principal, the FCA proposal could completely sterilize Dodd-Frank’s risk-retention requirements, even for residential mortgage 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 FCA’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

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9 The definition of “qualified residential mortgages” corresponds to the Consumer Financial Products Bureau’s definition of “qualified mortgages,” which involve 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.


11 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, Mathew Richardson, and Ingo Walter.
Reducing securitizing banks’ leverage and other regulatory capital ratios, among other generally conservative accounting effects, compared to the transactions being off-balance sheet.

Specifically, under current generally accepted accounting principles ("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.

3.4. Summary and Recommendations

As written, the FCA proposal would sterilize Dodd-Frank’s risk-retention requirements even for securitizations of residential mortgages. This aspect could easily be fixed, however, but exempting securitizations if they contained less than 50% or some other threshold amount 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 FCA’s Dodd-Frank off-ramp proposal discussed in Section 2 of this article.

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.

4. Short-Form Call Reports

4.1. 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’s website describes the nature and uses of Call Report data as follows:

Institutions submit Call Report data to the bank regulatory agencies each quarter for the agencies' use in monitoring the condition, performance, and risk profile of individual institutions and the industry as a whole. 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 Reports are the source of the most current statistical data available for identifying areas of focus for on-site examinations and off-site monitoring. The agencies use Call Report data to evaluate the corporate applications of institutions, and to calculate the deposit insurance assessments of institutions and the semiannual assessment fees of national banks and federal savings associations. Call Report data are also used by the public, state banking authorities, researchers, bank rating agencies, and the academic community.12

4.2. FCA Proposal

FCA, 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.

4.3. Evaluation of FCA Proposal

The ability to file short-form call reports in the first and third quarters likely would save community banks cost 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 quote from the FDIC website above, bank regulators indicate they use these reports to monitor banks between supervisory examinations, which occur only once every year or

eighteen months. 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. Hence, even for small community banks, quarterly Call Reports likely provide significant benefits in terms of regulatory and market discipline, and these benefit very well may outweigh the likely modest cost savings.

4.4. 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.

5. The Public Company Accounting Oversight Board

5.1. 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-监管 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 PCOAB as an independent non-profit 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 lengthy (and quite interesting) remarks supporting SOX reported in the Congressional Record.\(^{15}\)

### 5.2. FCA Proposals

FCA proposes two primary changes to SOX’s provisions regarding the PCAOB. First, FCA 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 FCA indicates 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, FCA Title VI, Subtitle A, Section 620 requires the SEC to conduct a study within one year of the enactment of FCA to set forth a plan to make the PCAOB subject to various provisions of this title. These provisions include requirements: (1) to 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) to assess and explain who will bear the burden of the new rules; (3) to consider comments on notices of proposed rulemaking; (4) to predict changes in market structure and behavior; (5) to conduct retrospective regulatory impact analyses; and (6) to enable adversely affected parties to bring actions in U.S. Appeals Court for judicial review of agency compliance with these requirements.

### 5.3. Evaluation of FCA Proposals

We do not object to the FCA’s requirement that the PCAOB make information available on a confidential basis to specified congressional committees. We raise a caution, however, about proceeding any 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, consistently being driven by the political expediency of the moment to the detriment of the development of well-functioning and coherent processes.\(^{16}\) 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 was a factor contributing to the creation of the PCAOB). Moreover, auditors are subject to frequent and costly litigation, regardless of their culpability. This concerns are particularly salient given in the highly concentrated audit market, in which very few firms (primarily the Big 4 auditors) are

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\(^{15}\) Congressional Record, Vol. 148, No. 90, S6330-6340, July 8, 2002.

\(^{16}\) 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, Mathew Richardson, and Ingo Walter.
capable of auditing the largest and most far-flung companies. The loss of another auditor would raise significant competitive and practical problems.

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 FCA 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.

5.4. Summary and Recommendations

Sufficient time has passed since the creation of the PCAOB for the appropriate congressional committees to evaluate whether and the extent to which this unusually powerful and politically insulated hybrid of non-profit corporation and federal agency is serving its intended purposes, and whether and how these purposes can be better served. We believe the need to keep ongoing investigations of auditors confidential remains critical to avoid unnecessary loss of auditor reputation and litigation costs.

More generally, we believe any congressional oversight of the PCAOB’s activities needs to be as non-political as possible, and needs to treat auditors as professionals and auditing as a profession. The best way for the profession to improve over time is to make it attractive to young people choosing 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.”