## Chapter 20*

## Bank Regulators Should Not Meddle in GAAP

### Background

As a result of the financial crisis, political pressure on accounting standard setting has never been higher. This recent scrutiny has focused on making generally accepted accounting principles (GAAP) more amenable to the goals of bank regulation. These goals are twofold: (1) to require banks to hold more capital in good times so as to cushion the blow when the economic cycle turns; and (2) to allow banks to record smaller write-downs in bad times to preserve their diminished regulatory capital. An example of the first goal is the proposal to require "through the cycle" loss reserving to induce banks to build up capital during strong economic times to help them better survive weak economic times when they occur. An example of the second goal is the proposal to suspend fair value accounting during economic crises. We evaluate these troublesome accounting proposals in Sections 7B and 7C of this e-book. Here, we discuss the underlying and equally problematic underlying political pressure on accounting standard setting.

Perhaps the most extreme example of this pressure was Representative Edward Perlmutter's (D-CO) proposed amendment to the original Financial Stability Improvement Act that was under consideration by the U.S. House of Representatives' Committee on Financial Services. That amendment would have effectively given a council of bank regulators veto power over GAAP. Fortunately, the Wall Street Reform and Consumer Protection Act (H.R. 4173) that made it through the House Financial Services Committee on December 2, 2009, contains the far less objectionable requirement in Section 1001(c)(11) for this council "[t]o review and submit comments to the Securities and Exchange Commission and any standards setting body with respect to an existing or proposed accounting principle, standard, or procedure."

Despite this positive development, it would be too optimistic to hope that the political pressure on accounting standard setting is going to disappear. This pressure must be quashed whenever it arises, and in our view, bank regulators should not have any significant power over GAAP.

The most direct way that GAAP requirements might create systemic risk is by reducing banks' regulatory capital ratios below the required levels during difficult economic times, leading to aggregate deleveraging of the banking system and driving down financial asset prices. If banks' regulatory capital were the only concern, however, then the natural approaches to deal with it would be to modify either required regulatory capital ratios (e.g., make them higher in good economic times and lower in bad economic times) or the regulatory accounting principles (RAP), upon which those ratios are calculated. (Note: we are skeptical of regulatory forbearance in bad economic times, as discussed below.) Intervening in the GAAP that governs financial reporting is not the solution.

The main impediment to these natural approaches is the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which includes various provisions that restrict bank regulators' ability to exercise regulatory forbearance. These provisions were included in FDICIA for the very good reason that forbearance exercised by bank regulators during the 1970s

* Working group: Stephen Ryan, Joshua Ronen

and 1980s delayed, and thereby significantly exacerbated, the costs of the resolution of the thrift crisis.

In particular, Section 121 of FDICIA requires that RAP be “consistent with generally accepted accounting principles…[unless bank regulators determine that] the application of any generally accepted accounting principle to any insured depository institution is inconsistent with the objectives described in paragraph (1), [in which case they] may…prescribe an accounting principle…which is *no less stringent* than generally accepted accounting principles” (emphasis added). Representative Perlmutter’s proposed amendment would have *de facto* repealed Section 121 of FDICIA and allowed bank regulators to exercise regulatory forbearance opaquely by making GAAP less stringent.

**The Issues**

Representative Perlmutter’s proposed amendment and other political pressures on GAAP invariably would create considerably larger problems than the one they purport to address. The comparative advantages of GAAP and financial reporting are to promote transparency and a well-informed investing public through financial reports that are informative and no more complex than necessary. Transparency plays an essential role in the functioning of financial and other markets, but one that is distinct from the safety-and-soundness role of bank regulation. If potential investors in risky firms and assets do not feel they have transparent information, then they will view those firms and assets with fear and loathing, thus creating illiquid financial markets and exacerbating systemic risk. These problems will exist and weigh on the economy in many ways every day, not just with respect to systemic risk during financial crises.

These political pressures would instead use GAAP for purposes to which it is not suited -- to require banks to build up capital during robust economic times and to allow bank regulators to exercise regulatory forbearance during poor economic times. GAAP’s potential use to allow the exercise of regulatory forbearance is particularly worrisome. Regulatory forbearance has pernicious effects on banks’ incentives -- if banks know it will occur, they will take on more systemic risk ex ante -- and so it should be exercised rarely, if at all, and only with extreme caution. When exercised, regulatory forbearance should be implemented in ways that are best understood and most controllable by bank regulators -- through modification of regulatory capital requirements and/or RAP. Regulatory forbearance should also be implemented transparently, because bank regulators are not immune from incentive problems. Giving bank regulators the power to cloak their failures through nontransparent financial reporting is a recipe for faulty bank regulation.

Moreover, bank regulators exhibit very little understanding of accounting. Accounting standard setting is a difficult process that requires broad and deep understanding of accounting standards. These standards are individually complex, collectively intertwined, and involve subtle interpretation in practice. This is particularly true for the highly technical standards that govern the accounting for financial instruments and transactions and that most significantly affect banks. Given these difficulties, the Financial Accounting Standards Board (FASB) occasionally makes poor decisions in retrospect. In its defense, the FASB has also exhibited a remarkable willingness and ability to accept criticism, to address its mistakes quickly, and to write standards that increase overall transparency over time.

It is impossible to believe that bank regulators would perform nearly so well as caretakers of GAAP. Even in their own areas of expertise, bank regulators have often acted sluggishly. For example, officials let the thrift crisis fester from the mid-1970s, when interest rates rose, until the early 1990s. Bank regulators' failure to appreciate the risks of increasingly undisciplined credit extension and highly leveraged investment and consumption throughout the global financial system over a long period played a crucial role in the recent financial crisis.

If politicians want to allow bank regulators to exercise regulatory forbearance, they should sponsor a bill amending Section 121 and other provisions of FDICIA so that bank regulators can modify RAP, not mess with GAAP.

**Recommendation**

Bank regulators and politicians must not be allowed to meddle in GAAP and financial reporting in their pursuit of more effective bank regulations.