GEORGETOWN UNIVERSITY LAW CENTER

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Written Testimony of

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Before the
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
&
Subcommittee on Capital Markets and Government Sponsored Enterprises

Joint Hearing on "H.R. 1697: The Communities First Act"

November 16, 2011
2:00 pm

Ms. Chairman Capito, Mr. Chairman Garret, Ranking Member Maloney, Ranking Member Waters, Members of the Subcommittees:

Good afternoon. My name is Adam Levitin. I am a Professor of Law at the Georgetown University Law Center in Washington, D.C., where I teach courses in bankruptcy, commercial law, contracts, and structured finance. I have previously served as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP).

I am here today to testify against H.R. 1697, the so-called "Communities First Act." I oppose the bill for several reasons:

- The Communities First Act will actually destroy communities by encouraging mortgage foreclosures that hurt families, neighboring property owners, and local government.
- The Communities First Act encourages spurious accounting practices that debase the informational currency on which American capital market investors depend.
- The Communities First Act would make it impossible for accounting rules to be updated unless they met a pseudo-scientific cost-benefit analysis standard.
- The Communities First Act would enable banks to game the regulatory system by picking their regulator.
- The Communities First Act would gut the Consumer Financial Protection Bureau.

Fundamentally, the Communities First Act is a regulatory subsidy for big and small banks, with some extra morsels tossed in for the small banks. It does nothing for communities. I urge the Subcommittees to reject the bill for the narrow, special interest pleading that it is.

1. The Communities First Act Puts Communities Last and Banks First

<u>The Communities First Act will result in families being thrown out of their homes.</u> Section 205 of the bill permits banks with less than $10 billion in net assets to stretch out loss recognition from foreclosures over 10 years for regulatory capital accounting purposes, rather than recognizing all of the losses when they actually occur, which is immediately. This extended amortization is not only bad accounting; it creates an incentive for banks to foreclose troubled mortgages, rather than modify them and work with borrowers. Favorable and unrealistic accounting treatment of foreclosures will result in more foreclosures and less loan modifications. <u>The Communities First Act will affirmatively hurt American families and communities</u>. It is bad accounting and it is bad policy.

The supporters of the Communities First Act note that Congress extended this sort of favorable loss recognition treatment to banks in the 1980s for troubled farm loans.[1] There is more to the historical story, however. First, Congress extended less favorable treatment loss recognition for agricultural loans than the Communities First Act proposes for residential mortgage loans. The Competitive Equality Banking Act of 1987 capped the loss amortization for agricultural loans at seven years, rather than the ten years proposed by the Communities First

[1] Competitive Equality Banking Act of 1987, Title VIII, § 801, 101 Stat. 656, P.L. 100-86, Aug. 10, 1987, codified at 12 U.S.C. § 1823 (permitting loss recognition on agricultural loans to be amortized over seven years); 52 F.R. 42090, Nov. 3, 1987, codified at 12 C.F.R. § 208.23 (formerly § 208.15) (same).

Act for residential mortgage loans. Second, and critically, Congress extended favorable loss recognition treatment only after having authorized family farmers and fishermen to file for bankruptcy more easily through the creation of Chapter 12 of the Bankruptcy Code in 1986, ten months before the loss amortization statute was passed.[2] Notably, Chapter 12 permits the cramdown of underwater farm loans.[3]

This House passed cramdown legislation in 2008.[4] Unfortunately, the legislation[5] failed to gain cloture in the Senate. That was the last best opportunity to deal with the $700 billion negative equity problem in this country that is weighing down the entire economy. Now the community banks want the regulatory accounting benefit without the burden. That's is a regulatory bailout of the community banks, plain and simple.

2. The Communities First Act Authorizes Voodoo Accounting

Section 206 of the Communities First Act would further exacerbate the incentive to foreclose. It would also institutionalize voodoo accounting. Currently, under Generally Accepted Accounting Principles (GAAP), as mortgage loans are held-to-maturity assets and tare therefore carried on banks' books at face value as long as they are performing. When a mortgage loan is impaired, however, the bank is required to carry it at the fair value of the collateral, under Statement of Financial Accounting Standards 114.

Section 206 would have Congress create a statutory exception to accounting principles for all banks. It would permit them to value the collateral of impaired loans based on the 5-year average price of the collateral property, rather than on current market valuation. This is voodoo accounting. It would allow a bank in 2011-2012 to benefit from the ridiculously inflated property values of 2006-2007 on an asset that might be in foreclosure in a month. Section 206 thus lessens the regulatory accounting blow to a bank from foreclosure and thereby incentivizes foreclosures over loan restructurings.

Section 206's voodoo accounting would allow for "zombie banks" to avoid prompt corrective action notices by artificially inflating their capital. A critical lesson from the S&L crisis was that we should never permit zombie banks to operate—once a bank is insolvent, it should be shut down lest it "gamble on resurrection" by investing in riskier assets in the hopes of a payoff that will return it to solvency. The gamble on resurrection is a gamble with the taxpayer's money and is contrary to fundamental principles of safe-and-sound bank regulation.[6] If a bank isn't solvent based on GAAP accounting, it shouldn't be operating. There is no reason to make exceptions to this common sense principle.

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[2] P.L. 99-554, 100 Stat. 3105-3114, Oct. 27, 1986, codified at 11 U.S.C. §§ 1201 *et seq*.

[3] P.L. 99-554, 100 Stat. 3105, 3109, Oct. 27, 1986, codified at 11 U.S.C. § 1222(b)(2).

[4] H.R. 1106, The Helping Families Save Their Homes Act of 2009 (111th Congress) (passed House on Mar. 5, 2009).

[5] S. 896, The Helping Families Save Their Homes Act of 2009 (111th Congress) (failed to achieve cloture while cramdown provision was included. Bill subsequently passed without cramdown provision).

[6] Section 206 would also appear to encourage banks to let foreclosed properties sit in their portfolios as REO, rather than return the properties to the market, because it would override the GAAP treatment of REO, which requires that foreclosed assets be carried at fair market value less the cost of resale. *See* Accounting Standards Codification 310-40-40-3.

Ultimately, accounting shenanigans are bad for business. The importance of good accounting for the financial system cannot be overstated. As former Treasury Secretary Lawrence Summers once observed, "[T]he single most important innovation shaping [the American capital] market was the idea of generally accepted accounting principles. The transparency implicit in the generally accepted accounting principles (GAAP) promotes efficient market responses to change, and it supports stability."[7] Information transparency is essential for markets to work correctly. This means recognizing losses and gains in the correct time period.

Voodoo accounting is a recipe for capital flight from community banks. If investors don't trust the accounting of community banks, they won't invest or will demand a premium. The regulatory accounting gain from voodoo accounting will come at a cost of capital loss for community banks and is deeply shortsighted.

3. The Communities First Act Would Impose a Pseudo-Scientific Cost-Benefit Analysis

Section 105 of the Communities First Act would require that the Securities and Exchange Commission conduct a cost-benefit analysis before approving any change to accounting standards proposed by the Financial Accounting Standards Board. No change could be approved unless the benefits "significantly" outweigh the costs *and* there is no undue economic impact on banks with less than $10 billion in assets. Thus, even if there were no undue economic impact on small banks, the SEC would still have to find that benefits of an accounting rule *significantly* outweigh the costs.

At first blush, cost-benefit analysis seems like an eminently reasonable, sensible idea. We should want regulation where the benefits outweigh the costs, no?

The problem with cost-benefit analysis, however, is that it is one of the wishiest-washiest, pseudo-scientific things ever. No one who has ever conducted a regulatory cost-benefit analysis would ever think to write legislation requiring such an analysis.

Once you have had a tour of the regulatory cost-benefit sausage factory, the idea that there is anything remotely scientific or even intellectually honest about the process rapidly dissipates. Instead, one quickly realizes that regulatory cost-benefit analysis means that there is a roadblock to regulation, plain and simple, and that ideologically-motivated judges may strike down any regulation they do not like by finding fault with an inherently subjective, faulty cost-benefit analysis process. Put differently, section 105 enables activist judges to strike down regulation on the basis of inherently unscientific cost-benefit analysis being unscientific.

Consider the absurdity of applying cost-benefit analysis to accounting standards. How is the SEC possibly to quantify the benefit to the market from having somewhat different accounting treatment of qualified special purposes entities or variable interest entities? How is the SEC to quantify the benefits of permitting lease liabilities to remain off-balance sheet? These are simply not quantifiable benefits. One cannot put a value on them the way one might value a human life or a human hand. Indeed, one might argue that clear accounting rules help prevent systemic risk. The chance of systemic risk is slight, but the loss severities are nearly infinite. Does that mean that if the SEC finds that an accounting rule helps increase financial

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[7] Lawrence H. Summers, "International Financial Crises: Causes, Prevention, and Cures," in ECONOMIC GLOBALIZATION IN ASIA (MANAS CHATTERJI & PARTHA GANGOPADHYAY, EDS.) 47, 56 (2005).

transparency and thus avoid systemic risk that the benefits outweigh almost any cost? Any attempt to quantify the benefits is inherently speculative and that speculation can be as broad or narrow as the SEC wishes.

As for costs, what are the costs to be considered? The marginal increase in auditors' fees? Surely they are so small that they are outweighed by nearly any cost-of-capital benefit from clearer accounting. The regulatory capital charges to the extent regulatory accounting principles follow GAAP?

Add to this the novel inclusion of the "significantly" outweigh requirement, not typically included in cost-benefit analysis. How much of a difference qualifies as "significant"? Again, this fuzzy standard merely opens the door to judicial activism.

The point here is that cost-benefit analysis as a mode of regulatory review is fundamentally ridiculous. Cost-benefit analysis may sound sensible at first, but those who have dealt with it know that in practice it is one of the worst ideas to come out of Congress and is really just a shadow form of deregulation.

The effect of requiring cost-benefit analysis for accounting standards would be to petrify the accounting standards as they stand today. That would prevents accounting standards from being modernized to keep up with transactions and means firms would have insufficient guidance regarding their accounting, opening them up to securities fraud litigation claims. Ultimately section 105 damages American capital markets because investors will come to question whether firms' financial statements actually give a true picture of the firms' finances.

4. The Communities First Act Would Permit Small Banks to Game the Regulatory System for Examinations

Section 108 of the Communities First Act would prohibit the Board of Governors of the Federal Reserve from transferring examination authority for federal consumer laws for insured depositories with less than $10 billion in assets to the Consumer Financial Protection Bureau (CFPB), as currently authorized under section 1012 of the Dodd-Frank Act.

The issue here is not whether there will be examinations of small banks for compliance with federal consumer laws. The only question is who will do the examinations. The only reason that small banks should care who does the examinations is if they think one examiner will be more favorable to them than another, and that is exactly why section 108 of the Communities First Act is terrible idea. Regulated entities should not be permitted to pick their regulator. Such permission allows them to engage in regulatory arbitrage, where they will always seek out the weaker, more permissive regulator. Section 108 of the Communities First Act, then, is a license to let small banks game the regulatory system.

5. The Communities First Act Is a Backdoor Attempt to Gut the Consumer Financial Protection Bureau

Section 107 of the Communities First Act would lower the standard needed for the Financial Stability Oversight Council (FSOC) to veto rule-makings by the Consumer Financial Protection Bureau (CFPB). The current standard requires the FSOC to find that the CFPB's rule-making poses a systemic risk to the United State's financial system, namely that it would "put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk."[8] The proposed standard in section 107 would require a lesser finding, namely that the rulemaking would be either "inconsistent with the safe and sound operation of United States financial institutions" or that it "could adversely impact a subset of the banking industry disproportionately." Note the use of "could" rather than "would" in the second phrase, implying that there need be only a possibility, not a likelihood or certainty of the result.

A. "Inconsistent with Safe and Sound Operation of United States Financial Institutions"

In the bank regulation context, safety and soundness means, first and foremost, profitability. It is axiomatic that a financial institution that is not profitable cannot be safe and sound. Consumer financial protection, however, is often inconsistent with bank profitability. Financial institutions only engage in unfair, deceptive and abusive acts and practices because they are profitable; they are not done for spite or Sadism. Predatory mortgage lending, for example, exists only because it is profitable.[9]

To the extent that a proposed CFPB regulation would reduce the profitability of a financial institution, it would reduce that institution's safety and soundness. Thus, any CFPB regulation, even if it merely increased compliance costs, would be "inconsistent with the safe and sound operations" of a financial institution.

While bank regulators have argued that consumer protection goes hand in hand with safety and soundness because it is unsafe for a bank to systematically exploit its customers or engage in unfair and deceptive practices, the run up to the financial crisis provides clear evidence that federal bank regulators were unwilling to put the brakes on unfair and deceptive mortgage lending. Similarly, the run up to the Credit CARD Act of 2009 shows that federal regulators were unwilling to act on unfair and deceptive credit card acts and practices until Congress itself started to move. Only then did the Federal Reserve, OTS, and NCUA hustle to amend their unfair and deceptive acts and practices (UDAP) regulations.

To understand just how overbroad the Communities First Act's proposed veto standard is, consider, for example, consider if there had been a CFPB in 2005, and it had proposed a rule that would have severely restricted the underwriting of payment-option adjustable-rate mortgages (so-called pick-a-pay mortgages) to borrowers who have demonstrated an ability to repay. Such a rulemaking would have put an end to the "Countrywide special," that was the hallmark of Angelo Mozillo and Countrywide, the nation's largest mortgage lender.

Such a restriction would have significantly curtailed Countrywide's mortgage lending business, and would surely have resulted in the OCC or OTS demanding an FSOC veto. Yet such a move could hardly be called radical. Congress itself passed just such a requirement in section 1411 of the Dodd-Frank Act,[10] and a parallel requirement for credit cards in section 109 of the Credit C.A.R.D. Act of 2009.[11]

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[8] 12 U.S.C. § 5513(a).

[9] There is no public policy justification for caring about the particular profit level of U.S. banks, as long as those banks are profitable. Safety-and-soundness concerns mandate that banks be profitable, but not a level of profitability.

[10] P.L. 111-203, § 1411, 124 Stat. 1376, 2142, July 21, 2010, *codified at* 15 U.S.C. § 1693c ("no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable

Indeed, we actually have an example from 2008 of a bank regulator challenging a proposed consumer financial protection regulation on safety-and-soundness grounds. In August 2008, Comptroller of the Currency John C. Dugan wrote to the Federal Reserve Board to urge it to insert two significant exceptions to the proposed Regulation AA (governing unfair and deceptive acts and practices) rule on credit cards that would limit the ability of card issuers to reprice (or, colloquially, "rate jack") cardholders.[12] Duggan wrote that the restrictions "raise safety and soundness concerns" because they limited the ability of issuers to re-price their loans if issuers determined that the risk profile of the customer had worsened.[13] If the CFPB had proposed such a rule, the OCC would surely have challenged it before the FSOC as "inconsistent with the safe and sound operations of United States financial institutions." Yet, Congress itself passed an even tougher restriction on credit card repricing less than a year later.[14]

Under the Communities First Act's veto standard, several laws passed by Congress in recent years, such as the Credit C.A.R.D. Act and the Mortgage Reform and Anti-Predatory Lending Act would themselves be unenforceable by regulation because the laws themselves might reduce bank safety-and-soundness (i.e., profitability), so any faithful rule-making would have to as well. The effect of the Communities First Act would be to eviscerate several recent, popular, consumer financial protection statutes. The proposed expansion of the FSOC veto would place bank profits ahead of the well-being of American families, and would put us on a return course to the financial crisis of 2008.[15]

B. "Could Adversely Impact a Subset of the Banking Industry Disproportionately"

For all the problems with the safety-and-soundness veto standard proposed by the Communities First Act, the alternative standard it proposes, namely that a CFPB rulemaking "could adversely impact a subset of the banking industry disproportionately" is just as troublesome. This lower standard would prevent the CFPB from regulating really bad, predatory products as long as they were only provided by some banks because the regulation would affect a subset of the industry disproportionately. Unless a problematic product or practice is industry-

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ability to repay the loan, according to its terms, and all applicable taxes, insurance (including mortgage guarantee insurance), and assessments.").

[11] P.L. 111-24, 123 Stat. 1743, § 109, May 22, 2009, *codified at* 15 U.S.C. § 1665e ("A card issuer may not open any credit card account for any consumer under an open end consumer credit plan, or increase any credit limit applicable to such account, unless the card issuer considers the ability of the consumer to make the required payments under the terms of such account.").

[12] Letter from Comptroller of the Currency John C. Dugan to Jennifer Johnson, Secretary, Board of Governors of the Federal Reserve System, Re: Docket Number R-1314, August 18, 2008.

[13] *Id.*

[14] P.L. 111-24, § 101, 123 Stat. 1736-37, May 22, 2009, *codified at* 15 U.S.C. § 1666i-1.

[15] I would also note that the FSOC veto under section 1023 of the Dodd-Frank Act, codified at 12 U.S.C. § 5513(a), is already of dubious constitutionality. On June 28, 2010, a fortnight before the enactment of the Dodd-Frank Act, the Supreme Court handed down its judgment in a case captioned *Free Enterprise Fund v. Public Company Accounting Oversight Board*, 130 S. Ct. 3138 (2010). In this case, the Supreme Court held that it was an unconstitutional violation of the separation of powers to restrict the President in his ability to "remove a [principal] officer of the United States, who is in turn restricted in his ability to remove an inferior officer, even though that inferior officer determines the policy and enforces the laws of the United States". *Id.* at 3147. This ruling raises the question of whether by giving the FSOC veto power over CFPB rulemaking, Congress has impermissibly restricted the power of the President to "take Care that the Laws be faithfully executed" through his appointee as Director of the Bureau of Consumer Financial Protection. It also raises the concern that the CFPB is not truly an independent agency as it would be subject to a veto exercised in part by cabinet agencies.

wide, regulation of that product not just could, but would adversely impact a subset of the banking industry disproportionately.

Imagine for a minute that a subset of the financial industry were selling financial poison, the financial equivalent of crystal meth. If the CFPB declare such a product to be unfair, deceptive, or abusive and prohibited it, the CFPB's action would undoubtedly hurt a subset of the financial industry, namely the "financial meth" pushers. That could trigger an FSOC veto. The threat of the veto in turn might chill the CFPB's actions, so that the financial meth would remain on the street. This isn't how things should work.

To apply this in very real terms, in 2009, Congress passed the CARD Act which restricted so-called "fee harvester" credit cards—cards with extremely low ($300 or less) credit limits and fees that often took up half of the credit limit.[16] There are a limited number of banks that issued fee harvester cards. They were surely adversely impacted by the CARD Act and disproportionately so. The regulation of fee harvester cards is exactly what we should want the CFPB to do, but the Communities First Act would always cast the threat of a FSOC veto over such a CFPB action.

C. The Purpose of the FSOC Veto: Systemic Risk, Not Maximization of Bank Profits

It is important to remember why there is an FSOC veto over the CFPB and why it is a systemic risk standard. The FSOC is a Justice League of bank regulators tasked with preventing *systemic* risk, not with ensuring optimal prudential regulation of banks and not protecting bank profits. The purpose of the FSOC veto is to ensure that the CFPB does not inadvertently create harm to the entire financial system. Community banks just aren't systemically important enough for the FSOC to consider.

And that points to what the proposed expansion of the FSOC veto is really about: it is a backdoor attempt to gut the CFPB. Banks don't like regulation in general, but the FSOC veto was never meant to prevent the CFPB from making rules that banks don't like. If that's the policy result that's desired, why not be frank about it and propose a bill that states, "Banks may choose to disregard any regulation they do not like"? It's an obviously preposterous idea, but that is what the proposed FSOC veto expansion is trying to do—give banks carte blanche in how they treat consumers.

Conclusion

The Communities First Act would affirmatively harm communities by encouraging foreclosures. It would harm capital markets by authorizing voodoo accounting and hamstringing GAAP, "the single most important innovation shaping [the American capital] market." It would enable banks to game the regulatory structure by awarding them a more lenient regulator. And the bill would gut the new Consumer Financial Protection Bureau before it has a chance to even implement a rule-making. The Communities First Act is another Orwellian title that belies what the bill is really about. A more accurate name for this legislation would be the Banks First Act of 2011. Congress needs to put the public's interest first, not the banks'.

[16] P.L. 111-24, 123 Stat. 1741-42, § 105, May 22, 2009, *codified at* 15 U.S.C. § 1637(n) (capping the fees that can be put against the credit limit of a credit card account in the first year during which the account is open at 25 percent in aggregate of the credit limit).

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
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4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
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I received a $10,000.00 ~~[illegible]~~ subcontract from the Federal Housing Finance Agency's Office of the Inspector General to write a tutorial on the foreclosure process and legal issues involved.

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