**Calendar No. 94**

| 106TH CONGRESS *1st Session* | SENATE | REPORT 106–44 |
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# FINANCIAL SERVICES MODERNIZATION ACT OF 1999

R E P O R T

OF THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

TO ACCOMPANY

S. 900

together with

ADDITIONAL VIEWS

APRIL 28, 1999.—Ordered to be printed

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# FINANCIAL SERVICES MODERNIZATION ACT OF 1999

APRIL 28, 1999.—Ordered to be printed

Mr. GRAMM, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

## REPORT

together with

## ADDITIONAL VIEWS

[To accompany S. 900]

The Committee on Banking, Housing, and Urban Affairs, having considered the Financial Services Modernization Act of 1999, reports favorably thereon as an original bill and recommends that the bill do pass.

### INTRODUCTION

On March 4, 1999, the Senate Committee on Banking, Housing, and Urban Affairs (the "Committee") marked up and ordered to be reported the "Financial Services Modernization Act of 1999," to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers, and for other purposes.

### HISTORY OF LEGISLATION

The Committee held three days of hearings on this landmark legislation to modernize the financial system and the laws governing financial intermediaries. At the first hearing on Tuesday, February 23, Federal Reserve Board Chairman Alan Greenspan testified.

On Wednesday, February 24, Secretary of the Treasury Robert E. Rubin testified, as did John D. Hawke, Jr., Comptroller of the Currency; James L. Pledger, Commissioner, Texas Savings and Loan Department, representing the American Council of State Savings

Supervisors; Ellen S. Seidman, Director, Office of Thrift Supervision; George Nichols III, Commissioner of Insurance, State of Kentucky, representing the National Association of Insurance Commissioners; Arthur Levitt, Jr., Chairman, Securities and Exchange Commission; Thomas E. Geyer, Commissioner, Division of Securities, State of Ohio, representing the North American Securities Administrators Association; Donna A. Tanoue, Chairman, Federal Deposit Insurance Corporation; and Catherine Ghiglieri, Commissioner, Texas Department of Banking, representing the Council of State Bank Supervisors.

On Thursday, February 25, the Committee received testimony from Michael Patterson, Vice President, J.P. Morgan and Company, representing the Financial Services Council; Ms. E. Lee Beard, President and CEO, First Federal Bank, Hazleton, Pennsylvania, representing America's Community Bankers; William L. McQuillan, President, City National Bank, Greeley, Nebraska, representing the Independent Bankers Association of America; James D. Ericson, President and CEO, Northwest Mutual Life Insurance Company, representing the American Council of Life Insurance, the American Insurance Association, the Alliance of American Insurers, the National Association of Independent Insurers, and the National Association of Mutual Insurance Companies; Jeff Tassey, Senior Vice President, American Financial Services Association; Robert W. Gillespie, Chairman and CEO, Key Corp, representing the Bankers Roundtable; Marc E. Lackritz, President, Securities Industry Association; Hjalma Johnson, Chairman and CEO, East Coast Bank Corporation, representing the American Bankers Association; Scott A. Sinder, Esq., representing the Independent Insurance Agents of America, the National Association of Life Underwriters, and the National Association of Professional Insurance Agents; John G. Finneran, Jr., Senior Vice President and General Counsel, Capitol One Financial Corporation, representing the Association of Financial Services Holding Companies; Mary Griffin, Insurance Counsel, representing the Consumers Union; Kathy Ozer, Executive Director, National Family Farm Coalition; F. Barton Harvey, Chairman and CEO, Enterprise Foundation; John Taylor, President and CEO, National Community Reinvestment Coalition; and Deborah Goldberg, Neighborhood Reinvestment Specialist, Center for Community Change.

On March 4, the Committee met in Executive Session to mark-up the Committee Print. During the mark-up, the Committee considered several amendments. Senator Shelby offered an amendment which was adopted by voice vote to allow officers and directors of public utilities to serve as officers or directors of banking and securities companies, subject to certain safeguards against conflicts of interests; Senator Shelby also offered an amendment adopted by voice vote to permit one or more thrift institutions to own bankers' banks. A third amendment offered by Senator Shelby (as amended by Chairman Gramm), adopted by a vote of 11–9 (Senators voting "Aye"—Gramm, Shelby, Mack, Bennett, Grams, Allard, Enzi, Hagel, Bunning, Crapo and Johnson. Senators voting "No"—Sarbanes, Dodd, Kerry, Bryan, Reed, Schumer, Bayh, Edwards and Santorum) exempts from the requirements of the Community Reinvestment Act of 1977 those banks and savings and

loan associations with total assets up to $100 million and that are located in non-metropolitan areas. Senator Grams offered an amendment which was adopted by a vote of 11–9 (Senators voting "Aye"—Gramm, Shelby, Mack, Bennett, Grams, Allard, Enzi, Hagel, Santorum, Bunning and Crapo. Senators voting "No"—Sarbanes, Dodd, Kerry, Bryan, Johnson, Reed, Schumer, Bayh and Edwards) creating a presumption that general State insurance licensing statutes or regulations are not applicable to short-term motor vehicle rental companies (or their employees) unless a State's statute or regulations specifically provide for such licensing. Senator Grams also offered an amendment (as amended by Senator Dodd) adopted by voice vote expressing the sense of the Congress that State insurance regulators develop uniform insurance agent and broker licensing and qualification requirements. Senator Bryan offered an amendment (as amended by Chairman Gramm) which was adopted by voice vote to substitute certain provisions of section 104 of the Committee Print, dealing with insurance sales activities of banks. Chairman Gramm offered an amendment which was adopted by voice vote permitting certain institutions that become bank holding companies following the date of enactment of the Financial Services Modernization Act of 1999 to continue to engage in or control shares of a company engaged in commodities trading, sales, and investment activities under certain conditions. Senator Sarbanes offered an amendment in the nature of a substitute, which was defeated by a vote of 11–9 (Senators voting "No"—Gramm, Shelby, Mack, Bennett, Grams, Allard, Enzi, Hagel, Santorum, Bunning and Crapo. Senators voting "Aye"—Sarbanes, Dodd, Kerry, Bryan, Johnson, Reed, Schumer, Bayh and Edwards).

The Committee then voted 11–9 to report the amended Committee Print to the Senate for consideration. Senators Gramm, Shelby, Mack, Bennett, Grams, Allard, Enzi, Hagel, Santorum, Bunning and Crapo voted in favor of the motion to report the bill from the Committee. Senators Sarbanes, Dodd, Kerry, Bryan, Johnson, Reed, Schumer, Bayh and Edwards voted against the motion to report the bill from the Committee.

## BACKGROUND

For over a decade, the Committee has been concerned that the statutory framework governing financial services has become outdated. Many of the statutes addressing financial services, dating from the Great Depression or even earlier, are not well adapted to the changes taking place in the financial services industry. In particular, developments in technology, globalization of financial services, and changes in the capital markets have rendered the laws governing financial services unsuitable and outdated in many respects. In 1988 and in 1991, the Committee reported bills that would have modernized the regulation of financial services.[1] In reporting the Financial Services Modernization Act of 1999 to the

[1] In 1988 the Committee reported S. 1886, the Financial Modernization Act of 1988. While the Senate passed this legislation, the full House took no action. In 1991 the Committee reported S. 543, the Comprehensive Deposit Insurance Reform and Taxpayer Protection Act of 1991. While portions of this bill were enacted as the "FDIC Improvement Act of 1991", the provisions restructuring the financial services industry were not enacted into law.

Senate, the Committee recommends a regulatory framework suitable for financial services as we move into the twenty-first century.

## NEED FOR THE LEGISLATION

The Committee believes that overhaul of our financial services regulatory framework is necessary in order to maintain the competitiveness of our financial institutions, to preserve the safety and soundness of our financial system, and to ensure that American consumers enjoy the best and broadest access to financial services possible with adequate consumer protections. It is important that the statutes regulating financial services promote these goals because of the crucial role that financial services play in the American economy. Not only does the financial services industry account for about 7.5 percent of our nation's gross domestic product and employ approximately 5 percent of our workforce, it is vital to the growth of the rest of the economy by serving as a channel for capital and credit. The financial services industry provides opportunities for savers, investors, borrowers, and businesses to realize their goals. It allows for the transfer of various kinds of risk to those most able to bear those risks. The pace of economic growth in this country depends in large part on the ability of the financial services industry to function efficiently.

The financial services industry is currently constrained by statutes that impose hurdles or outright prohibitions on the affiliation of banks on the one hand and securities firms and insurance companies on the other. These restrictions, many of which were enacted after the bank failures of the Great Depression, were intended to protect the financial system by insulating commercial banking from other forms of risk. Over time, these restrictions have hampered the ability of financial institutions to diversify their products. This inability to diversify actually increases risks to the financial system. By limiting competition, the outdated statutes also reduce incentives to develop new and more efficient products and services. This deprives consumers of the benefits of the marketplace.

Federal Deposit Insurance Corporation (FDIC) Chairman Donna Tanoue indicated that the current system, which divides the various sectors of the financial services industry, should be updated:

> The financial markets have changed dramatically since the 1930s when many of our nation's laws governing the financial system were written. Improvements in information technology and innovations in financial markets have rendered the current system increasingly obsolete and unable to provide the full range of financial services required by businesses and individual consumers in today's global economy. Modernization of the financial system is not only desirable, but necessary, to enable the financial services industry to meet the challenges that lie ahead.[2]

As the various sectors of financial services converge, providers of financial services are seeking to serve customers better by combining those sectors in one organization. Testifying for the Amer-

[2] Tanoue Testimony at 1.

ican Bankers Association, Hjalma Johnson, Chairman and CEO of East Coast Bank Corp, Dade City, Florida, described the blurring of the divisions between the financial services sectors:

> The virtually unanimous agreement among financial service providers that the time has come to modernize our financial structure is perhaps the most obvious evidence of the need for reform. Revolutionary improvements in technology and escalating competition are redefining the financial services business. The lines between different types of financial service firms have been blurred beyond recognition.
>
> Today, my customers have the option to write a check on a money-market mutual fund to pay their bills; they can have a credit card issued by a phone company; and they can get a home mortgage from an automobile manufacturer. This list of non-traditional suppliers of financial services competing for my customers gets longer every day. Even defining the term "financial service" is becoming difficult in today's market.[3]

In addition, as the number of nations participating in the global capital markets increases, providers of financial services face greater competition and seek greater economies of scale. Federal Reserve Board Chairman Greenspan describes the pressure that U.S. firms are experiencing:

> In the United States, our financial institutions have been required to take elaborate steps to develop and deliver new financial products and services in a manner that is consistent with our outdated laws. The costs of these efforts are becoming increasingly burdensome and serve no useful public purpose. Unless soon repealed, the archaic statutory barriers to efficiency could undermine the competitiveness of our financial institutions, their ability to innovate and to provide the best and broadest possible services to U.S. consumers, and ultimately, the global dominance of American finance.[4]

As banks, insurance companies, and securities firms enter one another's markets, regulation of financial services has become increasingly arbitrary. Witnesses identified numerous examples of this phenomenon to the Committee. Under current regulatory interpretation, national banks may sell insurance nationwide so long as such sales are based in a place of less than 5,000 people. Sales of insurance products may be subject to significantly different regulation depending on whether those sales are made by a bank or an insurance agent. Similarly, sales of securities may be regulated differently depending on whether they take place through a bank or a securities broker.

In many cases, existing statutes create impediments and inefficiencies for the affiliations occurring in the marketplace. Regulators and courts have on occasion fashioned paths around these impediments, but such actions are no substitute for the establish-

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[3] Johnson Testimony at 2.
[4] Greenspan Testimony at 2.

ment of fundamental policy by Congress. As Federal Reserve Board Chairman Alan Greenspan testified:

> Without congressional action to update our laws, the market will force ad hoc administrative responses that lead to inefficiencies and inconsistencies, expansion of the federal safety net, and potentially increased risk exposure to the federal deposit insurance funds. Such developments will undermine the competitiveness and innovative edge of major segments of our financial services industry. We believe that it is important that the rules for our financial services industry be set by the Congress rather than, as too often has been the case, by banking regulators dealing with our outdated laws. Only Congress has the ability to fashion rules that are comprehensive and equitable to all participants and that guard the public interest.[5]

Creating a new statutory framework for the financial services industry should translate into greater safety and soundness for the financial system, increased efficiency for financial services providers, and more choices and lower costs for consumers.

## PURPOSE AND SCOPE OF THE LEGISLATION

The Financial Services Modernization Act of 1999, as reported by the Committee, repeals the provisions of the Glass-Steagall Act that restrict the ability of banks and securities underwriters to affiliate with one another. Second, within the framework of the Bank Holding Company Act, the bill allows for a broader range of financial services to be affiliated, including commercial banking, insurance underwriting and merchant banking as defined in the legislation. It also contains provisions intended to provide appropriate regulation of bank sales of insurance. The bill also allows national banks with consolidated total assets not exceeding $1 billion, and not affiliated with a bank holding company, to engage in a broader range of financial services through subsidiaries. In order to engage in expanded activities in a principal capacity, the subsidiary must comply with certain safety and soundness requirements.

### *Permissible Affiliations*

Banks, securities firms, and insurance companies will be able to affiliate with one another through the bank holding company model. Bank holding companies will be allowed to engage in activities that are financial in nature or incidental thereto. This is a broader standard than the Aclosely related to banking" standard that currently delineates the permissible activities of bank holding companies.

The Committee believes that allowing broader affiliations within the bank holding company should place no segment of the financial services industry at a disadvantage. Banks, insurance companies, and securities firms should have equal opportunities to affiliate with one another.

Broader affiliations within the holding company structure will present new challenges for safety and soundness regulation of fi-

[5] Greenspan Testimony at 2.

nancial institutions. To meet these challenges, the bill establishes the Federal Reserve Board (the "Board") as the umbrella regulator of bank holding companies engaged in expanded financial activities. In order to engage in expanded financial activities, insured depository institution subsidiaries of a bank holding company must be well capitalized and well managed. The bill expressly provides that the provisions in Prompt Corrective Action (Section 38 of the Federal Deposit Insurance Act) will be used for purposes of determining whether an insured depository institution subsidiary of a bank holding company engaged in the new financial activities is well capitalized and whether an insured depository institution affiliate of a national bank with a financial subsidiary is well capitalized. Under Section 38(c) of Prompt Corrective Action, each Federal banking regulator has promulgated regulations specifying the levels at which an insured depository institution that is supervised by that regulator is well capitalized, adequately capitalized, undercapitalized, or significantly undercapitalized. To eliminate confusion and the potential for conflicting interpretations, the Committee intends that only the appropriate Federal banking agency for each insured depository institution subsidiary of a bank holding company or affiliate of a national bank shall determine the capital category for that institution in accordance with its regulations. In other words, the determination of whether an insured depository institution is well capitalized under this Act will be made by the OCC in the case of a national bank, the Board in the case of a state-member bank, the FDIC in the case of a state non-member bank, and the OTS in the case of an insured savings association.

*Organizational structure*

*The bank holding company*

The Committee carefully analyzed whether the holding company or the operating subsidiary approach is the appropriate organizational structure for new activities conducted by an insured bank. Some have characterized this debate as solely one of jurisdiction between the Board and the Treasury. The Committee disagrees. This is a fundamental issue which must be handled carefully in the context of the significant reforms in activities that we are considering.

Congress must be careful to provide sufficient safeguards for our new financial framework. The Committee does not want to see a repeat of the savings and loan crisis where the taxpayer had to bail out federally insured institutions that assumed excessive risks and operated without effective management, internal controls, and supervision. The deposit insurance funds must be adequately insulated from paying the losses of firms which are affiliated with insured banks. The Committee believes that the holding company structure best achieves this purpose. The Committee took into consideration Federal Reserve Board Chairman Greenspan's views on this topic. Many distinguished former regulators share his views. In a recent editorial, former Federal Reserve Board Chairman Paul Volcker wrote:

> The commercial bank must be a separate organization, insulated legally from its sister entities providing financial

services. Moreover, that arrangement is more easily compatible with continued "functional" supervision of the component parts * * *[6]

Finally, the Committee has previously endorsed the holding company framework. In 1991, the Committee approved S. 543, which repealed the Glass-Steagall Act and allowed banks to affiliate with securities firms using the holding company structure to ensure safety and soundness, a level competitive playing field, and protection of the taxpayer. The bill also adopts the holding company framework, but expands the range of permissible financial affiliations to include insurance underwriting, merchant banking, and activities complementary to financial activities.

*National bank subsidiaries*

While the general approach to affiliations under the bill is through the bank holding company framework, limited authorization also is granted to smaller national banks (those with consolidated assets not exceeding $1 billion that are not part of a holding company structure) to affiliate with other financial service providers through subsidiaries meeting certain safety and soundness requirements. Such financial subsidiaries, as defined in the bill, are authorized to conduct financial activities in a principal capacity.

The bill also expands the activities in which banks may engage. Section 121 of the bill authorizes national banks to underwrite municipal revenue bonds. Section 123 of the bill allows national bank subsidiaries to engage in any type of financial activity in an agency capacity. With respect to agency activities other than the sale of insurance products, the bill would prohibit States from preventing or restricting bank activities in these areas.

For at least 30 years, national banks have been authorized to invest in operating subsidiaries that are engaged only in activities that national banks may engage in directly. For example, national banks are authorized directly to make mortgage loans and engage in related mortgage banking activities. Many banks choose to conduct these activities through subsidiary corporations. Nothing in this legislation is intended to affect the authority of national banks to engage in bank permissible activities through subsidiary corporations, or to invest in joint ventures to engage in bank permissible activities with other banks or nonbank companies.

*Treasury role in determining "financial in nature"*

The Committee believes that the Treasury Department's views regarding what activities are "financial in nature" are highly relevant. Accordingly, the bill creates an explicit role for the Treasury Department in the Board's review process.

The Board must coordinate and consult with the Treasury Department in making its determinations regarding financial activities. The Board may not determine that an activity is financial in nature if the Treasury Department believes that it is not financial or incidental to a financial activity. The Treasury Department may

[6] Volcker, Paul. "Boost for Banking". Washington Post. September 10, 1998.

also recommend that an activity be deemed to be financial in nature, and the Board must determine within thirty days whether to initiate a public rulemaking regarding the Treasury Department's proposal.

*Merchant banking*

The bill creates a new Section 4(k) of the Bank Holding Company Act (the "BHCA"). Section 4(k)(4)(H) recognizes the essential role that principal investing, or merchant banking, plays in modern finance. A bank holding company or its non-bank affiliate (collectively, the "BHC") whether directly, indirectly, or through a fund, may make investments in any amount in, or otherwise acquire control of, a company, subject to conditions designed to maintain the separation between banking and commerce. The ownership interests must be acquired for appreciation and ultimate resale or other disposition. Such disposition can be subject to a variety of factors, including overall market conditions, the condition and results of operation of the portfolio company's business, and its duties to co-investors and advisory clients. The Committee recognizes that certain investments may be held for a period of time in order to realize their potential value.

The Committee believes that compliance with the requirements of Section 4(k)(4)(H) can be ascertained either by periodic reports from, or by examination of, the holding company or affiliate making the investment. No examination of the portfolio company is necessary other than in the case in which reports or examinations are necessary to assure compliance with restrictions governing transactions involving depository institutions and portfolios companies.

Furthermore, the Committee intends Section 4(k)(4)(H) to permit investment banking firms to continue to conduct their principal investing in substantially the same manner as at present. A BHC should not be placed at a competitive disadvantage with firms unaffiliated with any depository institution. The Board shall not require, even informally, any pre-clearance of principal investments and not impose arbitrary or unduly restrictive limitations on the holding period for such investments. Moreover, the Board should challenge the exercise of discretion regarding the duration of an investment only if clearly inconsistent with the purposes of this section. Finally, the Committee intends that the Board be the sole entity with legal standing to allege that a BHC is in violation of Section 4(k)(4)(H) with respect to a particular investment.

*Functional regulation*

The bill generally adheres to the principle of functional regulation, which holds that similar activities should be regulated by the same regulator. Different regulators have expertise at supervising different activities. It is inefficient and impractical to expect a regulator to have or to develop expertise in regulating all aspects of financial services. Accordingly, the bill is intended to ensure that banking activities are regulated by bank regulators, securities activities are regulated by securities regulators, and insurance activities are regulated by insurance regulators. The bill establishes procedures for determining whether future products should be underwritten within a bank, subject to banking regulation, or by an in-

surance company subject to insurance regulation. Similarly, the bill contains procedures for determining whether new products should be subject to banking regulation or securities regulation.

*Securities activities of banks*

The bill includes other provisions that pertain to the treatment of banking products that are also "securities" for the purposes of the Federal securities laws and certain traditional banking activities that involve securities transactions. Currently, banks are exempted from the definition of "broker" and "dealer" in the Securities and Exchange Act of 1934 (the "1934 Act"), and are, therefore, not required to register as broker-dealers with the Commission. The legislative history of the 1934 Act indicates that banks were excluded from the definition of "broker" and "dealer" because Congress recognized at that time that these institutions were already subject to a comprehensive scheme of Federal regulation.[7]

In recent years, however, the bank regulators have permitted banks and bank holding companies to expand their securities activities. The bill accommodates this trend within a functional regulatory framework. The repeal of Glass-Steagall's anti-affiliation rules and the blanket exemption for banks from broker-dealer registration raises the issue whether, and under what circumstances, such products and activities should be "pushed out" of (i.e., moved out of) a bank and into a registered broker-dealer affiliate.

The Committee does not believe that an extensive "push-out" of or restrictions on the conduct of traditional banking services is warranted. Banks have historically provided securities services largely through their trust departments, or as an accommodation to certain customers. Banks are uniquely qualified to provide these services and have done so without any problems for years. Banks provided trust services under the strict mandates of State trust and fiduciary law without problems long before Glass-Steagall was enacted; there is no compelling policy reason for changing Federal regulation of bank trust departments, solely because Glass-Steagall is being modified. Under IRS regulations, banks must offer self-directed Individual Retirement Accounts ("IRAs") in either a trustee or custodial capacity. Services rendered as a trustee do not require registration as a broker-dealer to the extent that these services fall within the trust exemption. The Committee believes that bank custodial, safekeeping, and clearing activities with respect to IRAs do not need to be pushed-out into a Commission registered broker-dealer.

Banks also provide services for employee benefit plans, dividend reinvestment plans, and issuer plans. Currently, such service plans can offer direct execution services to participants through transfer agents. By removing the intermediaries from the execution process, these plans provide cost-savings for their participants. The transfer agents receive a payment which is calculated based on transaction volume (typically, a set number of basis points of the volume).

The bill does not prevent the offering of such services for transaction-based fees. Since transfer agent activities are regulated, and

[7] See, *American Bankers Association* v. *SEC*, 804 F.2d 739 (D.C. Cir. 1986), which includes a thorough and lengthy analysis of the legislative history behind the bank exemption from the 1934 Act.

the transaction-based fees are for ministerial services which provide significant cost-savings for shareholders, the Committee finds no compelling reason to impose restrictions on transaction-based fees.

With respect to private placements, the Committee believes that, to the extent that these transactions are conducted pursuant to applicable Federal law or the rules and regulations issued thereunder, there is no compelling reason to "push-out" these activities (which have been supervised by banking regulators).

The bill gives both the Board and the Commission a role in determining whether new products must be pushed-out to a registered broker-dealer. The Committee believes these changes will allow banks to develop new products cheaply and efficiently, while giving due consideration to the dual goals of safety and soundness and investor protection.

*Insurance activities*

As approved by the Committee, the bill creates a new Federal framework for insured depository institutions to affiliate with other financial firms and to engage, directly or indirectly, in a variety of financial activities. The Committee recognizes, however, that States have long had regulatory authority over certain financial activities, such as the business of insurance. Thus, it is the Committee's intent that the affiliations and activities authorized or permitted by Federal law be conducted in a manner that is consistent with applicable State regulation.

On the other hand, the Committee is aware that some States have used their regulatory authority to discriminate against insured depository institutions, their subsidiaries and affiliates. The Committee has no desire to have State regulation prevent or otherwise frustrate the affiliations and activities authorized or permitted by the bill. Thus, Section 104 clarifies the application of State law to the affiliations and activities authorized or permitted by the bill (or other Federal law), and ensures that applicable State law cannot prevent, discriminate against, or otherwise frustrate such affiliations or activities.

*Preemption of State anti-affiliation laws*

Subsection 104(c)(1) preempts State laws that prevent affiliations authorized or permitted by the bill. It provides that a State may not by statute, regulation, order, interpretation, or other action "prevent or restrict" the affiliations authorized by the bill. Currently, a number of States have such so-called "anti-affiliation" laws in effect. Without Section 104(c)(1), such laws would frustrate one of the principal purposes of the bill, which is to permit insured depository institutions to affiliate with other financial firms, including securities and insurance firms. An example of a State law that would be preempted under the "prevent or restrict" standard is the Florida law that prohibits a Florida-licensed insurance agent from being associated with, owned, or controlled by a financial institution.

Subsections 104(g) (1) and (2) complement subsection 104(c)(1). Those subsections prohibit States from preventing or placing certain limitations on affiliations between insurance underwriters and

insured depository institutions. The Committee does not intend to imply, however, that the State actions described in subsections 104(g)(1) and (2) are not otherwise subject to preemption under the terms of subsection 104(c)(1).

*Exception for insurance affiliations*

In its effort to strike an appropriate balance between the preemption of State anti-affiliation laws and State regulation of the business of insurance, the Committee created a limited exception to Section 104(c)(1) for affiliations between insured depository institutions, their subsidiaries and affiliates, and insurance underwriters. Subsection 104(c)(2) provides that States may collect, review, and take actions on the acquisitions, changes, or continuations of control of an entity engaged in the business of insurance that is domiciled within the State.

This exception is aimed at affiliations between an insured depository institution, or a subsidiary or affiliate thereof, and firms engaged in the business of insurance. It permits a State to review such applications in order to ensure that the affiliation does not jeopardize the solvency of the underwriter.

Actions taken by a State pursuant to this exception cannot be inconsistent with the purpose of the bill to permit affiliations between insured depository institutions, their subsidiaries and affiliates, and the underwriters of insurance or annuities. Furthermore, State actions may not have the practical effect of discriminating, either intentionally or unintentionally, against an insured depository institution, subsidiary or affiliate thereof, or any other person or entity affiliated with an insured depository institution.

*General preemption standard for State laws related to authorized activities*

Subsection 104(d)(1) is a general preemption standard applicable to all State laws related to activities authorized or permitted by the bill. This general preemption standard provides that no State may take any action to "prevent or restrict" the ability of an insured depository institution, or subsidiary or affiliate thereof, from engaging directly or indirectly, either by itself or in conjunction with a subsidiary, affiliate, or any other entity or person, in an activity authorized by the bill. The Committee recognizes that this general preemption standard may not be appropriate for all types of State law. For example, the general "prevent or restrict" standard could, unintentionally, preempt capital and solvency requirements applicable to insurance underwriters. Thus, as explained below, the Committee established separate preemption standards for State insurance laws and certain other categories of State law.

*Preemption standards for State insurance sales laws adopted prior to September 3, 1998*

States have long been the primary regulators of insurance. In recognition of this, the bill establishes separate preemption standards applicable to State insurance sales, solicitation, and cross-marketing laws. These preemption standards distinguish between State insurance sales, solicitation, and cross-marketing laws adopt-

ed prior to September 3, 1998, and such laws adopted after that date.

The Committee believes that State insurance sales, solicitation, and cross-marketing laws adopted prior to September 3, 1998 should be subject to preemption under the preemption standards applicable when such laws were adopted. Thus, it is the Committee's intent that such laws may be subject to preemption under applicable case law, and the statutory preemption standard set forth in subsection 104(d)(2)(A), which is patterned after such case law. There is an extensive body of case law related to the preemption of State law. For example, in *Barnett Bank of Marion County, N.A.* v. *Nelson,* 116 S.Ct. 1103 (1996), the U.S. Supreme Court noted that Federal courts have preempted State laws that "prevent or significantly interfere" with a national bank's exercise of its powers; that "unlawfully encroach" on the rights and privileges of national banks; that "destroy or hamper" national banks' functions; or that "interfere with or impair" national banks' efficiency in performing authorized functions.

One example of a State law that would be preempted under the standard set forth in subsection 104(d)(2)(A) is a statute that requires all shareholders of an insurance agency to be licensed by the State. Such a requirement would prevent or significantly interfere with the ability of an insured depository institution, subsidiary, or affiliate to engage in insurance sales, since it is practically impossible for all shareholders of such entities to be licensed. Another example of a State law that would be preempted under the standard set forth in subsection 104(d)(2)(A) would be a statute that limits the volume or portion of insurance sales made by an insurance agent on the basis of whether such sales are made to customers of an insured depository institution or any affiliate of the agent. Such a statute would prevent or significantly interfere with the sale of insurance to an insured depository institution's customers.

*Preemption standards for insurance sales laws adopted after September 3, 1998*

For laws enacted after September 3, 1998, the Committee believes it is appropriate to apply not only traditional standards of preemption, but also a new, statutory nondiscrimination standard. The application of this additional test reflects the fact that versions of Section 104 have been pending in Congress since September 3, 1998. Therefore, State insurance sales, solicitation, and cross-marketing laws adopted after September 3, 1998, are subject to preemption not only under applicable case law and the statutory standard based upon that case law, which is set forth in subsection 104(d)(2)(A), but also to the nondiscrimination standard established in subsection 104(e).

The nondiscrimination standard created in subsection 104(e) preempts any State statute, regulation, order, interpretation, or other action that—

> (1) distinguishes by its terms between insured depository institutions, or subsidiaries or affiliates thereof, and other persons or entities engaged in such activities, in a manner that is in any way adverse to any such insured depository institution, or subsidiary or affiliate thereof;

(2) as interpreted or applied, has or will have an impact on depository institutions, or subsidiaries or affiliates thereof, that is substantially more adverse than its impact on other persons or entities providing the same products or services or engaged in the same activities that are not insured depository institutions, or subsidiaries or affiliates thereof, or persons or entities affiliated therewith;

(3) effectively prevents a depository institution, or subsidiary or affiliate thereof, from engaging in insurance activities authorized or permitted by this Act or any other provision of federal law; or

(4) conflicts with the intent of this Act generally to permit affiliations that are authorized or permitted by federal law between insured depository institutions, or subsidiaries or affiliates thereof, and persons and entities engaged in the business of insurance.

An example of a State law that would be preempted under this standard is a law that would prohibit the sale of insurance within 100 yards of a teller window. While such a law would apply equally to all parties, it would have an impact on an insured depository institution that is substantially more adverse than its impact on other persons engaged in insurance sales.

Finally, it is the Committee's intent that courts apply the various preemption standards applicable to State insurance sales, solicitation, and cross-marketing laws so as to give effect to each of the standards. In other words, the standards are intended to be complementary alternatives. One standard is not intended to limit or reduce the scope of another.

*Safe harbors*

The Committee determined that certain categories of State insurance sales, solicitation, and cross-marketing laws that relate to insured depository institutions should not be subject to preemption under traditional case law, the preemption standard established in subsection 104(d)(2)(A), or the nondiscrimination standard established in subsection 104(e). The Committee recognizes that many of these categories of State insurance sales, solicitation, and cross-marketing laws, which appear in subsection 104(d)(2)(B), are already subject to Federal banking agency advisories and guidelines. Thus, subsection 104(d)(2)(B) lists various categories of State insurance sales, solicitation, and cross-marketing laws that are not subject to preemption under the terms of this bill. With respect to the enumerated safe harbors, however, it is the Committee's intent that any restrictions imposed by the States not be more burdensome or restrictive.

Under the terms of subsection 104(d)(2)(B), a State may impose restrictions on the use of advertising or other promotional material by an insured depository institution to ensure that such advertisements or promotional materials do not cause a reasonable person to believe that a State or the Federal Government guarantees the insurance. This provision is necessary to avoid any potential for confusion by the purchasers of insurance products. On the other hand, it is not intended as a means for States to impose a complex regulatory structure related to the review and approval of adver-

tisements that is not otherwise applicable to other providers of insurance.

Similarly, subsection 104(d)(2)(B) permits a State to require that any person who receives a commission as an insurance agent hold a valid State license for the applicable class of insurance sold. Such a provision ensures that only qualified individuals act as agents and protects the purchasers of insurance from unprofessional, and potentially improper sales practices. On the other hand, such a provision is not intended to encourage States to impose different qualification standards for licenses held by agents that sell insurance by or on behalf of an insured depository institution than are applicable for other agents. Furthermore, this provision is not intended to suggest that an insured depository institution, itself, be licensed as an agent in order to either employ agents or contract with others to sell insurance.

Also, subsection 104(d)(2)(B) permits a State to prohibit the payment of any compensation to an individual who is not licensed to sell insurance if the compensation is based on the purchase of insurance by the customer. This provision is intended to prevent employees of insured depository institutions from having inappropriate incentives to sell insurance to customers. It is not, however, intended to apply to the payment of compensation for referrals when such compensation is unrelated to the purchase of insurance by a customer.

The Committee does not intend that State laws falling within any one of the safe harbor categories be identical to any one of those categories. However, the bill does provide that in order to fall within any one of these categories the State law must be substantially the same as the corresponding category in subsection 104(d)(2)(B), and no more burdensome than such category.

*Preemption standard for other State insurance laws*

The Committee recognizes that, as a general rule, State laws related to insurance underwriting activities have not been applied in a manner that is discriminatory to insured depository institutions, their subsidiaries, or affiliates. Thus, subsection 104(d)(3) provides that the general preemption standard applicable to authorized activities (subsection 104(d)(1)) does not apply to State statutes, regulations, interpretations, orders or other actions otherwise addressed in the subsection provided that such State actions do not contravene the nondiscrimination standard established in subsection 104(e).

*Exceptions for certain categories State law*

Subsection 104(d)(4) provides that the general preemption standard applicable to authorized activities (subsection 104(d)(1)) does not apply to State statutes, regulations, interpretations, orders, or other actions that are not otherwise addressed in the subsection (such as zoning laws), provided such State actions do not discriminate against insured depository institutions, their subsidiaries, and affiliates, and others engaged in the same activity. In other words, the general preemption standard applicable to authorized activities would not reach State zoning or criminal laws that may apply to

an insured depository institution, subsidiary or affiliate thereof, engaged in an authorized activity.

Subsection 104(f) provides that neither the preemption of State anti-affiliation laws (subsection 104(c)) nor the various activity preemption standards in subsection 104(d) apply to State securities investigations and enforcement actions, or to State laws, regulations, orders, interpretations, or other actions related to corporate governance or antitrust, provided such corporate or antitrust laws, regulations, orders, interpretations, or other actions are of general applicability and are not inconsistent with the purposes of the Act to authorize affiliations and remove barriers to such affiliations.

*Holding company regulation*

The bill seeks to provide regulation of BHCs that is sufficient to protect the safety and soundness of the financial system and the integrity of the Federal deposit insurance funds without imposing unnecessary regulatory burdens. While functional regulators are supervising various holding company subsidiaries, the Committee believes there is a need for oversight of the organization as a whole as well as subsidiaries not subject to functional regulation. The need for holding company regulation was stressed by witnesses before the Committee as well. For example, William McQuillan, President of City National Bank of Greeley, N.E., testified, "the IBAA strongly supports the establishment of an umbrella regulator for diversified financial services firms and feels the only Federal regulator equipped for this job is the Federal Reserve."[8]

Accordingly, the Board has authority to examine the holding company and, under certain circumstances, any holding company subsidiary that poses a material risk to an affiliated bank.

The Committee does not intend for holding company regulation to override functional regulation of holding company subsidiaries. For functionally regulated subsidiaries, the Board is required, to the greatest extent possible, to rely on reports required by and examinations conducted by the functional regulator. Thus, the Board must generally defer to regulation by the State insurance commissioners, the State and Federal banking agencies, the Securities and Exchange Commission (the "Commission"), the State securities commissioners, and appropriate self-regulatory organizations. The Board may not require that an insurance company or securities firm provide financial support to a troubled bank affiliate if the functional regulator determines this would have a materially adverse effect on the financial condition of the insurance company or securities firm.

*Too-big-to-fail*

The Committee felt strongly that language should be added to the bill to address the "too-big-to-fail" concerns. Accordingly, the bill amends the Federal Deposit Insurance Act to prevent the use of Federal deposit insurance funds to assist affiliates or subsidiaries of insured depository institutions. The intent of this provision is to ensure that the FDIC's deposit insurance funds not be used to protect uninsured affiliates of financial conglomerates.

[8] McQuillan Testimony at 10.

*Insurance customer protections*

The Committee recognizes the importance of protecting customers who will now be able to purchase a broader ranger of financial products from affiliated providers of financial services on the premises of or through banks. The wider variety of financial products available at a bank raises potential customer confusion about the insured status, risks, the issuer and the seller of the new products. The Committee is concerned about past instances in which depositors have purchased unsuitable investment products without understanding their nature, and wants to take reasonable steps to prevent misunderstanding and confusion when bank customers receive unsolicited sales presentations or see advertisements for securities and insurance products for purchase through the bank.

The bill requires, to the extent practicable, that sales take place in an area separate from the deposit-taking area, so that retail customers can distinguish whether a bank, a securities broker or insurance agent is offering the product. Salespersons would be required to inform potential customers about whether the products are insured or carry risks with conspicuous and readily understandable disclosures before sales occur, and would be prohibited from misrepresenting the products' uninsured nature. The bill requires sales personnel to be appropriately licensed. Unlicensed employees, such as tellers, would be allowed to receive a nominal, one-time, fixed-dollar fee for referring a customer to the stock or insurance broker, provided such fee's payment is not conditioned on whether the customer executes a transaction.

The bill requires the Federal bank regulators, in consultation with State insurance authorities, as appropriate, to issue regulations that are consistent with the requirements of the Act that apply to the retail sale of insurance products by or through banks. The Commission would administer the amended provisions of the 1934 Act affecting the retail sales of securities through networking arrangements on or off bank premises.

*Community Reinvestment Act (CRA)*

The bill does not expand the application of the Community Reinvestment Act (CRA). Thus, the criteria for engaging in expanded financial activities by a bank holding company, or by a qualifying national bank through a subsidiary, remain as in current law the fulfillment of capital and management requirements.

In addition, the bill makes CRA examinations meaningful by deeming an insured depository institution in compliance with the CRA (i.e., that the institution has met the credit needs of its entire community) if it has achieved at least a "satisfactory" rating in all of its CRA examination during the immediately preceding 36-month period. The presumption of an institution's CRA compliance may be rebutted or challenged by substantial verifiable evidence brought to the attention of the appropriate Federal bank regulatory agency. The objector will bear the burden of proving the substantial verifiable nature of the evidence.

The cost of regulatory compliance on smaller institutions is a matter of concern to the Committee. To this end, the bill also exempts from the requirements of the CRA small banks and thrifts (those with total assets not exceeding $100 million) located in non-

metropolitan areas. The exemption would, in effect, apply only to 38% of all banks and thrifts, which control less than 3% of banking assets nationally.

*Community banks*

Small independent banks are confronting unprecedented challenges as a result of growing competition from all financial service providers, the accelerating pace of technological change and the innovation it promotes, changing demographic patterns, and shifting consumer attitudes towards managing their personal finances. The Committee has attempted in this and other legislation within its jurisdiction to recognize the importance of community-oriented banks to our economy and the local markets they serve.

Because the Committee wants to make every effort to preserve the role of community banks, this bill includes a requirement for a General Accounting Office (the "GAO") study of certain revisions to S corporation tax rules permitting greater access by community banks to S corporation treatment.

*Federal Home Loan Banks*

The bill includes certain provisions addressing the Federal Home Loan Bank ("FHLB") System. The last major reform of the FHLB System took place in the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"). In 1989, Congress permitted commercial banks to gain access to the system. The provisions in the bill addressing the FHLB System are intended to recognize the changes in membership and regulatory structure put in place by FIRREA.

There are four major provisions in the bill affecting the FHLB System. The first changes the membership of thrifts from mandatory to voluntary. The system provides enough benefits to its members to ensure that it can sustain itself on the membership of those who wish to join. Second, the bill gives small banks greater access to advances by expanding the types of assets they may pledge as collateral. Third, the Resolution Funding Corporation obligation was changed from a fixed dollar figure to a percentage of the system's current net earnings. Lastly, many of the day-to-day management functions of the Federal Housing Finance Board ("FHFB"), which regulates the FHLB System, have been decentralized. Many of the day-to-day functions of the FHLBanks currently require approval from the FHFB. These approval requirements largely date to an earlier period when the FHLBanks were regulated by the Federal Home Loan Bank Board. Several studies, including one by the GAO, have suggested that the FHFB is too involved in day-to-day management decisions of the FHLBanks. The bill also requires a study by the GAO relating to the capital structure of the FHLB System.

*Foreign banks*

The bill gives the Board explicit authority to apply comparable capital and management standards to foreign banks operating a branch or agency or owning or controlling a commercial lending company in the United States.

Congress amended the International Bank Act ("IBA") in 1991, after the Bank of Credit and Commerce International ("BCCI") affair, to require that a foreign bank could not establish a representative office without obtaining the prior approval of the Board. In keeping with the common understanding of representative offices, a subsidiary of a foreign bank was excluded from the IBA definition of a representative office. The Committee has become aware that some foreign banks are seeking to avoid the prior approval requirement of the IBA by establishing separate subsidiaries or using existing nonbank subsidiaries to act as representative offices. Although the subsidiary is separately incorporated, it carries out the same representative function as if it were a traditional representative office of the foreign bank. A number of States do not distinguish between representative offices that are direct offices of the foreign bank and those that are subsidiaries. Accordingly, the bill would eliminate this loophole by striking the subsidiary exclusion from the definition of representative offices.

In addition, the bill clarifies the Board's authority to examine a U.S. affiliate of a foreign bank with a representative office in order to determine the compliance of the representative office with requirements of U.S. law. Presently, if a foreign bank has only a representative office and no other banking office in the United States, the Board may examine only the representative office. The Board cannot currently examine or seek information from U.S. affiliates of such foreign bank. This limitation could become a problem if there were serious questions raised about the nature or legality of relationships or transactions between the representative office and its U.S. affiliates. To illustrate such a problem, it must be recalled that BCCI illegally used its representative offices to engage in deposit-taking and money laundering in the United States.

*Unitary thrift holding companies*

Under the bill, new unitary savings and loan holding companies will not enjoy the benefits of unitary status and will be subject to the activity limitations of the Savings and Loan Holding Company Act. Existing unitary savings and loan holding companies (those meeting the grandfather date requirements of the bill) will not be subject to those limitations. Although some have advocated that the rights of those existing unitary companies should be extinguished upon sale, the bill reflects the Committee's judgment that the value of those companies, built up in justified reliance on a legitimate legal structure authorized by Congress, and often with the encouragement of Federal regulators, should not be subject to destruction or diminution resulting from the imposition of such restrictions. Instead, the bill preserves the existing transferability rights of such companies.

SECTION–BY–SECTION ANALYSIS

## Title I—Facilitating Affiliation Among Banks, Securities Firms, and Insurance Companies

### *Subtitle A—Affiliations*

#### *Section 101. Glass-Steagall reformed*

Section 101 repeals Sections 20 and 32 of the Glass-Steagall Act, allowing affiliations and interlocking employment among banks and securities firms.

#### *Section 102. Financial activities*

Section 102 establishes the existing bank holding company (BHC) structure as that under which banks may affiliate with securities and insurance firms. A BHC may so affiliate and engage in a broad range of financial activities and activities incidental thereto if all of its insured depository subsidiaries are well capitalized and well managed.

Activities that are "financial in nature" or "incidental to financial activities," include:

Lending and other traditional bank activities;

Insurance underwriting and agency activities;

Providing financial, investment, or economic advisory services;

Issuing or selling instruments representing interests in pools of assets that a bank may own directly;

Securities underwriting and dealing, and mutual fund distribution;

Merchant banking;

Any activity that the Federal Reserve Board (the "Board") has deemed "closely related to banking" under the Bank Holding Company Act;

Any activity that the Board has already approved for U.S. banks operating abroad;

Any other activity the Board may approve as "financial in nature" or "incidental" to a financial activity; and

Activities that are complementary to financial activities, or any service that the Board determines not to pose a substantial risk to the safety or soundness of depository institutions or the financial system generally.

The Board will determine by regulation or order which activities are financial in nature or incidental to financial activities. In determining whether activities are financial in nature or incidental to financial activities, the Board must take into account expected changes in markets or technology, and international competition.

The Board must coordinate and consult with the Treasury Department in making its determinations regarding financial activities. The Board may not determine that an activity is financial if the Treasury believes that it is not financial or incidental to a financial activity. The Treasury may also recommend that an activity be deemed financial, and the Board must determine within 30 days whether to initiate a public rulemaking regarding the proposal.

In determining whether an activity is financial in nature or incidental to one or more financial activities, the Committee intends that the Board take into account a number of factors. Those factors include the purposes of the Financial Services Modernization Act of 1999 (the "Act") and the BHCA, changes that have occurred or are reasonably expected in the marketplace in which bank holding companies compete or in the technology for delivering financial services, whether the activity in necessary and appropriate to allow a financial holding company and its affiliates to compete effectively with any company seeking to provide financial services in the United States, and any available or emerging technological means for providing financial services to customers or allowing customers to use financial services.

This authority includes authority to allow activities that are reasonably connected to one or more financial activities. For example, the Board has, under the existing closely related to banking test, permitted bank holding companies to engage in activities, such as processing any type of data or providing general management consulting services, that are incidental to permissible nonbanking activities, subject to certain limits. The Board has also allowed bank holding companies to market excess capacities that have been developed or acquired in the course of conducting permissible activities, in order that bank holding companies may make and plan for the most cost effective acquisition of technological and other facilities. This authority provides the Board with some flexibility to accommodate the affiliation of depository institutions with insurance companies, securities firms, and other financial services providers while continuing to be attentive not to allow the general mixing of banking and commerce in contravention of the purposes of this Act.

This section also grandfathers commodity activities and affiliations of certain companies becoming bank holding companies after the date of enactment of the Act. Generally, these companies may continue to engage in or, directly or indirectly, own or control shares of a company engaged in activities related to the trading, sale or investment in commodities and underlying physical properties if the holding company or any subsidiary was lawfully engaged in such activities as of September 30, 1997 in the United States; and the holding company is predominantly engaged in activities financial in nature.

*Section 103. Conforming amendments*

Section 103 amends the Home Owners' Loan Act of 1933 to permit multiple savings and loan holding companies to engage in activities permissible for bank holding companies.

*Section 104. Operation of State law*

Section 104 establishes the core rules that will apply to state regulation of the affiliations and activities authorized under the Act.

Section 104(a) simply restates that the McCarran-Ferguson Act, 15 U.S.C. §§ 1011 et seq., remains the law of the United States.

Section 104(b)(1) generally requires any person providing insurance in a State as principal or agent to be licensed as required by the appropriate insurance regulator of such State in accordance with the relevant State insurance law. This requirement is subject

to the general preemption and nondiscrimination requirements set forth in Section 104 (c), (d) and (e).

Section 104(c), in general, preempts a State's ability to prevent or restrict affiliations between insured depository institutions and financial entities, except that a State insurance regulator may collect, review and take actions on applications and documents or reports necessary or required in connection with proposed acquisitions, changes or continuations of control of entities domiciled within the State. The State actions must not have the practical effect of discriminating, intentionally or unintentionally, against an insured depository institution, subsidiary or affiliate thereof, or against any person or entity based upon affiliation with an insured depository institution.

Section 104(d)(1), in general, preempts a State's ability to prevent or restrict the sales activities authorized under this Act of an insured depository institution or subsidiary or affiliate thereof with the exception of insurance sales and certain other insurance activities.

Section 104(d)(2)(A) then establishes the general preemption rule that applies to state regulation of insurance sales, solicitation or cross-marketing activities. In accordance with the legal standards for preemption set forth in the decision of the Supreme Court of the United States in *Barnett Bank of Marion Co., N.A.* v. *Nelson,* 116 S. Ct. 1103 (1996), no State may prevent or significantly interfere with the ability of an insured depository institution, or a subsidiary or affiliate thereof, to engage in insurance sales, solicitation and cross-marketing activities.

Section 104(d)(2)(B) establishes 13 separate "safe harbor" provisions. These "safe harbors" permit a State to impose restrictions that are substantially the same as but no more burdensome or restrictive than the requirements included in each "safe harbor" provision. Any state law that falls within a safe harbor cannot be preempted under the provisions of Section 104(d)(2)(A). The "safe harbors" apply both to state laws and regulations already in place and to those that may be enacted in the future. They protect state restrictions—

Prohibiting the rejection of an insurance policy required in connection with a loan solely because it was sold or underwritten by an unaffiliated agent.

Prohibiting the imposition of extra charges on insurance policies required in connection with a loan that are purchased from unaffiliated agents.

Prohibiting misrepresentations regarding the insured or guaranteed status of any insurance product.

Requiring that commissions can be paid only to licensed insurance agents.

Prohibiting any referral fees paid to non-licensed individuals to be based on whether the referral results in a transaction.

Prohibiting the release of insurance information to nonaffiliated third parties for the purpose of soliciting or selling insurance without the express written consent of the customer.

Prohibiting the use of health information obtained from insurance records without the express written consent of the customer.

Prohibiting tying arrangements.

Requiring the written disclosure, prior to any insurance sale, that the products is—(1) not a deposit; (2) not insured by the FDIC; (3) not guaranteed by the financial institution or its subsidiaries or affiliates; and (4) where appropriate, involves investment risk, including loss of principal. This disclosure may be required to be in writing where a writing is practicable.

Requiring the disclosure, when insurance is required in connection with a loan, that the purchase of insurance from an unaffiliated agent will not affect the loan decision or the credit terms in any way.

Requiring the completion of credit and insurance transactions through separate documents.

Prohibiting the inclusion of the expense of insurance premiums in a primary credit transaction without the express consent of the customer.

Requiring the maintenance of separate insurance books and records that must be made available to state insurance regulators for inspection.

The Act provides special rules with respect to State laws, regulations, orders, interpretations and other actions enacted, issued or taken prior to September 3, 1998. Pursuant to Section 104(d)(2)(C)(ii), these laws and other actions will not be subject to the Act's nondiscrimination provisions found at Section 104(e). In addition, pursuant to Section 104(d)(2)(C)(i), when these laws and other actions are reviewed in the courts, traditional rules of judicial deference will be applied. These special rules do not apply to State laws and other actions that fall within the "safe harbors" found at Section 104(d)(2)(B).

With respect to State laws, regulations, orders, interpretations and other actions enacted, issued or taken on or after September 3, 1998, the Act will apply a nondiscrimination standard found at Section 104(e), unless the laws or actions fall within the safe harbors found at Section 104(d)(2)(B). Courts reviewing State laws enacted on or after September 3, 1998 will also apply new provisions relating to deference, found at Section 203(e).

Whether or not a State law, regulation, order, interpretation or other action involving insurance sales, solicitation or cross-marketing activities was enacted, issued, or taken prior to or on or after September 3, 1998, the principles of the *Barnett* case will still apply, as well as the statutory preemption standard at Section 104(d)(2)(A), except to the extent that the State law or action falls within the safe harbor protections.

Finally, Section 104(d)(2)(C)(iii) provides generally that Section 104(d)(2) should not be construed to limit the applicability of the *Barnett* decision or draw inferences regarding other State law not referenced by one of the 13 safe harbors.

Sections 104(d) (3) and (4) clarify that no preemption under paragraph (d)(1) is intended with respect to certain State laws that do not violate the nondiscrimination standards established in Section 104(e).

Section 104(e) establishes a second preemption standard that prohibits a State from regulating the activities authorized or permitted under this Act or any other provision of law in a manner

that—(1) distinguishes by its terms between insured depository institutions and other persons engaged in similar activities that is in any way adverse to an insured depository institution; (2) as interpreted or applied, has or will have an impact on insured depository institutions that is substantially more adverse than its impact on other persons providing similar products and services; (3) effectively prevents an insured depository institution from exercising its powers under this Act or Federal law; or (4) conflicts with the intent of this Act.

Section 104(f) makes clear that nothing included in Section 104 is intended to affect the investigatory and enforcement powers of State securities regulators or the application of state laws, regulations, orders, interpretations or other actions of general applicability, including state antitrust laws that are not inconsistent with the purposes of this Act.

Section 104(g) provides that, except as provided in Section 104(d)(2), no State may prevent or restrict the ability of an insurer, or an affiliate of an insurer, to become a BHC. Section 104(g) further provides that no State may limit the amount of an insurer's assets that may be invested in the voting securities of an insured depository institution or a company that controls such an institution, except that the State of the insurer's domicile may limit the investment to 5 percent of the insurer's admitted assets. Section 104(g) also provides that no State other than the State of the insurer's domicile may prevent, restrict, or have the authority to review, approve, or disapprove a plan of reorganization from mutual to stock form. The Committee notes that the State of domicile is not necessarily the State in which most of the insurer's policyholders reside. Therefore, in a proposed reorganization from mutual to stock form, the appropriate regulatory authority of the insurer's State of domicile is required to consult with the appropriate regulatory authority in other States in which the insurer conducts business, regarding issues affecting the best interests of policyholders.

Section 104(h) establishes a special rule that applies to the licensing of any person engaged in the sale of insurance products in conjunction with the short-term rental of motor vehicles. Unless a State statute, rule, or regulation expressly requires such persons to be licensed, then such persons need not be licensed pursuant to Section 104(b)(1). This provision is not intended to impede a State's ability to require rental car company employees to be licensed in any way. It is instead intended to foreclose third parties from seeking damages related to the sale of insurance products by unlicensed rental car agents unless and until a State has affirmatively concluded that such agents must be licensed.

*Subtitle B—Streamlining Supervision of Bank Holding Companies*

*Section 111. Streamlining bank holding company supervision*

Section 111 provides that the Board may require any bank holding company or subsidiary thereof to submit reports informing the Board of its financial condition, financial systems and statutory compliance. The Board is directed to use existing examination reports prepared by other regulators, publicly reported information and reports filed with other agencies to the fullest extent possible.

The Board is authorized to examine each bank holding company and its subsidiaries. However, it may examine functionally regulated subsidiaries only if the Board has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to the depository institution or is not in compliance with certain statutory and regulatory restrictions. The Board is directed to use to the fullest extent possible examinations made by appropriate Federal and State regulators.

If a bank holding company is not "significantly engaged" in nonbanking activities (e.g., a shell holding company), the bill would authorize the Board to designate the appropriate bank regulatory agency of the lead depository institution subsidiary as the appropriate Federal banking agency for the bank holding company.

The Board is not authorized to prescribe capital requirements for any functionally regulated subsidiary of a holding company that is in compliance with applicable capital requirements of another Federal regulatory authority, a State insurance authority, or is a registered investment adviser. In developing, establishing, and assessing holding company capital or capital adequacy rules, guidelines, standards, or requirements, the Board also has been prohibited from taking into account the activities, operations, or investments of an affiliated investment company, unless the investment company is a bank holding company or a bank holding company owns more than 25 percent of the shares of the investment company (other than certain small investment companies). The Committee adopted this measure because investment companies are specially regulated entities that must meet diversification, liquidity, and other requirements specifically suited to their role as investment vehicles. Consequently, the Committee believed that it was important to ensure that the Board not indirectly regulate these entities through the imposition of capital requirements at the holding company level, except in the very limited circumstances noted above.

Section 111 makes clear that securities and insurance activities conducted in regulated entities are subject to functional regulation by relevant State securities authorities, the Securities and Exchange Commission (the "Commission"), or relevant State insurance regulators.

*Section 112. Authority of State insurance regulator and Securities and Exchange Commission*

Section 112 amends Section 5 of the BHCA to prohibit the Board from requiring a broker-dealer or insurance company that is a bank holding company to infuse funds into an insured depository subsidiary if the holding company's functional regulator, the Commission or State insurance regulator, determines in writing that "such action would have a material adverse effect on the financial condition of the insurance company or the broker or dealer, as the case may be." If the Commission or State insurance regulator makes such a determination, the Board can order the holding company to divest the insured depository institution.

*Section 113. Role of the Board of Governors of the Federal Reserve System*

Section 113 adds a new Section 10A to the BHCA. Section 10A is intended to protect functionally regulated subsidiaries from additional and duplicative regulation by the Board. Section 10A prohibits the Board generally from the entry of orders, imposition of restraints, restrictions, guidelines, or other requirements with respect to a functionally regulated subsidiary of a bank holding company unless the action is necessary to prevent or redress an unsafe or unsound practice or breach of fiduciary duty by that subsidiary that poses a "material risk" to the safety and soundness of an affiliated insured depository institution or the domestic or international payment system and that the Board cannot protect against through action directed at or against the affiliated insured depository institution or insured depository institutions generally.

The term "material risk" should be interpreted to mean that level of risk which, under the circumstances, poses a threat to the financial safety, soundness or stability of a particular insured depository institution, insured depository institutions generally, or to the domestic or international payment system. The Committee expects that the Board and other Federal banking agencies and functional regulators, as appropriate, to exercise their authority in order to protect against such feared risk, and to coordinate with and accommodate requests for action by the Board.

*Section 114. Examination of investment companies*

Federal banking agencies are prohibited from inspecting or examining registered investment companies unless the investment company is a bank holding company or savings and loan holding company. The Commission is directed to provide to any Federal banking agency, upon request, examination reports, records, or other relevant information. The section does not prohibit the FDIC from examining an investment company affiliate of an insured depository institution, pursuant to its authority under Section 10(b)(4) of the Federal Deposit Insurance Act, as necessary, to disclose fully the relationship between the insured depository institution and the affiliate, and the effect of such relationship on the insured depository institution.

*Section 115. Equivalent regulation and supervision*

Section 115 provides that the limitations imposed upon the Board pursuant to the provisions of Section 5(c), 5(g) and 10A of the BHCA also limit the authority of the other Federal banking agencies to require reports, make examinations, impose capital requirements, or take other actions with respect to holding companies and their functionally regulated nondepository institution subsidiaries. This section ensures that the OCC, the Office of Thrift Supervision (the "OTS") and the FDIC will not be able to assume and duplicate the function of being the general supervisor over functionally regulated subsidiaries. The Committee recognizes that, under the concept of functional regulation, the extent of the authority of these agencies to take actions under any statute against, or with respect to, functionally regulated subsidiaries should not be any greater than that of the Board under Sections 111 and 113.

*Section 116. Interagency consultation*

Section 116 states the Committee's intent that the Board as the appropriate Federal banking regulator, and the State insurance regulator as the functional regulator of insurance activities, should consult with each other and share examination reports and other information. It provides that upon the request of a State insurance regulator, the Board may provide any information regarding the financial condition, risk management policies, and operations of any bank holding company that controls an insurance company regulated by that State insurance regulator, and vice versa. It further provides that upon the request of a State insurance regulator, the appropriate Federal banking agency may provide information about any transaction or relationship between a depository institution and affiliated insurance company regulated by that State insurance regulator, and vice versa. In addition, the appropriate Federal banking regulator is required to consult with the appropriate State insurance regulator before making determinations between an insured depository institution or bank holding company with an insurance company.

*Section 117. Preserving the integrity of FDIC resources*

Section 117 amends Section 11(a)(4)(B) of the Federal Deposit Insurance Act generally to prohibit the use of the Bank Insurance Fund and the Savings Association Insurance Fund to benefit any shareholder, subsidiary or nondepository affiliate.

*Subtitle C—Activities of National Banks*

*Section 121. Authority of national banks to underwrite municipal revenue bonds*

Section 121 amends 12 U.S.C. 24(7) to expand the scope of securities activities permissible for a national bank to include the underwriting of municipal revenue bonds, limited obligation bonds and other obligations that satisfy the requirements of Section 142(b)(1) of the Internal Revenue Code issued by a State or political subdivision thereof.

*Section 122. Subsidiaries of national banks*

Section 122(a) adds a new Section 5136A to the Revised Statutes of the United States. Pursuant to and in accordance with Section 5136A(a), a national bank is permitted to control a "financial subsidiary" or to hold an interest in a financial subsidiary only if the bank has consolidated total assets not exceeding $1 billion, is not affiliated with a bank holding company, is well capitalized and well managed (along with its insured depository institution affiliates), and receives OCC approval to engage in the proposed activities. The OCC is authorized to prescribe regulations for the enforcement of these requirements. A financial subsidiary is defined to mean a company that is a subsidiary of a national bank that engages as principal in any activity that is permissible for a bank holding company under Section 4(k) of the BHCA but is not permissible for national banks to conduct directly.

In order to conduct activities through a financial subsidiary, the national bank must comply with certain safety and soundness re-

quirements: for purposes of determining regulatory capital, a deduction from assets and tangible equity is required for the aggregate amount of outstanding equity investments by the national bank in a financial subsidiary; also for determining regulatory capital, the assets and liabilities of the financial subsidiary may not be consolidated with those of the national bank; and the approval of the OCC is required prior to making any equity investment in the financial subsidiary if the investment, when made, would exceed the amount that the national bank could pay as a dividend without obtaining prior regulatory approval. The national bank also must maintain procedures, among others, for identifying and managing financial and operational risks within the bank and financial subsidiary.

New Section 5136A is intended to allow small, independent national banks an opportunity to take advantage of financial modernization legislation without being required to incur the added costs and burdens of forming a bank holding company.

Pursuant to Section 5136A(e), a national bank is authorized to retain control of a company or retain an interest in a company, and conduct through such company activities lawfully conducted therein as of the date of enactment of this Act. This subsection also clarifies that a national bank may conduct through a subsidiary any activity in which national banks may engage directly. The Committee does not intend that this provision be construed to authorize the retention by national banks of DPC assets beyond those periods permitted by the OCC under applicable regulations. Further, the Committee does not intend to limit the authority that national banks have under Federal statutes such as Section 25A of the Federal Reserve Act, the Bank Service Company Act or the Small Business Act that specifically authorize national banks to own an interest in specific types of companies. The enactment of new Section 5136A does, however, make the OCC's Part 5 Rule inoperative.

Section 122(b) amends Section 23A of the Federal Reserve Act to include a financial subsidiary of a national bank within the definition of "affiliate." The purchase of or investment in equity securities issued by the financial subsidiary will not be deemed to be a covered transaction.

Section 122(c) provides that a financial subsidiary of a national bank engaging in activities pursuant to Section 5136A(a) of the Revised Statutes of the United States will be deemed to be a subsidiary of a bank holding company for purposes of the antitying provisions of the Bank Holding Company Act Amendments of 1970.

*Section 123. Agency activities*

Section 123 provides that national bank subsidiaries may engage in agency activities that have been determined by the OCC to be permissible for national banks or to be financial in nature or incidental to financial activities (pursuant to Section 4(k) of the BHCA) provided that the subsidiary engages in the activities solely as agent and not directly or indirectly as principal.

*Section 124. Misrepresentations regarding financial institution liability for obligations of affiliates*

Section 124 makes it a crime for bank or bank affiliate or bank subsidiary personnel to fraudulently represent that the bank will be liable for any obligation of a bank affiliate or subsidiary.

*Section 125. Insurance underwriting by national banks*

Section 125(a)(1) establishes the general rule that a national bank may only provide insurance as principal in accordance with Section 5136A(a) of the Revised Statutes of the United States, as added by this Act.

Section 125(a)(2) provides for an exception to that general rule. Without regard to the requirements of Section 5136A(a), a national bank is permitted to offer any "authorized insurance product" in a principal capacity.

Under Section 125(b), a product is "authorized" if, as of January 1, 1999, national banks were lawfully providing it as principal or the OCC had determined in writing that national banks may provide it as principal; no court of relevant jurisdiction had, by final judgment, overturned a determination by the OCC that national banks may provide it as principal; and the product is not an annuity contract subject to tax treatment under Section 72 of the Internal Revenue Code. Under the Committee bill, the provision by national bank subsidiaries of title insurance in a principal capacity is not prohibited.

Section 125(c) defines "insurance" for purposes of Section 125. Under Section 125(c)(1), "insurance" means any product regulated as insurance as of January 1, 1999 in the State in which the product is provided. Under Section 125(c)(2), insurance means any product first offered after January 1, 1999 which a State insurance regulator determines shall be regulated as insurance in the State in which the product is provided because the product insures, guarantees, or indemnifies against loss of life, loss of health, or loss through damage to or destruction of property. Insurance is defined to exclude those products which are a product or service of a bank, such as a deposit product, loan, discount, letter of credit, or other extension of credit; a trust or other fiduciary service; a qualified financial contract as defined in Section 11(e)(8)(D)(i) of the Federal Deposit Insurance Act; or a financial guaranty. A bank product does not include a product that has an insurance component such that if offered by a bank as principal the product would be treated as a life insurance contract under Section 7702 of the Internal Revenue Code, or losses incurred with respect to the product would qualify for treatment under Section 832(b)(5) of the Internal Revenue Code if the bank were subject to tax as an insurance company under Section 832 of the Internal Revenue Code. The term "financial guaranty" in Section 125(c)(2)(v) is not intended to exclude surety bonds from the definition of insurance. Under Section 125(c)(3), insurance means any annuity contract on which the income is subject to tax under Section 72 of the Internal Revenue Code.

*Subtitle D—National Treatment of Foreign Financial Institutions*

*Section 151. National treatment of foreign financial institutions*

Section 151 amends Section 8(c) of the International Banking Act of 1978 (IBA) by adding a new paragraph (3) to permit termination of the financial grandfathering authority granted by the IBA and other statutes to foreign banks to engage in certain financial activities. The bill provides that foreign banks should no longer be entitled to financial grandfathered rights authorized under new Section 4(k) of the BHCA after the bank has filed a declaration under Section 4(l) of the BHCA.

*Section 152. Representative offices*

Section 152(a) removes the exemption for subsidiaries of foreign banks from the definition of a representative office. Thus, direct subsidiaries of foreign banks will need Board approval as "representative offices" of the foreign bank.

Section 152(b) provides that the Board may examine any affiliate of a foreign bank in any State.

Title II—Insurance Customer Protections

*Section 201. Functional regulation*

Section 201 provides that, subject to Sections 104(c), (d) and (e), the insurance sales activities of any person or entity shall be functionally regulated by the States. Section 104 establishes a safe harbor for State regulation of insurance sales, as well as a method for determining whether State regulation falling outside the safe harbor would be preempted.

*Section 202. Insurance customer protections*

Section 202 includes several consumer protection requirements that the Federal banking agencies will be required to implement within one year from the date of enactment of the Act. These requirements would establish federal minimum consumer protections. They require the promulgation of regulations—

Prohibiting discrimination against non-affiliated agents provisions by providing expedited or enhanced treatment if insurance is purchased from affiliated agents;

Prohibiting tying and other coercive practices;

Prohibiting misrepresentations regarding the federally insured or guaranteed status of any insurance product;

Requiring, to the extent practicable, the separation of insurance and deposit-taking activities;

Limiting the payment of referral fees to bank tellers to a nominal amount that may not be based on whether the referral results in a transaction;

Requiring the disclosure, prior to any insurance sale, that the insurance is—(1) not a deposit; (2) not insured by the FDIC; (3) not guaranteed by the financial institution or its subsidiaries or affiliates; and (4) where appropriate, involves investment risk, including loss of principal;

Requiring that an acknowledgment be obtained whenever a disclosure is required from the customer verifying receipt of the disclosure.

In promulgating the requisite regulations, the Federal banking agencies must ensure that the regulations do not have the practical effect of discriminating, either intentionally or unintentional, against any person engaged in insurance sales or solicitations that is not affiliated with an insured depository institution. The Federal banking regulators are required to determine whether any parallel state customer protection requirement is more protective; if it is not, the Federal banking regulators must advise the State that the Federal requirement will apply. The State may then "opt-out" of this preemption if it enacts a statute within three years of the receipt of Federal notice.

*Section 203. Federal and State dispute resolution*

Section 203(a) provides that in the event of a regulatory conflict between a State insurance regulator and a Federal regulator as to insurance issues, including whether a State statute, regulation, order, or interpretation regarding insurance sales or solicitation activity is preempted under Federal law, either regulator may seek expedited judicial review. Either regulator may file a petition for review in the U.S. Court of Appeals for the District of Columbia Circuit or in the U.S. Court of Appeals for the circuit in which the State is located.

Under Section 203(b), the relevant U.S. Court of Appeals must complete all action on the petition, including rendering a judgment, within 60 days from the filing of the petition unless all parties agree to an extension. Under Section 203(c), any request for certiorari to the U.S. Supreme Court must be filed as soon as practicable after the judgment of the U.S. Court of Appeals is issued. Section 203(d) provides that no action challenging an order, ruling, determination, or other action of a Federal or State regulator may be brought under these procedures after the later of (i) 12-months after the first public notice of the order, ruling, or determination in its final form, or (ii) 6-months period after the order, ruling, or determination takes effect.

Section 203(e) requires the court to base its decision on an action filed under this section upon its review on the merits of all questions presented under Federal and State law. The court must review the nature of the product or activity and the history and purpose of its regulation under Federal and State law. The court must accord equal deference to the Federal regulator and the State insurance regulator.

## Title III—Regulatory Improvements

*Section 301. Elimination of SAIF and DIF special reserves*

Section 301 amends the Federal Deposit Insurance Act to eliminate the SAIF special reserve created by the Deposit Insurance Funds Act of 1996.

*Section 302. Expanded small bank access to S corporation treatment*

Section 302 requires that the GAO conduct a study of possible revisions to the rules governing S corporations, including increasing the permissible number of shareholders in such corporations; permitting shares of such corporations to be held in individual retirement accounts; clarifying that interest on investments held for safety, soundness, and liquidity purposes should not be considered to be passive income; discontinuation of the treatment of stock held by bank directors as a disqualifying personal class of stock for such corporations; and improving Federal tax treatment of bad debt and interest deductions. The study is also to report on the impact that such revisions might have on community banks.

*Section 303. Meaningful CRA examinations*

Section 303 provides that an insured depository institution rated as "satisfactory" or better in its most recent examination under the CRA, and in each such examination during the immediately preceding 36-month period shall be deemed to be in compliance with the requirements of the CRA (i.e., that the insured depository institution has met the credit needs of its entire community) until the completion of a subsequent regularly scheduled CRA examination, unless substantial verifiable information arising since the time of the most recent CRA examination demonstrating CRA noncompliance is filed with the appropriate Federal banking agency. The appropriate Federal banking agency must determine, on a timely basis, whether the information filed to challenge the insured depository institution's CRA compliance provides sufficient proof of the institution's CRA noncompliance. The person filing information with the appropriate Federal banking agency bears the burden of proving the substantial verifiable nature of that information.

*Section 304. Temporary extension of bank insurance fund member FICO assessment rates*

Section 304 extends for three years, until December 31, 2002, the BIF-member FICO assessment rates.

*Section 305. Cross-marketing restrictions; limited purpose bank relief; divestiture*

Section 305(a) amends Section 4(f) of the BHCA by striking paragraph (3). This provision would repeal the current cross marketing restriction, allowing CEBA banks to cross market their products and services with the products and services of affiliates.

Section 305(b) amends Section 4(f) of the BHCA by adding a new paragraph (3) to permit certain overdrafts. This provision would expand "permissible overdrafts" to include overdrafts incurred by affiliates that incidentally engage in financial services activities, if the overdraft is within the restrictions imposed by Section 23A and 23B of the Federal Reserve Act.

Section 305(c) amends Section 2(c)(2)(H) of the BHCA. Section 2(c)(2)(H) exempts industrial loan companies from the definition of "bank" for purposes of the BHCA. Under Section 2(c)(2)(H), the exemption is conditioned on an industrial loan company's not permitting an overdraft on behalf of an affiliate, or incurring an overdraft

on behalf of an affiliate at its account at a Federal Reserve bank, unless such overdraft is the result of an inadvertent computer or accounting error. Section 305(c) amends Section 2(c)(2)(H) to allow industrial loan companies to incur the same overdrafts on behalf of affiliates as are permitted for banks described in Section 4(f)(1) of the BHCA (banks that, prior to the enactment of the Competitive Equality Banking Act of 1987 ("CEBA"), either made commercial loans or accepted insured deposits but did not do both).

Section 305(d) amends Section 4(f) of the BHCA. This provision repeals the restriction which prohibited limited-purpose banks from engaging in activities they were not engaged in prior to March 5, 1987. Limited-purpose banks would still be prohibited from both accepting demand deposits and engaging in the business of commercial lending (i.e. a limited-purpose bank can do one or the other, but not both). This section also clarifies that a limited purpose bank may acquire without limit the same type of consumer assets that it can originate.

Section 305(e) amends Section 4(f)(4) of the BHCA. This section would modify the provision of CEBA which requires divestiture of a limited-purpose bank in the event the bank or its owner fails to remain qualified for the CEBA exception. The amendment allows limited-purpose bank owners to avoid divestiture by promptly correcting the violation (within 180 days of receipt of notice from the Board) that would otherwise lead to divestiture and implementing procedures to prevent similar violations in the future.

*Section 306. "Plain language" requirement for Federal banking agency rules*

Section 306 directs the Federal banking agencies to use plain language in all proposed and final rulemakings published in the Federal Register after January 1, 2000. Not later than March 1, 2001, each Federal banking agency shall submit to the Congress a report describing how the agency has complied with that requirement.

*Section 307. Retention of "Federal" in name of converted Federal savings association*

Section 307 would permit Federal savings associations that convert to National or State bank charters to keep the word "Federal" in their names. For example, if First Federal Savings Bank converts from a Federal savings association to a State bank charter, it may retain its former name.

*Section 308. Community Reinvestment Act exemption*

Section 308 exempts from the requirements of the CRA FDIC-insured banks and thrifts with total assets not exceeding $100 million and that are located in non-metropolitan areas. A non-metropolitan area is defined as any area, no part of which is within an area designated as a Metropolitan Statistical Area by the United States Office of Management and Budget. The $100 million amount is to be adjusted annually by the annual percentage increase in the Consumer Price Index for Urban Wage Earners and Clerical Workers published by the Bureau of Labor Statistics.

*Section 309. Bank officers and directors as officers and directors of public utilities*

Section 309 amends Section 305(b) of the Federal Power Act to permit generally officers or directors of public utilities to serve as officers or directors of banks, trust companies, or securities firms if certain safeguards against conflicts of interest are complied with.

*Section 310. Control of bankers' banks*

Section 310 amends Section 2(a)(5)(E)(i) of the BHCA to allow one or more thrift institutions to own a state-chartered bank or trust company, whose business is restricted to accepting deposits from thrift institutions or savings banks; deposits arising from the corporate business of the thrift institutions or savings banks that own the bank or trust company; or deposits of public funds.

*Section 311. Multi-state licensing and interstate insurance sales activities*

This section expresses the sense of the Congress that by the end of the 36-month period beginning on the date of enactment of the Act, the States should implement uniform insurance agent and broker licensing application and qualification requirements; eliminate pre- or post-licensure requirements having the practical effect of discriminating, directly or indirectly, against nonresident insurance agents or brokers; and if such actions are not taken, Congress should take steps to rectify the problems noted. Any entity established by the Congress should be under the supervision and oversight of the National Association of Insurance Commissioners.

## Title IV—Federal Home Loan Bank System Modernization

*Section 401. Short title*

Section 401 designates this subtitle as the "Federal Home Loan Bank System Modernization Act of 1999".

*Section 402. Definitions*

Section 402 provides technical changes to definitions within the Federal Home Loan Bank Act ("FHLBA"). It also creates a new class of "community financial institutions" with average total assets less than $500 million, based on an average of total assets over the preceding 3 years. Adjustments to the $500 million limit will be made annually based on the annual percentage increase, if any, in the Consumer Price Index for all urban consumers, as published by the Department of Labor.

*Section 403. Savings association membership*

Section 403 makes Federal Home Loan Bank ("FHLBank") membership voluntary, as of June 1, 2000, for savings and loan associations. Under current law, membership is mandatory.

*Section 404. Advances to members; collateral*

Section 404 expands the types of assets which can be pledged as collateral for advances for certain institutions. Currently, only mortgage loans, mortgage-backed securities, FHLBank deposits, and certain other real estate assets may be used as collateral for

advances. Many smaller banks are unable to hold sufficient mortgage loans to pledge as collateral. The bill would permit banks with assets of $500 million or less, to pledge secured small business and agriculture loans as collateral (including securities representing a whole interest in such secured loans), and use the advances to fund small business, small farm and small agri-business loans. The Federal Housing Finance Board ("FHFB") would also be allowed to review, and if necessary for safety and soundness, increase certain collateral standards.

*Section 405. Eligibility criteria*

Section 405 waives the ten percent residential mortgage asset test for FDIC-insured institutions with assets of $500 million dollars or less. All institutions are currently required to have ten percent of their total assets in residential mortgage loans in order to become members of the system.

*Section 406. Management of banks*

Section 406 transfers from the FHFB to the individual FHLBanks authority over a number of operational areas, including director and employee compensation, terms and conditions for advances, interest rates on advances, dividends, and forms for advance applications. The section also clarifies other powers and duties of the FHFB with regard to enforcement.

*Section 407. Resolution Funding Corporation*

Section 407 changes the current annual $300 million funding formula for the Resolution Funding Corporation obligations of the FHLBanks to a percentage of annual net earnings. This change will become effective on June 1, 2000.

*Section 408. GAO study on Federal Home Loan Bank System capital*

Section 408 directs the GAO to conduct a study of possible revisions to the capital structure of the FHLB System, including the need for more permanent capital; a statutory leverage ratio; a risk-based capital structure; and the impact such revisions might have on the operations of the FHLB System.

## Title V—Functional Regulation of Brokers and Dealers

*Section 501. Definition of broker*

Section 501 amends the Securities and Exchange Act of 1934 (the "1934 Act") definition of "broker" to narrow the blanket exemption for banks. A "broker" is defined as "any person engaged in the business of effecting transactions in securities for the account of others". The bill exempts a bank from classification as a "broker" only to the extent that the bank engages in activities that are enumerated in this section.

*Section 502. Definition of dealer*

Section 502 amends the 1934 Act's blanket exemption for banks from the definition of "dealer". A "dealer" is defined as "any person engaged in the business of buying or selling securities for such per-

son's own account through a broker or otherwise". The bill exempts a bank from classification as a "dealer" only to the extent that the bank engages in: transactions for investment purposes for accounts where the bank acts as a trustee or fiduciary; transactions in commercial paper, bank acceptances, commercial bills, qualified Canadian government obligations, and Brady bonds; the issuance or sale of asset backed securities to qualified investors; or transactions in "traditional banking products."

*Section 503. Definition and treatment of banking products*

Section 503 defines "traditional banking product," for the purposes of the bank broker-dealer exemptions. The definition includes: deposit accounts; deposit instruments issued by a bank; bankers acceptances; letters of credit or loans issued by a bank; debit accounts arising from a credit card or similar arrangement; loan participations sold to qualified investors; and swap agreements as defined in Section 11(e)(8)(D)(vi) of the Federal Deposit Insurance Act.

With respect to new products, the Commission may, with the concurrence of the Board, determine by regulation that a new product is a security, subject to registration with the Commission, as opposed to a banking product. The Commission may not require the registration of a new product as a security unless, with the concurrence of the Board, the SEC determines by regulation that the product is a new product; the product is a security; and that the imposition of registration requirements is necessary or appropriate in the public interest and for the protection of investors. The section makes clear that the rights or authority of the Board, any appropriate Federal banking agency, or any interested party under any other provision of law shall not be affected in any way to object to or seek judicial review as to whether a product or instrument is or is not appropriately classified as a traditional banking product.

*Section 504. Qualified investor defined*

Section 504 defines "qualified investor" to include: any registered investment company; bank; savings and loan association; broker; dealer; insurance company; business development company; licensed small business investment company; State sponsored employee benefit plan or employee benefit plan under ERISA (other than an IRA); certain trusts; any market intermediary; any foreign bank or any foreign government; any corporation, company or individual who owns and invests at least $10 million; any government or political subdivision who owns and invests at least $50 million; and any multinational or supra-national entity; or any other person that the Commission determines to be a qualified investor.

*Section 505. Government securities defined*

Section 505 amends the 1934 Act definition of "government securities" to include qualified Canadian government obligations for the purposes of Section 15C (which governs government securities brokers) as applied to a bank.

*Section 506. Effective date*

Section 506 provides that the subtitle shall take effect one year after enactment.

*Section 507. Rule of construction*

Section 507 provides that the bill shall not be construed so as to limit the scope or applicability of the Commodity Exchange Act.

Title VI—Unitary Savings and Loan Holding Companies

*Section 601. Prevention of creation of new S&L holding companies with commercial affiliates*

Section 601 amends Section 10(c) of the Home Owners' Loan Act to terminate expanded powers for new unitary savings and loan holding companies, excepting those that become a savings and loan holding company pursuant to an application filed with the OTS on or before February 28, 1999. Certain existing unitary savings and loan holding companies are exempted from these restrictions. In particular, these prohibitions do not apply to a unitary savings and loan holding company in existence on February 28, 1999, or that was formed pursuant to an application pending before the OTS on or before that date, provided that the company continues to meet the requirements to be a unitary savings and loan holding company under 12 U.S.C. 1467a(c)(3) and controls at least one of the savings associations that the company controlled (or had applied to control) as of February 28, 1999, or the successor to such a savings association (a "grandfathered unitary savings and loan holding company").

REGULATORY IMPACT STATEMENT

In accordance with paragraph 11(g), rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement regarding the regulatory impact of the bill.

The bill establishes a comprehensive framework to permit affiliations between banks, securities firms and insurance companies. It would modernize and reform outdated laws governing the financial system. The new framework promotes competition, enhances consumer choice, safeguards the Federal deposit insurance system, and protects the safety and soundness of insured depository institutions and the stability of the payment system.

The bill reduces substantially the current regulatory burdens placed on financial intermediaries—banks, broker-dealers, insurance and securities firms—in several ways. First, the bill incorporates the principle of functional regulation. By clearly allocating regulatory responsibility to Federal and State financial regulators, the proposed system of functional regulation promotes efficiency, eliminates regulatory overlap and duplication, and promotes increased investor, depositor and taxpayer protections.

Second, the bill streamlines the regulatory process by requiring coordination and information-sharing between the various Federal and State regulators. The bill seeks to provide regulation of financial holding companies that is sufficient to protect the safety and soundness of the financial system and the integrity of the Federal deposit insurance funds without imposing unnecessary regulatory burdens.

Third, the bill eliminates many notification and approval procedures mandated under current law. Because the bill seeks to streamline and update the financial regulatory framework, the Committee believes that this legislation will have a favorable regulatory impact.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

Senate rule XXVI, section 11(b) of the Standing Rules of the Senate, and Section 403 of the Congressional Budget Impoundment and Control Act, require that each committee report on a bill containing a statement estimating the cost of the proposed legislation, which was prepared by the Congressional Budget Office. The Congressional Budget Office Cost Estimate and its Estimate of Costs of Private-Sector Mandates, both dated April 22, 1999, are hereby included in this report.

CONGRESSIONAL BUDGET OFFICE,
U.S. CONGRESS,
*Washington, DC, April 22, 1999.*

Hon. PHIL GRAMM,
*Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC.*

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate and mandate statements for the Financial Services Modernization Act of 1999. One enclosure includes the estimate of federal costs and the estimate of the impact of the legislation on state, local, and tribal governments. The estimated impact of mandates on the private sector is discussed in a separate enclosure.

If you wish further details on these estimates, we will be pleased to provide them. The CBO staff contacts are Robert S. Seiler (for costs to the Federal Home Loan Banks), Mary Maginniss (for other federal costs), Carolyn Lynch (for federal revenues), Marjorie Miller (for the state and local impact), and Patrice Gordon (for the private-sector impact).

Sincerely,

BARRY B. ANDERSON
(For Dan L. Crippen, Director).

Enclosures.

*Financial Services Modernization Act of 1999*

*Summary*

The bill would eliminate certain barriers to ties between insured depository institutions and other financial services companies, including insurance and securities firms. While these changes could affect the government's spending for deposit insurance, CBO has no basis for predicting whether the long-run costs of deposit insurance would be higher or lower than under current law. Because insured depository institutions pay premiums to cover these costs, any such changes would have little or not net impact on the budget over the long term.

CBO estimates that implementing this act would decrease other direct spending by $42 million in 2000 and $338 million over the

2000–2004 period, and would decrease revenues by $3 million in 2000 and $15 million over the 2000–2004 period. Because the bill would affect direct spending and receipts, pay-as-you-go procedures would apply. Assuming appropriation of the necessary amount, CBO estimates that federal agencies would spend $3 million to $4 million annually from appropriated funds to carry out the provisions of the bill.

The legislation contains several intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA), but CBO estimates that these mandates would not impose significant costs on state, local, or tribal governments. Any such costs would not exceed the threshold established by that act ($50 million in 1996, adjusted annually for inflation). The bill also contains private-sector mandates as defined in UMRA. CBO's estimate of the cost of those private-sector mandates is detailed in a separate statement.

*Description of the bill's major provisions*

The Financial Services Modernization Act of 1999 would:

Permit affiliations of banking, securities, and insurance companies;

Eliminate the requirement that the Federal Deposit Insurance Corporation (FDIC) retain a "special reserve" for the Savings Association Insurance Fund (SAIF);

Amend the Federal Deposit Insurance Act to prevent the use of deposit insurance funds to assist affiliates or subsidiaries of insured financial institutions;

End the requirement that banks and thrifts located in rural areas and having assets less than $100 million comply with the provisions of the Community Reinvestment Act (CRA);

Reform the Federal Home Loan Bank (FHLB) System, making membership voluntary and replacing the $300 million annual payment made by the FHLBs for interest on bonds issued by the Resolution Funding Corporation (REFCORP) with an assessment set at 20.75 percent of the FHLBs' net income;

Require the Federal Reserve, along with the Treasury, to determine which activities bank holding companies may engage in;

Create a system of functional regulation, whereby institutions that conduct banking, securities, or insurance activities would be regulated by the agency responsible for each such activity (regulatory conflicts on insurance issues between federal and state regulators would be resolved on an expedited basis by the federal courts);

Terminate the authority of the Office of Thrift Supervision (OTS) to grant new thrift charters for unitary savings and loan holding companies for all applications other than those approved or pending as of February 28, 1999;

Extend for three more years the formula for determinig how much BIF-insured and SAIF-insured institutions will pay towards the interest payment on bonds that the Financing Corporation (FICO) issued to help pay for losses of failed savings institutions;

Require federal banking agencies to develop regulations governing sales or offers of insurance products; and

Require the General Accounting Office (GAO) to prepare two reports.

*Estimated cost to the Federal Government*

The bill would make a number of changes affecting direct spending and revenues, which would result in net increases in spending by the banking regulatory agencies, decreased spending by the Treasury, and a decrease in the annual payment—recorded as revenues—that the Federal Reserve remits to the Treasury. Assuming enactment late in fiscal year 1999, CBO estimates that direct spending would decrease by about $338 million over the 2000–2004 period and that revenues would decline by $15 million over the same period. The legislation also would lead to an increase in discretionary spending of an estimated $16 million over the 2000–2004 period, assuming appropriation of the necessary amounts. The estimated budgetary impact is shown in the following table. The outlay effects fall within budget functions 370 (commerce and housing credit) and 900 (interest).

| | By fiscal year, in millions of dollars— | | | | | |
|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
| DIRECT SPENDING | | | | | | |
| Spending Under Current Law: [1] | | | | | | |
| Estimated Budget Authority | 3,830 | 3,830 | 3,830 | 3,830 | 3,830 | 3,830 |
| Estimated Outlays | −1,503 | 473 | 1,438 | 2,074 | 2,564 | 2,967 |
| Proposed Changes: | | | | | | |
| Estimated Budget Authority | 0 | −45 | −63 | −71 | −80 | −87 |
| Estimated Outlays | 0 | −42 | −61 | −70 | −79 | −86 |
| Spending Under the Bill: | | | | | | |
| Estimated Budget Authority | 3,830 | 3,785 | 3,767 | 3,759 | 3,750 | 3,743 |
| Estimated Outlays | −1,503 | 431 | 1,377 | 2,004 | 2,485 | 2,881 |
| CHANGES IN REVENUES | | | | | | |
| Estimated Revenues [2] | 0 | −3 | −3 | −3 | −3 | −3 |
| CHANGES IN SPENDING SUBJECT TO APPROPRIATION | | | | | | |
| Estimated Authorization Level | 0 | 4 | 3 | 3 | 3 | 3 |
| Estimated Outlays | 0 | 4 | 3 | 3 | 3 | 3 |

[1] Includes spending for deposit insurance activities (subfunction 373) and Treasury payments for interest on REFCORP bonds.
[2] Includes changes in the annual payment from the Federal Reserve to the Treasury. A negative sign indicates a decrease in revenues.

*Basis of estimate*

*Direct Spending and Revenues:* The Financial Services Modernization Act could affect direct spending for deposit insurance by increasing or decreasing amounts paid by the insurance funds to resolve insolvent institutions and to cover the administrative expenses necessary to implement its provisions. Changes in spending related to failed banks and thrifts could be volatile and vary in size from year to year, but any such costs would be offset by insurance premiums. Thus, their budgetary impact would be negligible over time. The major budgetary impact of the bill would stem from an increase in the annual payments by the FHLBs for interest on bonds issued by the REFCORP. As a result, Treasury outlays for such interest would decline. In addition, changes in regulatory activities would result in small outlay increases and revenue decreases.

Deposit Insurance Funds.—Enacting the bill could affect the federal budget by causing changes in the government's spending for

deposit insurance, but CBO has no clear basis for predicting the direction or the amount of such changes. Changes in spending for deposit insurance could be significant in some years, but would have little or no net impact on the budget over time.

A number of provisions in the bill could affect spending by the deposit insurance funds. Some are likely to reduce the risks of future bank failures. For example, the bill would permit affiliations of banking, securities, and insurance companies, thereby giving such institutions the opportunity to diversify and to compete more effectively with other financial businesses. Changes in the marketplace, particularly the effects of technology, have already helped to blur the distinctions among financial service firms. Further, regulatory and judicial rulings continue to erode many of the barriers separating different segments of the financial services industry. For example, banks now sell mutual funds and insurance to their customers and, under limited circumstances, may underwrite securities. At the same time, some securities firms offer checking-like accounts linked to mutual funds and extend credit directly to businesses. Because the legislation would clarify the regulatory and legal structure that currently governs bank activities, CBO expects that its enactment would allow banks to compete more effectively and efficiently in the rapidly evolving financial services industry. Diversifying income sources also could result in lower overall risks for banks, assuming that the expansion of their activities is accompanied by adequate safeguards. The bill would specifically prohibit the FDIC from using the resources of the BIF to assist affiliates or subsidiaries of insured financial institutions.

It is also possible, however, that losses to the deposit insurance fund could increase as a result of enacting the bill. The increase in scale and complexity of the new financial holding companies could challenge the ability of the regulators to manage any additional risk of losses to the deposit insurance funds. If additional losses were to occur, the BIF would increase premiums that banks pay for deposit insurance. Similarly, if losses were to decrease, banks might pay smaller premiums. As a result, the net budgetary impact over the long term is likely to be negligible in either case.

Federal Home Loan Banks.—The bill would make a number of reforms to the FHLB system. Beginning in 2000, membership in the FHLB system would become voluntary. The bill also would require the FHLBs to replace the $300 million annual payment for the interest on bonds issued by the REFCORP with an assessment set at 20.75 percent of the FHLBs' net income. The Federal Housing Finance Board, which regulates the FHLBs, would be authorized to extend or shorten the period over which payments are made such that, over time, the average payment would equal $300 million a year, on a present-value basis.

Based on CBO's analysis of the FHLB system's balance sheet and income statement, and using CBO's current economic assumptions, we estimate that the provisions affecting the FHLBs would increase their payments to REFCORP by $45 million in 2000 and a total of $346 million over the 2000–2004 period. CBO expects that the estimated increase in payments in the near term would be offset by a decrease in payments of an equal amount (on a present-value basis) in future years.

The FHLB system is a government-sponsored enterprise and its activities are not included in the federal budget. But, because the Treasury pays the interest on REFCORP bonds not covered by the FHLBs, this change would reduce Treasury outlays by $346 million over the five-year period.

Regulatory Costs.—The Federal Reserve, the Securities and Exchange Commission (SEC), the state banking regulators, and other federal banking regulators—the Office of the Comptroller of the Currency (OCC), the FDIC, and the OTS—would have primary responsibility for monitoring compliance with the statute. CBO expects that higher costs for regulatory activities would increase outlays by $9 million and would decrease revenues by $15 million over the 2000–2004 period.

The banking agencies would be required to implement new regulations, policies, and training procedures related to securities, insurance, and other areas. The bill also would permit national banks with assets of $1 billion or less to conduct certain financial activities through operating subsidiaries. CBO expects that the FDIC would spend between $3 million and $4 million annually for these new activities. The OCC and the OTS would also incur annual expenses for these purposes—estimated to total between $1 million and $2 million for each agency, but those costs would be offset by increased fees, resulting in no net change in outlays for those agencies.

Under this legislation, in insuring compliance with the CRA statutes, banking regulators would no longer have to examine institutions with assets less than $100 million (indexed for inflation) and located in a rural area—about 37 percent of all insured banks and thrifts. We estimate that the FDIC would realize savings of about $2 million annually from this change. CBO estimates that savings from fewer CRA exams for the OTS and for the OCC would total about $1 million annually for each agency. The OTS and the OCC would reduce fees to reflect these savings, resulting in no net budgetary effects.

CBO estimates that, under this bill, the Federal Reserve would spend an additional $15 million over the 2000–2004 period. This bill would require it to supervise the activities of new bank holding companies and, in conjunction with the Treasury Department, to define new financial activities. Based on information from the Board of Governors of the Federal Reserve System, CBO estimates that the Federal Reserve's new supervisory activities would result in added examination costs of about $4 million per year once the act's requirements were fully effective in 2000. That increase in examination costs would total an estimated $20 million over the 2000–2004 period. The Federal Reserve's cost of processing applications is not expected to be affected. Applications for the newly authorized activities of holding companies would increase, but the added workload would likely be offset by a decrease in applications for nonbanking activities, resulting in no significant net budgetary impact.

The reduction in government receipts would be partially offset by a lowering of examination costs due to the amendment to CRA. The exemption from CRA of non-metropolitan financial institutions with assets of $100 million or less would result in less stringent ex-

amination, thereby decreasing the operating costs of the Federal Reserve System. Based on information provided by the Federal Reserve, we estimate that the CRA amendment would save the Federal Reserve $1 million annually beginning in 2000, for a total of $5 million over the 2000–2004 period. Other provisions in the bill would not significantly affect spending by the Federal Reserve.

The net effect of these provisions on the administrative costs of the Federal Reserve would be an increased in costs of $15 million over the 2000–2004 period. Because the Federal Reserve System remits its surplus to the Treasury, the increased costs would reduce governmental receipts, or revenues, by the same amount.

SAIF Special Reserves.—The bill would repeal the requirement for the Savings Association Insurance Fund to retain a special reserve fund. CBO expects that the cost of that repeal would total less than $500,000 in any year. The Deposit Insurance Funds Act of 1996 required the Federal Deposit Insurance Corporation to set aside, on January 1, 1999, all balances in the SAIF in excess of the required reserve level of $1.25 per $100 of insured deposits. The funds in this special reserve become available to pay for losses in failed institutions only if the SAIF's balance (excluding the reserve) subsequently falls below 50 percent of the required reserve level, and the FDIC determines that it is expected to remain at that level for a year. In January 1999, the FDIC allocated $1 billion of the SAIF's balances to the special reserve. CBO's baseline assumes administrative costs and thrift failures will remain sufficiently low to avoid raising assessment rates on SAIF-insured institutions through 2004. We expect that the SAIF's fund balances of about $10 billion will continue to earn interest, and that the fund's ratio of reserves to insured deposits will climb each year, reaching over 1.4 percent by 2004.

Although CBO's baseline estimates do not assume that the cost of thrift failures in any year would exceed the net interest earned by the SAIF, unanticipated thrift failures could result in a drop in the SAIF's reserve ratio below 1.25 percent. The baseline reflects CBO's best judgment as to the expected value of possible losses during a given year, but annual losses will likely vary from the levels assumed in the CBO baseline. Thus, some small probability exists that thrift failures could increase sufficiently to drive the reserve ratio below the required level of 1.25 percent, but not so low as to trigger use of the special reserve.

When the balance of an insurance fund dips below the required ratio, the FDIC is forced to increase assessments for deposit insurance to restore the fund balance to the required level. Thus, if thrift losses were to exceed baseline estimates by a significant amount, we would expect the FDIC to increase insurance premiums in order to maintain the SAIF's fund balance. Eliminating the special reserve would add to the fund balances and would make it less likely that the FDIC would have to raise insurance premiums. The probability that this change would affect premium rates is quite small, however, and therefore CBO expects that the loss of deposit insurance premiums that could result from eliminating the special reserve would total less than $500,000 in any year.

*Spending Subject to Appropriation:* A number of federal agencies would be responsible for monitoring changes resulting from enactment of the legislation. CBO estimate that total costs, assuming appropriation of the necessary amounts, would be about $3 million annually beginning in 2000, primarily for expenses of the SEC, GAO, and the Treasury Department. The SEC would incur costs to monitor market conditions, to examine firms offering certain security products, and to investigate practice to ensure compliance with the statute. We expect these additional rulemaking, inspection, and administrative expenses of the SEC would total about $2 million annually.

The bill would require several reports and would direct GAO to conduct two studies. CBO estimates that GAO would spend about $1 million in 2000 to prepare the reports.

*Pay-as-you-go considerations*

The Balanced Budget and Emergency Deficit Control Act sets up pay-as-you-go procedures for legislation affecting direct spending or receipts. Legislation providing funding necessary to meet the deposit insurance commitment is excluded from these procedures. Most of the FDIC's additional costs that would result from this bill ($3 million to $4 million a year) would be covered by this exemption. CBO believes that the various costs of the legislation related to consumer protection and eliminating SAIF's special reserve, along with the savings related to CRA compliance, would not qualify for the exemption that applies to the full funding of the deposit insurance commitment, and thus would count for pay-as-you go purposes. These changes would result in a net decrease in the FDIC's supervisory costs totaling about $2 million annually, for a total of $23 million over the 2000–2009 period. Net savings each year for similar activities of the OCC and the OTS, which are estimated to total about $1 million for each agency, would be offset by increases in fees of an equal amount, resulting in no significant net budgetary impact for those agencies.

CBO estimates that provisions affecting the FHLBs would result in an increase in their payments for REFCORP interest, and a corresponding decrease in Treasury outlays, totaling $919 million over the 2000–2009 period.

CBO estimates that the exemption from the requirements of CRA for certain depository institutions would reduce the administrative costs of the Federal Reserve and thus increase Treasury receipts by $1 million per year beginning in 2000, increasing to $2 million by 2005, for a total of $15 million over the 2000–2009 period. CBO also expects that the Federal Reserve would incur additional expenses associated with consumer issues that are not directly related to protecting the deposit insurance commitment. We estimate that the resulting increase in regulatory and other costs would reduce the surplus payment that the Federal Reserve remits to the Treasury by less than $500,000 annually.

The net changes in outlays and governmental receipts that are subject to pay-as-you-go procedures are shown in the following table. For the purposes of enforcing pay-as-you-go procedures, only the effects in the current year, the budget year, and the succeeding four years are counted.

| | By fiscal year, in millions of dollars— | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
| Changes in outlays: | | | | | | | | | | | |
| DIC | 0 | −2 | −2 | −2 | −2 | −2 | −2 | −2 | −2 | −2 | −3 |
| REFCORP payment | 0 | −45 | −63 | −71 | −80 | −87 | −94 | −100 | −109 | −126 | −144 |
| Total | 0 | −47 | −65 | −73 | −82 | −89 | −96 | −102 | −111 | −128 | −147 |
| Changes in receipts | 0 | 1 | 1 | 1 | 1 | 1 | 2 | 2 | 2 | 2 | 2 |

*Estimated impact on State, local, and tribal governments*

This bill contains a number of intergovernmental mandates as defined in UMRA, but CBO estimates that these mandates would not impose significant costs on state, local, or tribal governments. Any such costs would not exceed the threshold established by that act ($50 million in 1996, adjusted annually for inflation). Other provisions in the bill, which are not mandates, would affect the budgets of state and local governments, and are discussed below.

*Mandates:* A number of provisions in the bill would preempt state banking, insurance, and securities laws. States would not be allowed to prevent or restrict either the affiliations between banks, securities firms, and insurance companies authorized by the bill, or the expanded activities permitted banks by the bill. Further, while the bill would endorse states' primary role in licensing and regulating insurance operations, it would preempt their authority over these operations in a number of ways.

Based on information provided by organizations representing state and local governments, CBO expects that enactment of these provisions would not result in significant costs for such governments. While they would be prevented from enforcing certain rules and regulations, they would not be required to undertake any new activities.

*Other impacts:* State and local governments might benefit from a provision of this bill that would give national banks the authority to underwrite certain state and local obligations, including municipal revenue bonds. This provision would widen the market for these obligations and could reduce state and local borrowing costs.

To the extent that enactment of this bill would facilitate the integration of different types of financial services, it may have a variety of impacts on state finances. It is possible that its enactment could affect states' administrative and legal costs, revenues from fees imposed on regulated businesses, and insurance guarantee funds. It would be difficult, however, to separate the impact of this legislation from ongoing changes to the structure and regulation of financial services occurring under current federal law.

*Estimated impact on the private sector*

The bill would impose several private-sector mandates as defined in UMRA. CBO's analysis of those mandates is contained in a separate statement on private-sector mandates.

*Estimate prepared by:* Costs for FHLB's: Robert S. Seiler; Other Federal Costs: Mary Maginniss; Federal Revenues: Carolyn Lynch; Impact on State, Local, and Tribal Governments: Marjorie A. Miller.

*Estimate approved by:* Robert A. Sunshine, Deputy Assistant Director for Budget Analysis.

CONGRESSIONAL BUDGET OFFICE ESTIMATE OF COSTS OF PRIVATE-SECTOR MANDATES

*Financial Services Modernization Act of 1999*

*Summary*

Overall, the bill would reduce existing federal regulation of the financial services industry by relaxing certain restrictions on financial transactions throughout the economy. In particular, the bill would eliminate certain barriers to affiliations among banking organizations and other financial firms, including insurance firms and securities businesses. At the same time the bill would impose restrictions on newly authorized financial activities and prohibit associations between thrifts and commercial entities through new unitary thrift holding companies.

The bill would impose several new private-sector mandates as defined by the Unfunded Mandates Reform Act of 1995 (UMRA). The mandates in the bill would affect the Federal Home Loan Banks, banking organizations, U.S. operations of foreign banks, and insured depository institutions that pay interest on bonds issued by the Financing Corporation. CBO estimates that the net direct costs of mandates in the bill would not exceed the statutory threshold for private-sector mandates ($100 million in 1996 dollars, adjusted annually for inflation) in any one year for the first five years that the mandates are effective.

*Private-sector mandates contained in bill*

The bill contains several new mandates on businesses in the financial services sector. If enacted, the principal mandates in the bill would:

Replace the $300 million fixed annual payment for interest on Resolution Funding Corporation (REFCORP) bonds with a 20.75 percent annual assessment on the net earnings of the Federal Home Loan Banks (FHLBs);

Require banking organizations to adopt several consumer protection measures affecting sales of insurance products;

End the blanket exemption provided banks from the definition of "broker," and "dealer," making them subject to regulation by the Securities and Exchange Commission;

Require that foreign banks seek approval from the Federal Reserve before establishing separate subsidiaries or using nonbank subsidiaries to act as representative offices that handle primarily administrative matters, and give the Federal Reserve the authority to examine a U.S. affiliate of a foreign bank with a representative office; and

Extend the current two-tiered schedule of Financing Corporation (FICO) assessment rates for an additional three years which under current law, would be replaced by a uniform rate for banks and thrifts starting on January 1, 2000.

*Estimated direct cost to the private sector*

Most of the cost of the mandates in the bill would result from changes in payments from the Federal Home Loan Banks to REFCORP. CBO estimates the Federal Home Loan Banks would increase their payments to REFCORP by a total of $346 million over the 2000–2004 period as compared with current law. The short-term costs are somewhat misleading, however, because CBO expects that the estimated increase in payments in the near term would be offset by a decrease in payments of an equal amount (on a present-value basis) in future years.

Mandates on banks, banking organizations, and foreign banks would impose some incremental costs of compliance on the industry. The additional costs to these institutions would depend on the actions of regulators and the degree to which new customer protection regulations would preempt state laws. The direct costs of mandates on banks and banking organizations could be at least partially offset by savings from changes the bill would make to expand the powers of banks and bank holding companies. Because of the multiple uncertainties involved and the complex interactions in the financial services sector, CBO cannot estimate the direct costs, net of savings, with any precision. However, based on discussions with federal banking agencies, securities regulators, and industry trade groups, CBO expects that the costs to banking organizations and domestic operations of foreign banks of complying with mandates in the bill are not likely to exceed the annual threshold established in UMRA.

Insured depository institutions pay interest on FICO bonds based on their deposits in the Savings Association Insurance Fund (SAIF) and the Bank Insurance Fund (BIF). The increase in costs to institutions that would pay a high premium on SAIF-assessable deposits (as compared with the expected premium rate under current law) would be completely offset by savings to institutions that would pay a lower premium on BIF-assessable deposits.

*Federal Home Loan Bank System:* Section 407 would replace the current method of payment made by FHLBs for the interest on REFCORP bonds with a 20.75 percent assessment on the annual net earnings of each FHLB. That is, FHLBs would no longer have to pay a fixed amount regardless of annual earnings; under the bill they would have to pay a fixed percentage of net earnings. Based on projections of net earnings, CBO estimates that the new assessment rate would increase the payments made by FHLBs above the current payment of $300 million annually by $45 million in fiscal year 2000 and a total of $346 million over the 2000–2004 period. However, CBO expects that the present value of the total amount paid by the FHLBs to the federal government would not change. The bill would authorize the Federal Housing Finance Board, which regulates the FHLBs, to extend or shorten the period over which payments are made such that, over time, the average payment would equal $300 million a year, on a present-value basis.

*Consumer Protection Regulations—Insurance Sales:* Section 202 would direct the federal banking regulators to issue, within one year of enactment, final consumer protection regulations that would govern the sale of insurance by any bank or by any person at or on behalf of a bank. According to the bill, the regulations

should include requirements for: (1) anti-coercion rules (prohibiting banks from misleading consumers into believing that an extension of credit is conditional upon the purchase of insurance); (2) oral and written disclosures about whether a product is insured by the Federal Deposit Insurance Corporation (FDIC), about the risk associated with certain products, and about the prohibition against anti-tying and anti-coercion practices; (3) customer acknowledgment of disclosures; (4) an appropriate delineation of the settings and circumstances under which insurance sales should be physically segregated from bank loan and teller activities; and (5) rules against misleading advertising.

Except for the anti-coercion provision, the provisions in section 202 are based on current industry guidelines issued in 1994 by bank regulators in an Interagency Statement on Retail Sales of Nondeposit Investment Products. The anti-coercion provision is similar to the anti-tying provision in current law. Other new regulations would largely codify a modified version of existing guidelines drafted by the federal banking regulators and, therefore, would not likely impose large incremental costs on banks that currently engage in insurance activities. Moreover, in states where state insurance laws are inconsistent with the prescribed federal regulations but deemed to be at least as protective as those regulations, the new federal insurance customer protection regulations would not apply.

*Regulation of Securities Services:* The Glass-Steagall Act generally prohibits banks from underwriting and dealing in securities, except for "bank-eligible" securities. Eligible securities are limited to those offered and backed by the federal government and federally-sponsored agencies, and certain state and local government securities. As banks have sought to expand their product lines, federal regulators have provided banks, through affiliated firms, limited authority to underwrite and deal in other types of securities. Generally, a firm that provides securities brokerage services (known as a broker-dealer) must register with and be regulated by the Securities and Exchange Commission (SEC) and at least one self-regulatory organization such as the National Association of Securities Dealers, the New York Stock Exchange, or the American Stock Exchange. Banks, however, are currently exempted from those requirements.

The bill would end the current blanket exemption for banks from being treated as brokers or dealers under the Securities Exchange Act of 1934. Securities activities of banks would, therefore, be subject to SEC regulations, with some exceptions. The bill would exempt from SEC regulation the securities activities of banks handling fewer then 500 transactions annually. Many of the roughly 300 small banks that currently provide brokerage services on bank premises would fall under this exemption. Sections 501 and 502 also would exempt several traditional securities activities of banks from the registration requirements and regulations that apply to brokers or dealers under SEC regulation. The exemptions would cover most products and services that banks currently offer as agents so that they would not trigger SEC regulation. However, for the products and services related to securities that would no longer be exempt under the bill, banks would most likely channel the non-

exempt activities through their own securities affiliate or establish a relationship with a broker-dealer. A substantial number of banks that currently handle securities activities have a broker-dealer affiliate so that the incremental cost of complying with SEC regulation would involve moving non-exempt activities to such an affiliate and would not be significant.

*Foreign Banks:* Section 152 would amend the International Banking Act of 1978 (IBA) to require that foreign banks seek prior approval from the Federal Reserve Board for establishing separate subsidiaries or using nonbank subsidiaries to act as representative offices. Under current law, a foreign bank must obtain the approval of the Federal Reserve Board (FRB) before establishing a representative office in the United States. A representative office handles administrative matters and some types of sales for the foreign bank owner, but it does not handle deposits. In some cases, foreign banks are establishing separate subsidiaries or using nonbank subsidiaries to act as representative offices and thereby escaping the requirement for approval by the FRB. The bill would strike the exclusion for subsidiaries from the IBA and close this loophole. The industry association estimates that there are fewer than 20 entities that would have to register their subsidiaries as a representative office. CBO expects that the cost to existing subsidiaries of filing with the FRB would be small.

Section 152 also would require that U.S. affiliates of foreign banks with a representative office be subject to examination by the Federal Reserve Board. Under current law, if a foreign bank has only a representative office and no other banking office in the United States, the FRB may examine only the representative office. The FRB cannot examine or seek information from U.S. affiliates of such a foreign bank. The bill would give the FRB the authority to examine a foreign bank affiliate in this situation. CBO has no basis for estimating the potential costs to the industry of such examinations. According to one industry expert, it is likely that the FRB would only use this authority in a case where suspicious behavior warrants further examination. If the FRB would examine affiliates under such limited circumstances, the costs of the mandate to the industry would be very modest.

*Three-Year Extension of FICO Assessment Rates:* The Deposit Insurance Funds Act of 1996 provided for the payment of interest on bonds issued by the Financing Corporation. Those payments which amount to approximately $780 million per year, are made by all institutions that are covered by FDIC insurance. Under the act, the FICO obligation was to be split between Bank Insurance Fund (BIF) deposits and Savings Association Insurance Fund (SAIF) deposits such that the rate on SAIF deposits was five times the rate on BIF deposits. Also, under current law, the rates are to be equalized no later than January 1, 2000. The annual FICO assessment rate is currently about 6.10 basis points for SAIF-assessable deposits and 1.22 basis points for BIF-assessable deposits.

Section 304 would freeze the current FICO contribution formula for 3 years. Without the freeze, on January 1, 2000, both BIF and SAIF members will pay a uniform rate of about 2.2 basis points on insured deposits. Under the bill, for the next 3 years, institutions with SAIF-assessable deposits would have to pay a higher amount

than under current law. Institutions with BIF—assessable deposits would pay less than under current law. Some BIF and SAIF members hold assessable deposits in both funds—almost 40 percent of the SAIF-assessable base is held by BIF members and about 2 percent of the BIF-assessable base is held by SAIF members. Since the annual FICO payment would remain constant, the net cost of the freeze to BIF- and SAIF-insured institutions would be zero.

*Estimate Prepared By:* Patrice Gordon and Robin Seiler—Federal Home Loan Banks.

*Estimate Approved By:* Roger Hitchner, Acting Assistant Director for Natural Resources Commerce Division.

## CHANGES IN EXISTING LAW

In the opinion of the Committee, it is necessary to dispense with the requirement of section 12 of rule XXVI of the Standing Rules of the Senate in order to expedite the business of the Senate.

## ADDITIONAL VIEWS OF SENATORS BENNETT AND SHELBY

We join the Chairman in voicing our strong support for the Financial Services Modernization Act of 1999. The banking laws in the United States are outdated and no longer provide a useful framework for the regulation of the many diverse activities our financial institutions are conducting or seeking to conduct to remain competitive in the global economy. Yet legislative reform of these laws has been elusive. Now, as we move toward the 21st century, it is important to reform these laws and to do it without imposing any unnecessary restrictions that will limit the competitiveness of our financial institutions.

While we support this bill generally, we believe that the provisions governing operating subsidiaries unnecessarily limit the ability of financial institutions to structure their operations in the manner they deem most effective. The expert testimony presented to the Committee suggests that there is no reason to limit the use of the operating subsidiary structure to institutions with assets under $1 billion. Rather, there are important reasons why we support extending the use of that structure to all financial institutions.

Foreign banks operating in the United States are permitted to use the operating subsidiary structure without regard to size, and failing to give U.S. institutions the same choice will create a competitive disadvantage. Furthermore, the Chairman of the Federal Deposit Insurance Corporation has testified that the operating subsidiary structure creates no safety and soundness risks and may provide more protection to the bank insurance fund in the event of a failure. If there is no safety and soundness problem associated with operating subsidiaries, then all financial institutions should be given as much choice as possible in structuring their business operations, certainly the same choice enjoyed by foreign financial institutions operating in the United States.

We urge the Chairman to remove the arbitrary $1 billion asset limitation, and give American financial institutions choice in structuring their operations to maximize their competitiveness in the global economy.

ROBERT F. BENNETT.
RICHARD C. SHELBY.

## ADDITIONAL VIEWS OF SENATOR SANTORUM

As reported by the Senate Banking Committee, the Financial Services Modernization Act of 1999 includes a provision to extend for three years the existing premium disparity between Bank Insurance Fund (BIF)- and the Savings Association Insurance Fund (SAIF)-insured institutions. This provision is of particular interest and concern to me as I had hoped that it could have been fully debated and addressed before the committee reported the bill.

In 1996, Congress enacted legislation, the Deposit Insurance Funds Act ("Funds Act"), to avert a potential crisis in the federal deposit insurance system. The legislation sought to capitalize the SAIF and ensure the health of the federal deposit insurance system.

Prior to passage of that legislation, the SAIF did not meet statutory capitalization requirements. This situation arose, in part, from the fact that SAIF-insured institutions were required to pay annual FDIC insurance premiums of 23 basis points to capitalize the SAIF while banks paid an assessment rate of 4.6 basis points. Additionally, SAIF-insured institutions were solely responsible for paying the interest obligation on Financing Corporation (FICO) bonds used to resolve the Federal Savings and Loan Corporation. As a result, insured deposits were being shifted from the SAIF into the BIF, thereby shrinking the SAIF's assessment base, diminishing the BIF's reserve ratio and making capitalization of SAIF difficult to achieve. Realizing the gravity of this problem, Congress enacted the Funds Act at the urging of the FDIC, the Federal Reserve Board, the U.S. Department of Treasury, and the Office of Thrift Supervision.

The Funds Act set out to capitalize the SAIF by requiring SAIF-insured institutions to make a one-time payment of $4.5 billion while spreading the FICO interest obligation to all FDIC-insured institutions. Also spelled out under that Act was the scenario for the BIF and SAIF to be merged before 2000, but contingent upon convergence of the thrift and commercial bank charters. In the interim, BIF members were required to pay one-fifth of the FICO assessment rate of SAIF members until "the earlier of (a) December 31, 1999 or (b) the date as of which the last savings association ceases to exist," (Funds Act, Sec. 2703). After whichever date governed, BIF and SAIF member institutions were to pay the same assessment rate for FICO of 2.2 basis points.

Calculating that the merger of charters will not occur before December 31, 1999, the Senate Banking Committee included a three-year extension of the premium disparity in the committee print. In my view, changing the rules less than one year prior to when rate equalization was to occur is unwise. SAIF-insured institutions have made their legally required payments—nearly $6 billion—to capitalize SAIF and meet their FICO obligations. The Funds Act was

successful in its goal, and resulting from its mandate is a healthy BIF and SAIF.

As consideration of the Financial Services Modernization Act of 1999 moves forward, I encourage my colleagues to reconsider inclusion in the bill of any provision that extends the premium disparity.

RICK SANTORUM.

# ADDITIONAL VIEWS OF SENATORS SARBANES, DODD, KERRY, BRYAN, JOHNSON, REED, SCHUMER, BAYH, AND EDWARDS

## 1. INTRODUCTION

The Democratic Members of the Senate Committee on Banking, Housing, and Urban Affairs strongly support financial services modernization legislation. Last year, every Democratic Member of the Committee voted for financial services modernization in the form of H.R. 10, the Financial Services Act of 1998. That bill was reported by the Committee on a bipartisan vote of 16 to 2. This year, every Democratic Member of the Committee voted for financial services modernization in the form of a Substitute Amendment offered by Senator Sarbanes. The Substitute Amendment contained the text of last year's bill, with the addition of a bank operating subsidiary provision supported by the Treasury Department. The Substitute Amendment was defeated at the Committee's markup on a party line vote of 11 to 9. It has since been introduced by Senator Daschle and every Democratic Member of the Committee as S.753, the Financial Services Act of 1999.

The Democratic Members supported these efforts, both last year and this year, because the legislation met certain basic goals. These include permitting affiliations between banks, securities firms and insurance companies; preserving the safety and soundness of the financial system; continuing access to credit for all communities in our country; and protecting consumers. Because the bill now reported to the Senate does not meet these goals, every Democratic Member of the Committee voted against it.

The partisan divide that produced the reported bill is striking in view of the bipartisanship that has characterized the Committee's previous attempts to enact financial services modernization legislation. In 1988 and 1991, the Committee reported financial services modernization legislation to the full Senate with support from both sides of the aisle. Sixteen out of eighteen Committee Members voted for last year's bill. The broad, bipartisan margin of support enjoyed by last year's bill reflected the careful compromises struck during the course of its consideration. It was not opposed by a single major financial services industry association.

We are disappointed that the Committee Majority has abandoned the consensus so carefully developed last year. The Substitute Amendment reflects compromises among Committee Members and among industry groups on a wide range of issues, including the Community Reinvestment Act, consumer protections, and the separation of banking and commerce. The decision by the Committee Majority to abandon these compromises has led some industry groups to oppose the reported bill or important provisions thereof. Civil rights groups, community groups, consumer organizations,

and local government officials also strongly oppose the reported bill.

We are disappointed as well that the Committee Majority has refused to recognize that enactment of financial services legislation entails accommodation of differing views. The Committee Majority's Report makes no mention of either the bipartisan bill reported last year or the Substitute Amendment offered at this year's markup, as if these events had never occurred. This is in keeping with their failure to consider the views of Democratic Members, a failure that led directly to the party-line vote on the reported bill.

The views not only of Committee Members but also of the White House and the Treasury Department should have been considered. On March 2, 1999, before the Committee's markup, President Clinton wrote:

> This Administration has been a strong proponent of financial legislation that would reduce costs and increase access to financial services for consumers, businesses, and communities. * * * I agree that reform of the laws governing our nation's financial services industry would promote the public interest. However, I will veto the Financial Services Modernization Act if it is presented to me in its current form.

The President warned that the bill "would undermine the effectiveness of the Community Reinvestment Act," "would deny financial services firms the freedom to organize themselves in the way that best serves their customers," "would * * * provide inadequate consumer protections," and "could expand the ability of depository institutions and nonfinancial firms to affiliate * * *." The Committee Majority did nothing at markup to resolve these concerns. Unless the concerns of the Administration are resolved, it is clear that the reported bill will be vetoed.

## II. COMMUNITY REINVESTMENT ACT

As noted above, all Democratic Members of the Committee support financial services modernization. Financial services modernization legislation, however, must ensure that financial services are available to all communities in our country. The Community Reinvestment Act ("CRA") has played a critical role in expanding access to credit and investment in low- and moderate-income rural and urban communities. Accordingly, we cannot support legislation that would undermine the effectiveness of CRA.

The bill reported by the Committee fails this standard in three ways. First, it fails to require that a bank have and maintain a "satisfactory" CRA rating to engage in the new affiliations permitted by the legislation. Second, it provides a safe harbor to banks with a "satisfactory" CRA rating, effectively eliminating public comment on the CRA performance of these banks when they submit applications to regulators. Finally, it exempts all small rural banks from CRA.

President Clinton has stated that ill-conceived CRA provisions will result in a veto of this legislation. President Clinton's March 2, 1999 letter stated in part:

> [W]e cannot support the "Financial Services Modernization Act of 1999" * * *. In its current form, the bill would undermine the effectiveness of the Community Reinvestment Act (CRA), a law that has helped to build homes, create jobs, and restore hope in communities across America. The CRA is working, and we must preserve its vitality as we write the financial constitution for the 21st Century.

*Background on CRA*

CRA was enacted in 1977 to encourage banks and thrifts to serve the credit needs of their entire communities, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices.[1] CRA reflects the view that banks and thrifts, although privately owned, receive public benefits in the form of deposit insurance and access to the Federal Reserve's discount window and payments system. In return, they have charter obligations to serve the "convenience and needs" of their local communities.[2]

CRA requires the appropriate federal bank regulator to assess an institution's record of meeting the credit needs of its entire community. It does not place burdensome requirements on banks. Compliance examinations typically occur 18 to 24 months apart. CRA performance evaluations are very flexible. Most banks and thrifts are assessed on three factors: lending, service, and investment performance. Small banks and limited purpose institutions have streamlined examinations. Based on their performance, institutions receive a rating of "outstanding," "satisfactory," "needs to improve," or "substantial non-compliance." These ratings are made available to the public.

*Benefits of CRA*

CRA has significantly improved the availability of credit in historically underserved communities. CRA has been credited with a dramatic increase in home ownership by low- and moderate-income individuals. Between 1993 and 1997, private sector conventional home mortgage lending in low- and moderate-income census tracts increased by 45%.[3] CRA has also helped spur bank and thrift investment in multi-family rental housing development and rehabilitation and community economic development. In 1997, large banks and thrifts made approximately 525,000 small business loans totaling $34 billion to entrepreneurs located in low- and moderate-income areas.[4] Commercial banks and thrifts also invest in community development projects—nearly $19 billion in 1997 alone.[5] For example, according to the Office of the Comptroller of the Currency ("OCC"), CRA lending and investments have underwritten the expansion of African-American churches in Brooklyn, the renovation of a 100-unit apartment complex in a disadvantaged neighborhood in Washington, D.C., the provision of much needed retail services in the Roxbury section of Boston, and the strengthening of small

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[1] 12 U.S.C. Sec. 2903(a)(1).
[2] 12 U.S.C. Sec. 2901(a)(1).
[3] Attachment to FFIEC Press Release, August 6, 1998 (Table 7).
[4] Attachment to FFIEC Press Release, August 24, 1998 (Table 4.2).
[5] Attachment to FFIEC Press Release, August 24, 1998 (Table 5).

business through the Enterprise Development Center in Louisville, Kentucky. Federal Reserve Chairman Alan Greenspan noted during his testimony before the House Banking Committee on February 11, 1999, that CRA has "very significantly increased the amount of credit in communities" and that the changes have been quite profound."

The benefits of CRA extend beyond urban communities. CRA has also helped alleviate credit needs and improve services in rural areas. Banks and thrifts made $11 billion in small farm loans in 1997.[6] Low- and moderate-income rural communities benefited from $2.8 billion in small business loans in 1997.[7] Banks have entered into partnerships with community groups to provide affordable housing in many rural communities, such as in northeast Indiana and in Hillsborough, North Carolina.

With encouragement from CRA, banks have also increased their services on Native American reservations. For instance, there were only three bank branches and two ATMs on Navajo reservations in 1994. At the end of last year, there were 12 branches and 19 ATMs.[8] The Navajo reservation branches are highly profitable for banks. Residents of the reservation have benefitted from an array of new mortgage and small business loans.

There is a consensus among the regulatory agencies, community groups, local and state elected officials, and many bankers that CRA has been beneficial. President Clinton has repeatedly reaffirmed his support for CRA:

> [W]e should all be proud of what [CRA] has meant for low and moderate-income Americans of all races. Although we still have a long way to go in bringing all Americans into the economic mainstream, under CRA the private sector has pumped billions of dollars of credit to build housing, create jobs and restore hope in communities left behind.[9]

Chairman Greenspan has noted that "CRA has helped financial institutions to discover new markets that may have been underserved before."[10] The U.S. Conference of Mayors has promoted CRA as an essential tool in revitalizing cities, while the National League of Cities has listed CRA preservation as a major federal priority for 1999. Hugh McColl, Jr., chairman and CEO of BankAmerica Corp., stated earlier this year: "My company supports the Community Reinvestment Act in spirit and in fact. To be candid, we have gone way beyond its requirements. * * * We're quite happy living with the existing rules."[11]

CRA has accomplished these goals by encouraging banks and thrifts to make profitable, market rate loans and investments. It does not jeopardize the safety and soundness of any depository institution. Chairman Greenspan noted last year that there is "no evidence that banks' safety and soundness have been compromised

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[6] FFIEC Press Release, August 24, 1998.
[7] Id. at Table 4.2
[8] Source: Department of the Treasury.
[9] President Clinton, Remarks at White House on 20th Anniversary of CRA, October 12, 1997.
[10] Remarks, Social Compact Awards Luncheon, May 17, 1995.
[11] Bridge News, "Bank America CEO Opposes Linking CRA Reform to Banking Reform," January 4, 1999.

by [low- and moderate-income] lending and bankers often report sound business opportunities." [12]

Loans and banking services to low- and moderate-income communities have increased tremendously in recent years. Disparities still exist, however, in lending and banking services. CRA must remain a vital force in helping ensure that all creditworthy borrowers have access to essential capital and all communities have a chance to thrive.

*CRA provisions of substitute amendment*

The Substitute Amendment would require that banks have at least a "satisfactory" CRA rating as a precondition for affiliation with securities and insurance firms. Banks in the financial holding company would be required to maintain the "satisfactory" CRA rating in order to continue the new affiliations. As noted above, the Committee last year by a vote of sixteen to two approved financial services modernization legislation containing these provisions. Every financial services industry group accepted the bill with these provisions.

Those provisions were viewed as necessary to maintain the effectiveness of CRA within the expanded holding company structure. Currently, the application process serves as the mechanism for regulatory review and assessment of a bank or thrift's performance in meeting the credit needs of the communities it serves as well as its capital and management performance. Capital, management, and CRA performance are at issue when an institution files an application for deposit insurance, a charter, a merger, an acquisition or other corporate reorganization, a branch, or the relocation of a home office or branch.

The Substitute Amendment would permit holding companies to acquire insurance and securities firms without submitting applications for approval with the federal bank regulators. This is an important change from current law, which requires banks to submit applications before affiliating with non-banks. Accordingly, the CRA precondition requirement, like the preconditions regarding capital and management, would take the place of the review that now takes place in the application process. Without this requirement, an institution with an unsatisfactory CRA rating could nevertheless engage in the expanded affiliations permitted by the legislation.

This requirement is supported by the Treasury, FDIC, Office of Thrift Supervision, and OCC. As FDIC Chairman Donna Tanoue has said:

> The bank and thrift regulatory agencies consistently take into account an insured institution's record of performance under CRA when considering an application to open or relocate a branch, a main office, or acquire or merge with another institution. As this legislation would enable institutions to enter into additional activities, it

[12] Remarks at Community Forum on Community Reinvestment and Access to Credit, January 12, 1998.

would seem consistent that CRA compliance should continue to be a determining factor.[13]

*CRA Provisions of reported bill:*

On a party line vote, the Committee Majority this year rejected last year's bipartisan approach. The reported bill contains three CRA provisions that are unacceptable to Democratic Members of the Committee and the Administration.

*1. Eliminates "satisfactory" CRA rating as a precondition of expanded affiliations*

Unlike the Substitute Amendment, the reported bill does not require that all banks within a holding company have and maintain "satisfactory" CRA ratings in order to engage in and maintain expanded affiliations. The Committee Majority has asserted that an explicit requirement that banks have a "satisfactory" CRA rating to engage in these affiliations is not needed because, unlike last year's bill, the reported bill does not create a "financial holding company." Instead, it expands the Bank Holding Company Act to permit broader financial activities. Since CRA applies to banking activities under the Bank Holding Company Act, it is argued that it would apply to the broader financial activities as well.

In reality, CRA would not apply to these activities. Current law does not explicitly permit affiliations between banks and other financial services firms. Both the Substitute Amendment and the reported bill would change current law to permit these affiliations explicitly. Since these affiliations would be permitted pursuant to new statutory authority, new statutory authority is needed to condition these affiliations on compliance with bank regulatory standards. Both the Substitute Amendment and the reported bill make compliance with bank capital and management standards a statutory precondition for the new affiliations. Both do so because, the assertions of the Committee Majority's Report notwithstanding, compliance with capital and management standards are not currently a statutory requirement for banks' affiliations with nonbanks.

However, the reported bill fails to make CRA compliance a precondition. By virtue of the failure to include CRA performance as a condition to affiliations, the reported bill cannot be described as "neutral." In fact, enactment of the reported bill without the precondition of a "satisfactory" CRA rating would dramatically undermine CRA. Under the bill, bank holding company acquisitions of banks would remain subject to CRA. However, banking industry experts and regulators agree that most of the consolidations within the banking community have occurred. Mergers among banks, securities and insurance firms are likely to increase. As Treasury Secretary Robert Rubin testified to the House Banking Committee on February 12, 1999,

> If we wish to preserve the relevance of CRA at a time when the relative importance of bank mergers may decline and the establishment of non-bank financial services will

[13] Responses of FDIC Chairman Tanoue to Questions from Senator Paul S. Sarbanes, April 9, 1999 ("Tanoue Responses"), at A.1.

become increasingly important, the authority to engage in newly authorized activities should be connected to a satisfactory CRA performance.

*2. Safe harbor for banks with a "satisfactory" CRA rating*

The Democratic Members strongly oppose the provision in the reported bill providing a safe harbor for banks with a "satisfactory" or better CRA rating. This provision would effectively eliminate public comment on CRA performance at the time of bank applications. Under this provision, a bank that received a "satisfactory" or better CRA rating at its most recent examination and at each examination during the preceding three years would be deemed in compliance with CRA. It would be immune from public comments on CRA performance during pending bank applications. This immunity would remain unless individuals or groups presented "substantial verifiable information to the contrary" arising since the last examination. The provision imposes the burden of proof on those presenting the information.

Federal bank regulatory agencies oppose this provision. They agree that a "satisfactory" CRA rating is not conclusive evidence that a bank is "meeting the credit needs of all of its communities." On the contrary, they welcome comments from the public regarding the CRA performance of the institutions they supervise. Comptroller of the Currency John Hawke said:

> Public comment is extremely valuable in providing relevant information to an agency in its evaluation of an application under the CRA, convenience and needs, and other applicable standards—even by an institution that has a "satisfactory" CRA rating. This amendment would limit or reduce public comment that is useful in our application process.[14]

Ellen Seidman, Director of the Office of Thrift Supervision ("OTS"), testified before the Committee on February 24, 1999:

> [w]e generally find that the information received from those few who do comment on applications is relevant, constructive, and thoughtful, and frequently raise issues that need to be considered. In order for us to reach a supportable disposition on an application, and satisfy our statutory responsibilities, we need to have public input.

Public comment is especially useful in the case of large banks serving multiple markets, because regulators sample only a portion of these markets to determine the institution's CRA rating. Performance in small communities is weighted less than performance in larger areas. Public comment provides an opportunity for community members to point out facts and data that may have been overlooked in a particular examination. Moreover, circumstances can change rapidly over the course of an examination cycle.

The safe harbor provision of the reported bill would stifle public comment on banks' and thrifts' CRA performance, because nearly all banks and thrifts receive "satisfactory" or better CRA ratings.

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[14] Responses of Comptroller of the Currency Hawke to Questions from Senator Paul S. Sarbanes, March 23, 1999 ("Hawke Responses"), at A.2.

In fact, 97% of institutions examined in 1997 and 1998 received CRA ratings of "satisfactory" or better.[15] While the Committee Majority asserts that the public comment process has been routinely abused, that assertion is not supported by the record. The vast majority of applications reviewed on CRA grounds are approved expeditiously and do not receive any adverse comments. Data collected from the four regulatory agencies show that less than one percent of applications subject to CRA received adverse comments.[16] Of those applications that received adverse comments, only one percent were denied. The data also show that few applications that receive adverse CRA comments are significantly delayed. According to the OCC, since 1995 "the average time for processing protested applications is only 27 days beyond standard processing targets."[17]

The exception to the safe harbor provision for CRA comments based on "substantial verifiable information" is unworkable in practice. Under the bill's rebuttable presumption, information relevant to a bank's CRA performance could not be introduced if it relates to problems existing at the time of the last examination. The provision places an excessive burden on ordinary citizens and community organizations, which would need to provide comments on every bank examination. FDIC Chairman Tanoue stated, "public comments relating to CRA should not bear a burden of proof that is not imposed on public comment related to any other aspect of a bank's performance."[18] Comptroller Hawke warned "the agencies will have to make the examination much more searching and time consuming than it is at present."[19] It also unfairly singles out CRA comments for restrictive treatment. Individuals seeking to comment on other aspects of the bank's performance, such as financial and managerial resources or competitive implications, would not have their rights similarly curtailed.

*3. Small bank exemption*[20]

Eight Democratic Members also oppose the provision which would exempt from CRA rural institutions with less than $100 million in assets. If enacted, the provision will have devastating consequences for low- and moderate-income rural communities, which depend almost exclusively on small banks for their credit needs. Access to credit in rural areas is already scarce, due in part to the lack of competition in those markets.

Over 76% of rural U.S. banks and thrifts have assets less than $100 million.[21] It is asserted that these small rural banks by their nature serve the credit needs of their local communities. However, small banks have historically received the lowest CRA ratings. Institutions with less than $100 million in assets accounted for 92% of institutions receiving "substantial noncompliance" ratings in 1997–1998.[22] Small banks are subject to CRA because they receive

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[15] FFIEC Web Site, "Interagency CRA Ratings," visited March 22, 1999.
[16] See, e.g., Hawke Responses at A.5 ("In the past three years, less than one percent of the applications subject to CRA that were filed with the OCC were protested.").
[17] Hawke Responses at A.5.
[18] Tanoue Responses at A.2.
[19] Id. at A.2.
[20] Senator Johnson does not join in this portion of the Additional Views.
[21] Source: Federal Deposit Insurance Corporation.
[22] FFIEC Website, "Interagency CRA Ratings," visited March 22, 1999.

public benefits, namely deposit insurance and access to the Federal Reserve's discount window and payment system.

Although many small banks do serve the needs of their communities, statistics from the Federal Deposit Insurance Corporation reveal that 57% of small banks and thrifts have a loan-to-deposit ratios below 70%, with 17% of these having levels less than 50%.[23] Observers note that small banks often invest in government securities rather than in their own communities. A 1995 editorial in the Madison, Wisconsin Capital Times summed up the practice of many banks in rural communities:

> [M]any rural banks, establish a very different pattern [than reinvesting in their communities], where local lending takes a lower priority than making more assured investment, like federal government securities. Thus, such banks drain local resources of the very localities that support them, making it much harder for local citizens to get credit.[24]

An exemption for small banks is unnecessary to relieve regulatory burden. The Federal bank regulators revised their CRA regulations in 1995 to reduce small banks' cost of compliance. This action followed the review of thousands of public comments, submitted by financial institutions, organizations, and individuals. According to the American Bankers Association, "[f]or the vast majority of banks it reduced record keeping, exams went quicker and banks now know what is required of them."[25] The new CRA rules, which took effect January 1, 1996, provide a streamlined examination for banks with less than $250 million in assets. These institutions generally need not do paperwork or keep records beyond what they would do in the ordinary course of their business. The new rules exempt small banks from reporting requirements and emphasize institutions' actual performance rather than paperwork and process. CRA ratings for small banks focus exclusively on lending and lending-related activities: loan-to-deposit ratio, percentage of loans in a given political subdivision, lending to borrowers of different income and different sizes, and geographic distribution of loans. Moreover, banks that find it difficult to meet the requirements outlined in the regulations have the option of developing a strategic plan by which they will be evaluated.

The FDIC, OTS, and OCC support the application of CRA to small banks. OTS Director Seidman has stated:

> Small banks should be subject to CRA. The simple assumption that if an institution is small it must be serving its community is not entirely correct. It is the unfortunate fact that it is possible for an institution to make money simply by arbitrating the spread between insurance-backed deposits and other safe investments, including Treasury bonds. Although the overwhelming majority of small institutions have a favorable CRA ratings history, during 1998 alone 18 of the 24 (66%) thrifts that were

[23] Source: Federal Deposit Insurance Corporation.
[24] "Bank Measure Bad for Farms," July 20, 1995.
[25] American Banker, "Ludwig Gets Bankers' Credit for Helping Modernize Industry," January 20, 1998.

> rated Substantial Noncompliance or Needs to Improve by OTS had assets under $100 million. Overall, 40% of OTS-regulated institutions have assets under $100 million.

FDIC Chairman Tanoue stated similarly:

> Although the vast majority of institutions satisfactorily help to meet the credit needs of their communities, not all institutions may do so over time, including small institutions. Some institutions may unreasonably lend outside of their communities, or arbitrarily exclude low- and moderate-income areas or individuals within their communities. We believe that periodic CRA examinations for all insured depository institutions, regardless of asset-size, are an effective means to ensure that institutions help to meet the credit needs of their entire communities, including low- and moderate-income areas.[26]

*Conclusions regarding CRA*

Reinstating the "satisfactory" CRA rating as a precondition of expanded affiliations and deleting the safe harbor and small bank exemption would bring the reported bill in line with the approach taken by the House Banking Committee. The bill reported by the House Banking Committee on March 11, 1999 by a vote of 51 to 8 (also known as H.R. 10) dealt with these three issues in the same way as the Substitute Amendment supported by the Democratic Members. This is the same approach to these three issues that passed the full House and the Senate Banking Committee last year. By including these onerous CRA provisions, the reported bill moves in a direction previously rejected in both Houses of Congress and makes passage of financial services modernization legislation significantly more difficult.

## III. OPERATING SUBSIDIARIES OF NATIONAL BANKS

One of the difficult issues raised in the financial services modernization debate over the past two years has been what activities may take place in subsidiaries of banks, and under what conditions. The bill reported by the Committee last year contemplated that activities as principal, such as underwriting of securities and insurance, would take place in holding company subsidiaries rather than bank subsidiaries.[27] Certain agency activities, such as sales of insurance, were permitted in bank subsidiaries. While this approach was supported by the Federal Reserve, it was opposed by the Treasury Department. The Federal Reserve argued that the holding company structure offered greater safety and soundness protection. The Treasury Department pointed out the bill would restrict banks' ability to organize their operations as they think best and that financial activities could be conducted as safely in a bank subsidiary as in a holding company subsidiary. The FDIC agreed with the Treasury that financial activities in bank subsidiaries can be consistent with safety and soundness and protection of the deposit insurance funds.

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[26] Tanoue Responses at A.4.

[27] Holding company subsidiaries are often referred to as "bank affiliates."

As the legislative process has proceeded, the Treasury Department has agreed to significant additional safeguards regarding the scope and regulation of bank subsidiaries' activities, discussed in detail below. With these safeguards, the Democratic Members believe banks should be given the option of conducting financial activities in operating subsidiaries. Moreover, President Clinton has indicated that he will veto the reported bill, in part because it "would deny financial services firms the freedom to organize themselves in a way that best serves their customers * * *." The Substitute Amendment supported at the Committee's markup by all Democratic Members therefore would allow certain financial activities to take place in bank subsidiaries, subject to those safeguards.

*Safeguards on bank operating subsidiaries*

*1. Insurance underwriting*

First, the Treasury has agreed that insurance underwriting may not take place in a bank subsidiary. In his February 24, 1999 testimony, Secretary Rubin explained that the business nexus between commercial banking and insurance underwriting is not as great as that between commercial banking and investment banking. Therefore, the Treasury would support legislation containing a prohibition on insurance underwriting in bank subsidiaries. Banks also have less experience with insurance underwriting than with other financial activities, such as securities underwriting. This suggests that insurance underwriting in bank subsidiaries might pose greater risks than other activities. The prohibition on insurance underwriting would be in addition to an explicit prohibition on real estate development conducted by bank subsidiaries, to which the Treasury agreed last year.

*2. Merchant banking*

The Treasury has also agreed that the Federal Reserve shall have exclusive authority to define merchant banking activities in bank subsidiaries. Merchant banking refers to the practice whereby an investment bank takes a passive equity stake in a company in connection with the provision of financial services, such as underwriting the company's securities, with a view towards appreciation and eventual sale. In the context of an investment bank's affiliation with a commercial bank, merchant banking activities present a potential breach in the separation of banking and commerce. They raise the possibility of commercial bank lending decisions being influenced by the merchant banking investments of an affiliate, with accompanying risks to the Federal deposit insurance fund.

The possible dangers would be increased if two different regulators, namely the OCC and the Federal Reserve, were to define the dimensions of merchant banking activities permissible in two different categories of bank affiliate, namely bank subsidiaries and bank holding company subsidiaries. Defining the scope of merchant banking will involve drawing fine lines. In response to this concern, the Treasury Department agrees that the Federal Reserve should have exclusive rulemaking authority over merchant banking activities. The Federal Reserve will define merchant banking both for the bank holding company subsidiaries it already regulates and for

bank subsidiaries, over which the Federal Reserve otherwise has no authority. This meaningful step on the part of the Treasury will contribute to bank subsidiary activities being structured in a prudent fashion.

*3. Joint rulemaking*

The potential competition between bank regulators is present in other contexts as well. Having the OCC define what activities are "financial in nature" when they take place in a bank subsidiary, while the Federal Reserve defines what is "financial in nature" for a holding company subsidiary, would be troubling. It could put pressure on each regulator to interpret its regulations broadly, so as not to lose regulatory jurisdiction to the other. The Treasury Department endorses a number of steps intended to eliminate this risk. The Treasury Department agrees that the Secretary and the Federal Reserve shall jointly determine which activities are "financial in nature," both for a holding company subsidiary and for a bank subsidiary. The Secretary and the Federal Reserve shall also jointly issue regulations and interpretations under the "financial in nature" standard.

*4. Regulatory parity*

To further place activities on an equal footing, the same conditions would apply to a national bank seeking to exercise expanded powers through a subsidiary as to a holding company seeking to exercise those powers through a subsidiary. These conditions are that the banks be well capitalized, well managed, and in compliance with CRA. The same penalties would apply to an institution that falls out of compliance with those provisions. The Treasury also supports the application of functional regulation to securities and insurance activities taking place in bank subsidiaries just as it applies to holding company subsidiaries. The Securities and Exchange Commission thus would have the same authority over a broker-dealer subsidiary of a bank as over a broker-dealer subsidiary of a holding company. State insurance regulators would have the same authority over an insurance agency owned by a bank as over an insurance agency owned by a holding company. These provisions should ensure a level competitive playing field for financial firms and appropriate regulation for financial activities, wherever they take place.

In addition, the Treasury supports a requirement that national banks with total assets of $10 billion or more retain a holding company, even if they choose to engage in expanded financial activities through subsidiaries. This is designed to preserve the oversight that the Federal Reserve now has over the nation's largest commercial banks via their holding companies. The Federal Reserve believes this oversight capability is crucial to the conduct of monetary policy and to identification of systemic risks to the financial system.

*5. Additional safeguards*

The Substitute Amendment supported by the Democratic Members contained certain additional safeguards that the Treasury Department has advocated for financial services modernization legis-

lation. Every dollar of a bank's investment in a subsidiary would be deducted from the bank's capital for regulatory purposes. In this way, the bank would have to remain well-capitalized even after deducting the investment in the subsidiary and even should it lose its entire investment. Further, a bank could not invest in a subsidiary an amount exceeding the amount the bank could pay to its holding company as a dividend. This should place investments in bank subsidiaries and investments in holding company subsidiaries on a level regulatory footing. While a bank's investment in a subsidiary would still be counted as an asset for financial accounting purposes, these provisions should lead the financial markets to treat a bank subsidiary in the same manner as a bank affiliate.

Finally, Sections 23A and 23B of the Federal Reserve Act would apply the same strict limits on transactions between banks and their subsidiaries as already apply to transactions between banks and their affiliates. These statutes restrict extensions of credit from banks to their affiliates, guarantees by banks for the benefit of their affiliates, and purchases of assets by banks from their affiliates. Sections 23A and 23B require that all such transactions be at arms' length and fully collateralized and limit the total amount of such transactions between a bank and all of its affiliates.

In total, these safeguards pertaining to the regulation of bank subsidiaries should eliminate any economic benefit that may exist when activities are conducted in bank subsidiaries rather than holding company subsidiaries. The provisions regarding the scope of activities permissible for bank subsidiaries should remove any opportunity for regulators to compete with one another to the detriment of the safety and soundness of the banking system or the separation of banking and commerce. FDIC Chairman Tanoue testified to the Committee on February 24, 1999:

> From a safety-and-soundness perspective, both the bank operating subsidiary and the holding company affiliate structures can provide adequate protection to the insured depository institution from the direct and indirect effects of losses in nonbank subsidiaries or affiliates. . . .[I]n practice, regulatory safeguards for operating subsidiaries [discussed above] and existing safeguards for affiliates, such as Sections 23A and 23B of the Federal Reserve Act, would inhibit a bank from passing any net marginal subsidy either to a direct subsidiary or to an affiliate of the holding company.

Chairman Tanoue's position is echoed by three former Chairmen of the FDIC. In a September 2, 1998 American Banker editorial, former Chairmen Ricki Tigert Helfer, William M. Isaac, and L. William Seidman wrote,

> Whether financial activities . . . are in a bank subsidiary or a holding company affiliate, it is important that they be capitalized and funded separately from the bank. If we require this separation, the bank will be exposed to the identical risk of loss whether the company is organized as a bank subsidiary or a holding company affiliate.
>
> On the basis of the provisions agreed to by the Treasury Department and the testimony given by the FDIC, the

Democratic Members believe that permitting bank operating subsidiaries can be consistent with the goals of preserving safety and soundness, protecting consumers, and promoting comparable regulation. Accordingly, the Substitute Amendment that was supported by all Democratic Members included authority for bank operating subsidiaries, subject to all the restrictions discussed above.

The reported bill authorizes operating subsidiaries only for certain small banks, namely those with less than $1 billion in assets. In his February 24, 1999 testimony, Secretary Rubin opposed putting a limit on the asset size of banks allowed to choose the operating subsidiary structure. Given the position of President Clinton as stated in his March 2, 1999 letter cited earlier, this provision of the reported bill would also result in a veto. The Democratic Members believe that adoption of the operating subsidiary provisions of the Substitute Amendment would be a meaningful step toward enactment of financial services modernization legislation into law.

## IV. CONSUMER PROTECTION

The Democratic Members believe that any financial services modernization bill must ensure adequate consumer protections. The blurring of lines between banking, securities and insurance products and the consolidation of these different financial services under one corporate roof increase the potential for confusion on the part of consumers. For example, the wider variety of financial products available through banks raises potential customer confusion about the insured status, risks, and the issuer and seller of those products. In the past, some depository institutions have sought to take advantage of this confusion. Appropriate measures addressing issues such as disclosure to customers and licensing of personnel can keep misunderstandings to a minimum. Such provisions must be included in any financial services modernization bill. The reported bill, however, fails to include important consumer protection provisions that passed the Committee overwhelmingly last year.

### *Insurance sales*

Insurance sales have always been regulated at the State level. The State insurance commissioners have staff and expertise in this area. Roughly 30 States have enacted statutes specifically addressing sales of insurance by banks. Currently, under the Supreme Court's *Barnett Bank* decision,[28] States may regulate sales of insurance by national banks so long as they do not "prevent or significantly interfere" with such sales.

The Committee Print presented at the March 4, 1999 markup would have contained broad preemption provisions. It would have preempted State laws that differentiate in any way between sales of insurance by agents and sales of insurance by banks. Accordingly, regulations in those 30 States that differentiate between sales of insurance by banks and sales of insurance by brokers without "significantly interfering" with bank sales would nevertheless have been preempted as "discriminatory."

[28] *Barnett Bank* v. *Nelson,* 517 U.S. 25 (1996).

At markup, the Committee adopted an amendment offered by Senator Bryan. The Bryan Amendment substituted the provisions from last year's bipartisan bill addressing the ability of States to regulate sales of insurance by banks. It deleted the overbroad preemption contained in the Committee Print. Instead, it codifies the *Barnett Bank* holding that States may not prevent or significantly interfere with a national bank's ability to sell insurance. It protects thirteen specific areas of State regulation from preemption. These include restrictions on the payment of commissions and referral fees to unlicensed bank personnel, restrictions on the release of customer insurance information, and requirements that banking and insurance transactions be documented separately.

While substituting these provisions from last year's bill did much to improve the consumer protection provisions of the reported bill, more remains to be done. The Substitute Amendment required the Federal bank regulators to establish mechanisms for receiving and addressing consumer complaints. The reported bill contains no such requirement. In addition, the Substitute Amendment provided that Federal regulations would supersede State regulations when the Federal regulations afforded greater protection for consumers. The reported bill allows State regulations to trump Federal regulations, even when the State offers less protection to consumers. These deficiencies in the bill should be rectified.

*Securities activities*

The reported bill reduces consumer protections not just in the conduct of insurance activities by banks but in the conduct of securities activities by banks as well. The Substitute Amendment ensured that the protections of the Federal securities laws were available to consumers in a wider range of circumstances than does the reported bill.

Currently, banks enjoy a total exemption from the definitions of "broker," "dealer," and "investment adviser" under the Federal securities laws. Because of the blanket exemption, the Securities and Exchange Commission ("SEC") cannot regulate securities activities taking place directly within banks. Banks are exempt from oversight by the securities self-regulatory organizations as well. This was appropriate in 1933 and for many years thereafter, when securities activities of banks were strictly limited.

Beginning in the 1980's, bank regulators have allowed banks greater participation in securities activities. Banks may now offer brokerage services and conduct private placements. Because of the blanket exemption, consumers who purchase securities from banks do not receive any of the protections of the securities laws. These protections are in many ways superior to those offered by the banking laws. For example, broker-dealer personnel have an obligation to recommend to their clients only transactions that are suitable, based on their clients' tolerance for risk, overall portfolio and so on. Bank personnel have no such obligation. Broker-dealer personnel must pass licensing exams given by the National Association of Securities Dealers ("NASD") and are subject to continuing education requirements. Bank personnel are exempt from these requirements. Disciplinary histories of broker-dealer personnel are made publicly available to investors by the NASD and State securities

regulators. No such history is available regarding bank personnel. Broker-dealer managers have a duty to supervise their sales personnel that is enforceable under the Federal securities laws. Bank managers do not. Finally, customers' disputes with brokerage firms are subject to arbitration, which offers a specialized, quicker, and cheaper forum for settling disputes. No arbitration exists for customers' disputes with banks.

Like the Substitute Amendment, the reported bill would repeal the total exemption banks enjoy from the definition of "broker" and "dealer." Also like the Substitute Amendment, it contains a number of exceptions that allow certain securities activities to continue to take place directly within banks. However, the exceptions in the reported bill are significantly wider than those in the Substitute Amendment.

For example, the reported bill allows a bank trust department conducting securities transactions to be compensated on a transaction-by-transaction basis, just like a broker. It also allows a bank conducting transfer agent services for employee benefit plans and dividend reinvestment plans to be compensated on a transaction-by-transaction basis. This gives banks an opportunity to move brokerage activities directly into the banks, where customers receive less protection as detailed above. The Substitute Amendment would require the compensation to be a flat administrative fee in both cases. Where the Substitute Amendment would allow a bank to sell unregistered securities exclusively to sophisticated investors, the reported bill allows a bank to sell unregistered securities to all investors. Where the Substitute Amendent would prevent a bank from selling unregistered securities when the bank has a securities affiliate, the reported bill allows a bank that has securities affiliates to sell unregistered securities directly from the bank. Finally, the reported bill prohibits the SEC from determining that a new product is a security, and therefore must be sold by an SEC-registered broker-dealer, unless the Federal Reserve concurs. Over time, this will move even more securities activities directly into banks. The Substitute Amendment would afford the SEC the first opportunity to define new products as securities. In each of these circumstances, purchasers of securities will receive less protection under the reported bill than they would receive under the Substitute Amendment.

The reported bill also provides less protection to mutual fund investors than would the Substitute Amendment. The SEC regulates mutual funds and their investment advisers. As noted above, banks are exempt from the definition of "investment adviser." Therefore, when a bank serves as investment adviser to a mutual fund, the SEC can review only one side of the equation. The Substitute Amendment would remove the exemption from the definition of "investment adviser" when banks advise mutual funds. The reported bill does not include this provision. It leaves the SEC with less authority over bank-advised mutual funds and with less ability to protect investors in those funds.

Finally, the Substitute Amendment would have required the Federal banking regulators to issue regulations regarding the sale of securities by banks and bank affiliates. The bank regulators would have established mechanisms to review and address consumer com-

plaints. Currently, the Federal bank regulators have issued guidelines, which do not have the force of law, rather than regulations. The reported bill does not include this provision, leaving only the guidelines in force. The failure of the bank regulators to issue regulations underscores the importance of maintaining SEC oversight of securities activities.

The Committee Majority's Report correctly notes that "sales of securities may be regulated differently depending on whether they take place through a bank or a securities broker." The reported bill, however, would actually make those regulatory discrepancies worse. The reported bill falls short in this area and thereby places investors at risk.

## V. BANKING AND COMMERCE

A final aspect of the reported bill that differs significantly from the Substitute Amendment is its approach to the separation of banking and commerce. U.S. law has long separated banking activities from commercial activities. Currently, a commercial firm such as General Motors or Microsoft may not own a bank or be owned by a bank.

A number of commentators, including Chairman Greenspan, Secretary Rubin, former Federal Reserve Chairman Paul Volcker, banking industry associations and public interest groups, expressed caution regarding breaching the separation of banking and commerce. Chairman Greenspan testified to the Committee on February 23, 1999, "[i]t seems to us wise to move first toward the integration of banking, insurance, and securities and employ the lessons we learn from that important step before we consider whether and under what conditions it would be desirable to move to the second stage of the full integration of commerce and banking." Secretary Rubin has stated, "[w]e continue to oppose any efforts to expand the integration of banking and commerce." [29]

The Substitute Amendment reflects careful bipartisan compromises developed last year on the issue of banking and commerce. In general, it would have allowed affiliation between banking and commercial firms only in the context of merchant banking and insurance underwriting activities. The reported bill weakens the separation of banking and commerce by permitting broader combinations of banking and commerce than are allowed under current law. The Independent Bankers Association of American has expressed its "strong opposition" to the reported bill, terming it "dangerous since it would permit the almost unbridled cross-ownership of banks and commercial firms."30 In his March 2, 1999 letter stating he will veto the bill in its current form, President Clinton objected to the bill because it "could expand the ability of depository institutions and nonfinancial firms to affiliate, at a time when experience around the world suggests the need for caution in this area." [30]

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[29] Responses of Secretary of the Treasury Rubin to Questions from Senator Paul S. Sarbanes ("Rubin Responses"), at A.1.

[30] News from IBAA, "IBAA/IBAT Label Senate Banking Bill 'Dangerous'," March 4, 1999.

*Traditional separation of banking and commerce:*

The separation of banking and commerce has long been a feature of U.S. law. It was embodied in the national bank system established by the National Bank Act of 1864, which specifically forbids banks to engage or invest in commercial or industrial activities. Except in certain limited situations, a national bank may not own for its own account any shares of stock of any corporation.[31]

When the rise of bank holding companies opened the possibility of the combination of banking and industrial firms through the holding company structure, Congress enacted the Bank Holding Company Act of 1956. This statute prohibited commercial firms from owning banks and prohibited holding companies owning two or more banks from owning commercial firms. This policy was strengthened by the Bank Holding Company Act Amendments of 1970, which extended the prohibition on owning commercial firms to holding companies owning just one bank. This policy was supported by both the Nixon Administration and the Democratic Congress. In submitting the 1970 Amendments, President Nixon said, "the strength of our banking system depends largely on its independence. Banking must not dominate commerce or be dominated by it."[32]

*Potential Risks of Mixing Banking and Commerce*

Allowing bank affiliations with commercial firms could raise numerous concerns relating to risk to the deposit insurance funds, the impartial granting of credit, unfair competition, and concentration of economic power. A bank that is affiliated with a commercial firm could have an incentive to make loans to that firm, even if the firm is less credit-worthy than other borrowers. The bank could have a similar incentive not to lend to the firm's competitors, even if they are credit-worthy. If banks were to make lending decisions based on criteria other than creditworthiness, the taxpayer-backed deposit insurance fund ultimately would be put at risk.

Some financial experts have pointed out these dangers. Secretary Rubin testified before the House Banking Committee on March 1, 1995 that mixing banking and commerce

> * * * might pose additional, unforeseen and undue risk to the safety and soundness of the financial system, potentially exposing the federal deposit insurance funds and taxpayers to substantial losses. . . . Equally uncertain is the effect such combinations might have on the cost and availability of credit to numerous, diverse borrowers and on the concentration of economic resources.

Noted economist Henry Kaufman has warned that mixing banking and commerce would lead to conflicts of interest and unfair competition in the allocation of credit. In his view,

> A large corporation that controls a big bank would use the bank for extending credit to those who can benefit the whole organization. . . . The bank would be inclined to

[31] 12 U.S.C. Sec. 24.

[32] Statement of President Richard M. Nixon of March 24, 1969, reprinted in H. Rep. No. 1747, 91st Cong., 2d Sess. 11 (1970).

> withhold credit from those who are, or could be, competitors to the parent corporation. Thus, the cornerstone of effective banking, independent credit decisions based on objective evaluation of creditworthiness, would be undermined.[33]

Some public interest groups have made the same points. Consumers Union testified before the Committee on February 25, 1999 that it opposes "permitting federally-insured institutions to combine with commercial interests because of the potential to skew the availability of credit, conflict of interest issues, and general safety and soundness concerns from expanding the safety net provided by the government."

Some believe that the difficulties experienced in Asia demonstrate the risks associated with mixing banking and commerce. Both Secretary Rubin and Chairman Greenspan testified that the financial crisis in Asia was made worse by imprudent lending by banks to affiliated commercial firms. Secretary Rubin said that his serious concerns about mixing banking and commerce "are heightened as we reflect on the financial crisis that has affected so many countries around the world over the past two years." Chairman Greenspan testified "the Asian crisis highlighted some of the risks that can arise if relationships between banks and commercial firms are too close, and makes caution at this stage prudent in our judgment." Other factors, including weak bank supervision and lack of transparency, contributed to the Asian financial crisis as well. Former Federal Reserve Chairman Volcker has written:

> Recent experience with the banking crises in countries as different in their stages of development as Japan, Indonesia and Russia demonstrates the folly of permitting industrial-financial conglomerates to dominate financial markets and potentially larger areas of the economy. But we need look no further than our own savings-and-loan crisis in the 1980s for the lesson. Combinations of insured depository institutions and speculative real estate developers cost American taxpayers, who ultimately stood behind the thrift insurance funds, tens of billions of dollars.[34]

*Substitute Amendment Retained the Separation of Banking and Commerce*

Under the Substitute Amendment, agreed to as part of last year's bipartisan compromise, banks could be owned by bank holding companies and by new "financial holding companies" as well. While the financial holding companies could engage in a broader range of financial activities, they would not be allowed to own commercial firms.

The Substitute Amendment would allow bank affiliates to engage in merchant banking activities, subject to certain specified conditions. As discussed above, merchant banking refers to the practice of taking a passive equity stake in a company in connection with the provision of financial services with a view towards resale. Under the Substitute Amendment, bank affiliates could invest in a

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[33] Talk Before UBS Securities Global Banking Conference, April 29, 1997.
[34] Washington Post, "Boost for Banking," September 10, 1998.

"bona fide" merchant banking activity for the purpose of appreciation and ultimate resale. The investment could be held "only for such a period of time as will permit the sale or disposition thereof on a reasonable basis," and the bank could not actively participate in the company's day to day management.

The Substitute Amendment also would prohibit the formation of new unitary thrift holding companies by commercial firms. As noted above, a holding company that owns even one bank may not own a commercial firm, nor may a holding company that owns more than one thrift. However, a holding company that owns just one thrift (a "unitary thrift holding company") is not subject to the same prohibition. This provision of the law may take on greater importance than in prior years, as the statutory focus on residential mortgage lending for thrifts has been modified.

The Substitute Amendment would prohibit any company that engages in commercial activities from acquiring control of a thrift. Under a "grandfather" provision, existing unitary thrift holding companies would be allowed to retain their commercial affiliations. The "grandfather" would also apply to any unitary thrift holding company formed pursuant to an application already pending before the Office of Thrift Supervision. The Substitute Amendment would continue to allow these thrifts to be acquired by financial companies, such as insurance companies and securities firms. However, it would prohibit the sale of these thrifts to commercial firms. There are currently over 500 thrifts owned by unitary holding companies. Allowing these thrifts to be transferred to commercial ownership would call the separation of banking and commerce into question. The Substitute Amendment would create parity of opportunity for banks and thrifts to be acquired by the same types of financial institutions.

*Reported bill weakens separation of banking and commerce*

Unlike the Substitute Amendment, the reported bill significantly weakens the separation of banking and commerce. It goes beyond what is necessary to accomodate commercial bank affiliations with insurance companies and securities firms. First, it allows for unnecessarily open-ended Amerchant banking" investments. Next, it continues to allow commercial firms to acquire thrifts through the unitary holding company provision. Finally, it permits holding companies to engage in any nonfinancial activities that regulators believe are Acomplementary" to financial activities.

*1. Merchant banking*

Like the Substitute Amendment, the reported bill permits bank affiliates to acquire any type of company in connection with merchant banking activities, defined to include "investment activities engaged in for the purpose of appreciation and ultimate resale or disposition of the investment." However, the reported bill drops safeguards on merchant banking activities that were contained in last year's bipartisan bill. It would not prohibit a bank holding company from actively participating in the day-to-day management of the companies in which it invests. It also would not limit the duration of the investment to "such a period of time as will permit the sale or disposition thereof on a reasonable basis." Thus, the re-

ported bill would not place restrictions on a bank holding company's acquisition and operation of any company, including commercial companies of any size and in any industry. This could effectively break down the separation of banking and commerce. Over time, the lending decisions of the affiliated bank could be biased to benefit the commercial firm. The potential risks raised by mixing banking and commerce could then be squarely presented: the commercial firm may have a competitive advantage over its rivals and the deposit insurance fund might be exposed to unnecessary risk.

*2. Unitary thrift holding company provision*

The reported bill does not effectively close the unitary thrift holding company provision. While the bill would prevent a commercial company from acquiring a thrift after March 1, 1999, it would allow a commercial company to acquire any of the existing unitary thrift holding companies. Unitary thrift holding companies currently own over 500 thrifts. Allowing these thrifts to be acquired by commercial firms would move far down the road toward a mixing of banking and commerce, with all its attendant dangers.

Some financial leaders and banking industry groups advised the Committee to prohibit commercial firms from acquiring control of thrifts. Chairman Greenspan testified on February 23, 1999, that "the Board continues to support elimination of the unitary thrift loophole, which currently allows any type of commercial firm to control a federally insured depository institution." He recommended that financial services modernization legislation "at least prohibit or significantly restrict the ability of grandfathered unitary thrift holding companies to transfer their legislatively created grandfather rights to another commercial organization through mergers or acquisitions." Secretary Rubin has stated,

> There are currently some 580 unitary thrift holding companies. If financial modernization legislation were enacted, insurance companies and securities firms would be free to affiliate with banks, and the unitary thrift holding company might be attractive primarily to commercial firms seeking to avoid the general prohibition against owning banks. For that reason, we support the bill's prohibition against forming additional unitary holding companies, and would further support an amendment terminating the grandfather rights of existing unitaries if they were transferred to commercial firms. Without such a limit on transferability, existing charters may tend to migrate to commercial firms and could become a significant exception to the general prohibition against commercial ownership of depository institutions.[35]

The American Bankers Association and Independent Bankers Association of America both testified before the Committee on February 25, 1999 expressing their support for closing the unitary thrift holding company provision, including restricting transferability of existing unitaries. The American Bankers said, "commerce and banking should not be allowed to mix in the wholesale

[35] Rubin Responses at A.1.

fashion permitted under the unitary thrift concept." The Independent Bankers oppose the reported bill because it "would perpetuate the unitary thrift loophole by permitting more than 500 existing unitaries to be sold to commercial firms."

OTS Director Seidman testified in favor of retaining the current features of the thrift charter, including the unitary holding company. She testified before the Committee on February 24, 1999:

> In our experience, the modern thrift charter provides business flexibility and choice coupled with sound regulatory oversight. It permits affiliations of insured depository institutions with insurance, securities, and other firms, but with built-in safeguards to avoid undue risks to the taxpayer and to meet the needs of consumers and communities. Based on our experience, there is no evidence that shows that affiliations permitted in the unitary thrift holding company structure are inherently risky and should be constrained. In fact, there are numerous reasons to retain the structure in its current form.

Some have argued that limiting transferability of unitary thrift holding companies would be unfair because companies bought thrifts at a time when they could sell to any commercial company. In the past, however, Congress has changed statutes governing savings associations and required compliance. For example, in 1987 Congress imposed a "qualified thrift lender test" requiring thrifts to hold a percentage of their total assets as "qualified thrift investments." A unitary thrift holding company owning a thrift that failed to comply with the new requirement was required to divest its commercial activities. Also in 1987, Congress limited the transferability of non-bank banks by requiring that upon transfer the new owner bank would be required to register as a bank holding company. Because the Congress broke no contracts in taking these actions, they created no liability for the Federal government. These prior Congressional actions provide a precedent for the position taken by the Substitute Amendment and are advocated by Chairman Greenspan, Secretary Rubin and others.

*3. "Complementary" activities*

Finally, as would the Substitute Amendment, the reported bill allows holding companies that own banks to engage in activities that are "financial in nature or incidental to such financial activities." Both would also permit numerous specific non-banking activities. These include activities consistent with reasonably expected changes in technology or the financial marketplace and investments in commercial firms by insurance companies.

The reported bill goes even further, by authorizing holding companies to engage in activities that are "complementary" activities that are financial in nature and incidental thereto. While subject to interpretation by regulators, the reported bill itself provides no definition of or limitations on these "complementary" activities. Some "complementary" activities would very likely be commercial in nature, raising the potential dangers of biased lending decisions described above. This open-ended grant of authority seems unnecessary.

## VI. CONCLUSION

The Democratic Members of the Committee support financial services modernization legislation. All Democratic Members of the Committee supported last year's bipartisan bill. All Democratic Members of the Committee this year supported the Substitute Amendment, which contained the text of last year's bipartisan bill with the addition of authority for bank operating subsidiaries and appropriate safeguards. These provisions achieve the primary objective of financial services modernization, namely allowing affiliation of banks, securities firms and insurance companies. The provisions do so while preserving safety and soundness, protecting consumers, providing for regulatory parity, and promoting the availability of financial services to all communities.

The bill now reported by the Committee, however, falls short of these goals. It undermines the Community Reinvestment Act. It does not protect purchasers of securities and insurance products from banks. It does not provide bank operating subsidiaries with the scope sought by the Treasury Department. Finally, it breaches the separation of banking and commerce. For these reasons, President Clinton has declared he will veto it in its current form.

If financial modernization legislation is to be enacted, the Senate must return to the bipartisanship that characterized legislative efforts in this area until this year. The Substitute Amendment offered at the Committee markup has been introduced by Senator Daschle and every Democratic Member of the Commitee as a stand-alone bill, S. 753. It is a balanced, prudent approach to financial services modernization. It reflects careful, bipartisan compromises struck last year. It is not opposed by any financial services industry association. It is similar to the bill passed with broad bipartisan support by the House Banking Committee earlier this year. It is clearly the approach most likely to achieve the enactment of financial services modernization legislation.

Failure to proceed on a bipartisan basis will, at best, waste the Senate's time in fruitless effort. At worst, the reported bill would increase risks to the taxpayer-backed deposit insurance funds, reduce the availability of credit in underserved communities, and expose consumers to unnecessary confusion.

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JOHN F. KERRY.
TIM JOHNSON.
RICHARD H. BRYAN.
EVAN BAYH.
JOHN EDWARDS.
CHARLES SCHUMER.
JACK REED.
CHRISTOPHER J. DODD.

## ADDITIONAL VIEWS OF SENATOR REED

At the outset, I would like to indicate my desire to pass financial services modernization legislation. Indeed, I believe the existing legal framework governing the financial services industry is an anachronism that bears no relationship to the realities of today's financial markets. Moreover, the theories advanced at the time of Glass-Steagall's enactment which suggested the need to separate banking, securities, and insurance as a prudential measure, have long since been abandoned. In fact, today there is general consensus that these activities can safely be conducted in one firm if appropriate firewalls are in place.

For these reasons, I am a proponent of financial modernization. More specifically, I support legislation that will allow financial institutions to affiliate, while preserving safety and soundness, and ensuring community access to credit. I believe last year's financial modernization bill, H.R. 10, which passed the House and overwhelmingly passed the Senate Banking Committee, adequately addressed these priorities. Unfortunately, that bill was prevented from coming to the Senate floor because of a desire by some to eliminate the Community Reinvestment Act (CRA) provisions included in the bill. As a result, the Senate missed an historic opportunity to enact fair and balanced financial modernization legislation.

The bill now being considered substantially deviates from the bipartisan compromise passed by the Committee last year. To be sure, this legislation falls woefully short on a range of issues which, in my opinion, are essential components of financial services modernization.

First, the current modernization bill includes several provisions that would significantly undermine CRA—legislation which has been responsible for $1 trillion in loans and loan commitments to low-income communities since its enactment in 1977. For example, one provision of the bill would create an exemption to CRA for rural financial institutions with assets under $100 million. Although this exemption is limited to the smallest institutions, over 76 percent of rural banks would be covered. This is of great concern since small banks have historically received the lowest CRA ratings. In fact, institutions with less than $100 million in assets accounted for 92 percent of institutions receiving "substantial noncompliance" CRA ratings in 1997–1998.

I am also concerned about this exemption because banks are typically the primary sources of credit in rural communities. Hence, absent CRA, it is likely that many rural communities could become credit-starved.

The bill also includes a provision that would provide a safe harbor for banks with a "satisfactory" or better CRA rating. Specifically, institutions receiving a satisfactory CRA rating at their most

recent examination would be presumptively in compliance with CRA, unless "substantial verifiable information" to the contrary was presented.

I am concerned about this provision because it establishes a very difficult-to-satisfy burden of proof for individuals or groups wishing to protest a bank merger on CRA grounds. Indeed, I fear this provision will greatly inhibit the ability of groups to get the necessary information from banks to protest a merger. Also, when considering the fact that 97 percent of institutions receive a satisfactory or better CRA rating, it is clear that this provision will effectively eliminate CRA comment on a bank merger.

In addition to CRA, provisions in the bill establishing a $1 billion asset cap for banks engaging in securities underwriting and merchant banking in an operating subsidiary raise concerns. I believe that banks of any size should have the flexibility to engage in the designated principal activities in an operating subsidiary as long as the proper safeguards are in place such as capital deduction requirements and limitations on self-dealing. In accordance with my views on this issue, I offered an amendment to H.R. 10 in the Banking Committee last year that would have allowed banks to engage in securities underwriting and merchant banking in an operating subsidiary. This amendment has been incorporated into an alternative Democratic financial services modernization bill, S. 753.

The financial modernization bill is also problematic since it does not include provisions to require prior approval from the Federal Reserve Board (FRB) before allowing a bank to merge or engage in new activities. At a minimum, the FRB should be required to consider whether the merger or new activity will compromise safety and soundness, will adversely affect competition, and will serve the public interest. Such provisions were included in H.R. 10 and have been included in the Democratic alternative.

I also have general concerns about the regulatory scheme established in the modernization bill. For example, the bill expands the powers of financial institutions, while simultaneously limiting the powers of federal regulators. This is evident in section 114, which prohibits the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) from examining a mutual fund being operated by a bank or thrift. This provision curtails existing powers of the OCC and OTS, both of which currently have limited authority to examine a mutual fund operated by a bank or thrift. I believe it is important that this authority be maintained.

Another similarly restrictive provision found in section 111 would prohibit the FRB from examining a securities or insurance affiliate unless there is "reasonable cause to believe" the affiliate is engaging in a risky activity. Absent the ability to examine the affiliate, it is unclear how the FRB could determine whether the affiliate is engaging in a risky activity.

Ultimately, I am concerned that this regulatory scheme, as illustrated by the foregoing provisions, is too porous. I fear that regulators may sometimes be unable to coordinate their responsibilities, which could result in situations in which detrimental practices may go unchecked.

Finally, provisions of the bill that would limit the FRB's authority to require an insurance affiliate to recapitalize a failing bank

raise concerns. These provisions undermine the "source of strength" doctrine, and, in my opinion, could lead to a regulatory standoff between the FRB and state insurance commissioners. I could easily envision a situation in which a state insurance commissioner acts out of his/her political interest and prohibits a well-capitalized insurance affiliate from assisting a failing bank. In this case, the FRB's only recourse would be to require the bank holding company to sell off the bank. However, it is unlikely that there would be a buyer for an insolvent bank, in which case deposit insurance funds would have to cover losses.

In view of my concerns with the Committee-passed bill, I joined my Democratic colleagues in introducing an alternative financial modernization bill, S. 753, which is substantially similar to the H.R. 10 bill that enjoyed broad industry support and which passed the House and Senate Banking Committee last year. In my opinion, S. 753 addresses the need to modernize our financial services system, while preserving safety and soundness, as well as protecting community access to credit. I hope my colleagues can support S. 753 if we have an opportunity to consider it on the Senate floor.

JACK REED.

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