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THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995

JOINT HEARINGS

BEFORE THE

SUBCOMMITTEE ON
TELECOMMUNICATIONS AND FINANCE

AND THE

SUBCOMMITTEE ON
COMMERCE, TRADE, AND HAZARDOUS MATERIALS

OF THE

COMMITTEE ON COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

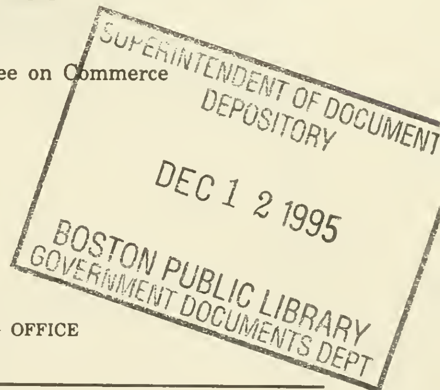
ON

H.R. 1062

JUNE 6 AND 8, 1995

Serial No. 104–33

Printed for the use of the Committee on Commerce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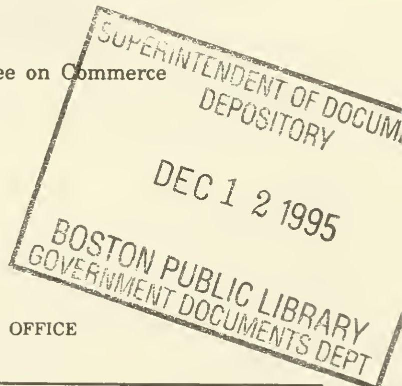
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CONTENTS

	Page
Hearings held on:	
June 6, 1995	1
June 8, 1995	143
Testimony of:	
Baptista, Samuel, President, Financial Service Council	296
Bracewell, Joseph S., Chairman and CEO, Century National Bank	101
Browne, Peter C., Chairman, National Association of Life Underwriters, Representing the Committee on Federal Law and Legislation	159
Cassidy, Andrew, Chairman, Task Force on Financial Services, Council of Insurance Brokers and Agents	154
Feigin, Philip, President, North American Securities Administrators Association	120
Fink, Matthew, President, Investment Company Institute	169
Foster, Steven T., Commissioner of Insurance, Commonwealth of Virginia	306
Grace, Michael, President Elect, Wright and Percy Insurance Company, Representing the National Association of Professional Insurance Agents	155
Greenspan, Alan, Chairman, Federal Reserve System	24
Helfer, Ricki, Chairman, Federal Deposit Insurance Corporation	41
Hughes, Gary, Vice President and Chief Counsel, American Council of Life Insurers	95
Jones, R. Scott, Director, American Bankers Association	231
Klagholz, James, Chairman, Government Affairs Committee for the Independent Insurance Agents of America	146
Lackritz, Mark, President, Securities Industry Association	224
Levitt, Arthur, Chairman, Securities and Exchange Commission	11
Mayer, Martin, Brookings Institution	131
Pfirrman, Drew, Senior Vice President and Counsel, Fleet Financial Group	292
Randall, Elizabeth, Commissioner of Banking, State of New Jersey, representing the Conference of State Bank Supervisors	116
Tassey, Jeffrey, Senior Vice President, American Financial Services Association	245
Williams, Julie, Chief Counsel, Office of the Comptroller of the Currency, Department of the Treasury	31
Zimpher, Craig, Vice President of Government Relations, Nationwide Insurance Enterprise	302
Material submitted for the record by:	
American Bankers Association, letter dated June 30, 1995, with responses for the record	317

THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995

TUESDAY, JUNE 6, 1995

HOUSE OF REPRESENTATIVES, COMMITTEE ON COMMERCE, SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE, AND THE SUBCOMMITTEE ON COMMERCE, TRADE, AND HAZARDOUS MATERIALS,

Washington, DC.

The subcommittees met, pursuant to notice, at 10 a.m., in Room 2123, Rayburn House Office Building, Hon. Jack Fields [chairman of the Subcommittee on Telecommunications and Finance] and Hon. Michael G. Oxley [chairman of the Subcommittee on Commerce, Trade, and Hazardous Materials], cochairing.

Members present, Subcommittee on Telecommunications and Finance: Representatives Fields, Oxley, Moorhead, Stearns, Cox, Deal, Frisa, White, Coburn, Bliley (ex officio), Markey, Gordon, and Dingell (ex officio).

Members present, Subcommittee on Commerce, Trade, and Hazardous Materials: Representatives Oxley, Fields, Upton, Whitfield, Ganske, Frisa, Norwood, White, Bliley (ex officio), Markey, Brown, and Dingell (ex officio).

Staff present: Robert Gordon, majority counsel; David Cavicke, majority counsel; Stephen A. Blumenthal, majority counsel; Jeffrey Duncan, minority counsel; Consuela Washington, minority counsel; and Timothy Forde, minority counsel.

Mr. FIELDS. Good morning. Today the Subcommittee on Telecommunications and Finance and the Subcommittee on Commerce, Trade, and Hazardous Materials will hold our first joint hearing on H.R. 1062, the Financial Services Competitiveness Act of 1995. Financial services reform is an issue that has been revisited every few years for the last 2 decades. Extensive changes have been proposed but consensus and success in the legislative process have eluded us. This year that will be different.

H.R. 1062 was reported out of the Banking Committee on May 18 and referred in its entirety to the Commerce Committee. We will be holding an additional hearing on June 8, and the full committee will report out legislation before June 22. Considering the importance and the complexity of the restructuring of the capital raising mechanism of our country, the task that has been set for us by Speaker Gingrich is enormous, and we will rise to the challenge.

In our review of this legislation, we ask to consider the wisdom of allowing banks, securities firms, and insurance companies to

deal in each other's products and services as if this was not already the case.

In fact, existing law, no matter what the original congressional intent was, has not been effective in separating banking from nonbanking financial activities. Banking organizations already participate in private placement of securities, mutual funds sales, discount brokerage, investment advisory services, the distribution of asset-backed securities, and through section 20 subsidiaries, many other securities activities, including underwriting corporate equity and debt.

On the other hand, diversified financial service organizations, having been built around the nucleus of a securities broker-dealer or an insurance company, frequently own any number of limited purpose banks through which they make consumer loans, offer credit cards, and perform a host of other traditional banking functions.

The question for Members of Congress is a simple question. Are we going to continue to permit a fraying patchwork quilt of regulation to distort the development of markets or are we going to rationalize the system of regulation and open the opportunities of new markets to all? Imposing well thought out requirements for removing the remaining restrictions that prevent the interface of banking, securities, and insurance will ensure that the liberalization process will be accomplished while bank safety and soundness is maintained and other participants in the financial markets are able to compete.

The ultimate goal, of course, is to encourage these firms to develop and offer new and better financial products and services to their customers. This is particularly important as trends show, increasingly, people in this country must be responsible for their own financial security. Never in our history have the needs of the population for a greater diversity of financial products so intersected with the desire of the financial service industry to provide those products to the consumers.

Our subcommittee will not report out a banking reform bill but rather a financial services reform bill. If history teaches us any lesson in this field, it is that banks are pretty good salesmen of securities and insurance and that brokers and insurance companies make pretty good bankers. We are dealing with one market for financial services and the competition is only over who gets to divide the pie into how many slices.

H.R. 1062, the Financial Services Competitiveness Act of 1995, is at once evolutionary and revolutionary. It provides a framework for the efficient integration of the securities and banking industries, a legislative goal sought long before many of us were elected to Congress. It accomplishes this by using the existing regulatory structure of functional regulation of bank holding companies and their broker-dealer subsidiaries.

Clearly the intent is to minimize disruption of existing business entities, allowing people to continue to do business as they have been whenever possible. Billions of dollars of securities business is currently being done by banks, and billions of dollars of banking business is currently being done by brokers. We are not writing on a clean slate. The advantage of working within a familiar regu-

latory environment with an established body of law and regulation is that it can be most easily adapted to the special needs and circumstances of the newly merged industries and its participants.

Although I find myself in agreement with much of the legislation, I have concerns about competitive and regulatory inequalities that are contained within some of its provisions. The desire to accommodate existing business practices often runs headlong into conflict with our desire to rationalize the regulation of these industries. We must insist upon symmetry in our legislation.

People engaged in the same business should be subject to the same regulation. Regulatory arbitrage is not an acceptable source of additional profits. We may allow flexibility in the way these companies structure their organizations, but not in the manner in which rules that protect investors and taxpayers are developed and enforced. The hearing we hold today addresses exactly this issue.

We welcome our distinguished panel of witnesses and thank them for taking time. Now I will recognize other members.

I will first recognize the chairman of the full committee, Chairman Bliley, the gentleman from Virginia.

Mr. BLILEY. I thank you, Mr. Chairman. I have lost count on how many opening statements I have given in committee hearings calling for Glass-Steagall reform, so I will make my statement a short one because my positions are well known.

I support and have always supported legislative efforts to modernize the regulation of our financial services industry. I do so because I believe that it is our duty as elected representatives to oversee the regulation of these markets and remove impediments to their evolution. We must take these actions after careful consideration and in a manner that does not reduce investor or depositor protection.

The removal of restrictions must also be done in a way that does not inadvertently direct the development of the marketplace by giving an unjustified advantage to one set of participants. Change on this order of magnitude and direction of national policy in financial services reform must be the exclusive province of we, the elected representatives. Such action is inappropriate when undertaken by the people who staff the regulatory agencies and that enforce these laws, no matter how well meaning and patriotic their motives.

Today the Commerce Committee begins its consideration of H.R. 1062, Financial Services Competitiveness Act of 1995, introduced by my good friend, Jim Leach, the chairman of the Committee on Banking and Financial Services. H.R. 1062 provides a foundation for the type of restructuring that I can support and that I am sure will be supported by a majority of my colleagues in the House of Representatives.

I have worked closely with Chairman Leach as this bill has progressed through this panel, and I have instructed our staff to continue to work with Banking Committee staff as this legislation moves through our committee. The subject matter of the bill concerns how to include the elements of the financial services industry into a comprehensive and all-inclusive regulatory framework. This requires the coordination and cooperative efforts of the affected industries and the committees of Congress with jurisdiction for oversight of the process.

I promised the Speaker of the House that my committee would coordinate and cooperate in this effort. We have done so and will continue to do so through the remaining legislative consideration of this proposal.

Mr. Chairman, I commend you and Chairman Oxley for coordinating your efforts today to expedite the consideration of this important bill in the relatively short time period during which it must be considered. I want to join you in welcoming our panel today and yield back the balance of my time.

Mr. FIELDS. The Chair now recognizes the gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman, very much. I want to commend you for holding this joint hearing on legislation restructuring the laws governing the financial services industry. As Yogi Berra would say, it is deja vu all over again.

In 1988 and again in 1991, the Congress devoted a considerable amount of time attempting to enact legislation repealing the Glass-Steagall Act separation between commercial and investment banking. On both occasions, a compromise could not be reached. On both occasions, banks wanted new powers but opposed the requisite safeguards. As a result, no final bill ever reached the President's desk.

Banking, securities, insurance, these are huge industries. Their different interests and agendas make it tempting to view the sometimes arcane policy debate over functional regulation, firewalls, affiliate structures, and new powers as little more than a struggle between the rich and the extremely wealthy, but the outcome of this debate could have profound implications for consumers, businesses, investors, depositors, and taxpayers who are just deciding who gets to increase their slice of the financial services pie.

We are talking about nothing less than changing the fundamental structure of the capital formation system that is the engine of our national economy. The decisions we make in this legislation and the incentives and disincentives we create could affect the manner in which companies raise capital, what financial products the public uses for savings and investment, and whether adequate safeguards and protections will exist to protect consumers from abusive or anticompetitive practices.

When Congress enacted the Glass-Steagall Act in 1933, it considered and rejected the option of mixing banking and securities activities. It did so because it concluded that the potential abuses were so subtle as not to be recognized. While we are constantly reminded that our financial marketplace has changed considerably since the 1930's, we must also be mindful that human nature remains basically unchanged.

If the Glass-Steagall wall is finally to be torn down, it must be replaced with a new structure that effectively ferrets out the subtleties of abuse which inevitably will occur. This requires elimination of outdated regulatory schemes in favor of a more efficient system of functional regulation which allows banking and securities regulators to focus on their respective areas of expertise.

I am, therefore, troubled that H.R. 1062 permits construction of a Byzantine structure in which some securities activities could be carried out inside the bank subject to supervision by the bank reg-

ulators, some securities activities could be done in a so-called separately identifiable department or SID regulated by the SEC, other securities activities could be effectuated through a SID regulated by bank regulators, while still other securities activities could be carried out through a fully separate SEC regulated affiliate.

Will Rogers once remarked that a holding company is where you put the money when the cops show up. Well, the SID's structure in H.R. 1062 may be just as susceptible to abuse as the complex holding company structure of Will Rogers' day. SIDs will provide an open invitation to engage in a regulatory arbitrage that shifts money and transactions around the bank's corporate structure in order to avoid regulatory firewalls or obtain favorable capital treatment. The resulting competitive distortions could have a serious adverse impact on the smooth operation of our Nation's securities markets.

For this reason, I would like to explore whether we should consider replacing them with a simpler regulatory structure in which banks generally conduct all of their securities activities in a separate affiliate. In addition, any repeal of Glass-Steagall necessitates the creation of impermeable firewalls to protect against conflicts of interest and other abuses arising out of the combination of banking and securities functions. For this reason, I am concerned about the sweeping role granted to the Fed which includes the power to alter or lift the bill's statutory firewalls.

Finally, while some have said that financial services legislation should be focusing on providing a two-way street that allows providers to offer a full range of financial services, it is clear that H.R. 1062, that under it, all roads lead to the Fed. I will be interested in hearing from our witnesses about whether the broad new grants of discretionary authority to the Fed truly are warranted.

Mr. Chairman, I look forward to working with you on this important piece of legislation, and I want to join with you in welcoming our distinguished panel of witnesses.

Mr. FIELDS. This is a joint hearing this morning with the Subcommittee on Commerce, Trade, and Hazardous Materials, and staying with a concept that is important to this subcommittee, the concept of functionality, I will Chair the first and third panel and Chairman Oxley will Chair the second panel.

I now recognize the distinguished chairman, Mr. Oxley, of Ohio.

Mr. OXLEY. Thank you, Mr. Chairman. I, too, would like to welcome our distinguished panel this morning. Today we are hearing testimony on H.R. 1062, the Financial Services Competitiveness Act of 1995. This bill is the Glass-Steagall reform package put together by the House Committee on Banking and Financial Services, and I congratulate Chairman Leach and my Banking Committee colleagues for their fine effort in piecing together this very controversial legislation.

Today's hearing will focus on two primary issues, how to effectively tear down the barriers between the banking and securities industries to allow for a safe and efficient financial services market, and the appropriate role of the State and Federal Government in regulating the third leg of the financial services market, the business of insurance.

As chairman of the Commerce Subcommittee, I look forward to chairing the second panel later today.

H.R. 1062 in its current form accomplishes a number of tasks. It repeals the anti-affiliation barriers between banks and securities broker-dealers, allowing cross ownership under a financial services holding company; it requires banking and securities activities to be conducted in separate subsidiaries or separately identified departments and makes each activity subject to functional regulation by the appropriate bank regulator or the SEC. It imposes statutory firewalls between the banking and securities activities to prevent unfair competition and to protect the deposit insurance system from additional risk.

H.R. 1062 may be further amended by this committee to break down the barriers between banks and insurance to complete a three-way flow among the financial service markets. We have already had 1 day of testimony on the recent expansion of bank insurance powers at the Federal level, and the resulting effect on State functional regulation of insurance. That hearing focused on the ability of a State to control the conduct of the business of insurance within a State's borders.

Today we will also be looking at the related issue of State anti-affiliation laws or the ability of one State to effectively prevent a federally chartered bank from having an affiliate in any of the 50 States. In examining these issues, we will be looking both at the public policy question of how to most effectively and safely promote competition and increase commercial efficiency and also the question of which restrictions should be left for the States to control and which aspects of the financial services market are truly interstate or international in nature.

With that, Mr. Chairman, I yield back the balance of my time.

Mr. FIELDS. The Chair will now recognize the gentleman from Tennessee, Mr. Gordon.

Mr. GORDON. Thank you, Mr. Chairman. As has already been stated, this is an important hearing, one that is going to have great impact on our financial markets. Being a former member of the Banking Committee, I feel like I am getting a second bite at this apple, and I want to give a special welcome to my neighbor and good friend and Smyrna, Tennessee's finest, Ms. Helfer. It is good to have a neighbor that is a good advisor from home.

Thank you.

Mr. FIELDS. The Chair will now recognize the gentleman from Iowa, Mr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman.

Current financial services market access preclusions in the Glass-Steagall Act constrain market competition and restrict consumer choice. The financial services industry and consumers would benefit from breaking down some of these anticompetitive barriers. However, I do want to express a few concerns.

I am interested in functional insurance regulation, an issue that has been the subject of some controversy in attempting to balance relevant interests in the past. While I believe that the underwriting and sale of insurance should continue to be regulated by States, we must recognize the legitimacy of some of the concerns raised. We must be careful in defining what products are deemed to be in-

surance and, therefore, subject to State regulation. The definition must achieve a proper balance between competing interests of Federal and State regulators.

The United States Supreme Court has stated that the office of the Comptroller of the Currency will be given deference in its interpretation of Federal law so long as the OCC interpretation is "reasonable." Current case law must be carefully weighed with the competing interests of State insurance regulators. Another important concern is related to discriminatory regulations that State insurance regulators might place on the insurance activities of banks. We must ensure that such discrimination doesn't take place in either a direct or indirect manner.

I hear from both sides of the issue that the goal should be a "level playing field." Easy words to say, but as past attempts have shown, a hard goal to achieve.

I look forward to the testimony from our guests today.

Thank you, Mr. Chairman.

Mr. FIELDS. The Chair recognizes the gentleman from Ohio, Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman. I have no opening statement.

Mr. FIELDS. The Chair will now recognize the gentleman from Georgia, Mr. Norwood.

Mr. NORWOOD. Thank you, Mr. Chairman. I do appreciate you holding these hearings and certainly welcome our distinguished panel. As unlikely as it may seem, I will forego any opening remarks today.

Mr. FIELDS. An unusual day.

The gentleman from California, Mr. Cox.

Mr. COX. Thank you, Mr. Chairman.

I want to congratulate you once again for holding hearings on such an important matter for American jobs. Last month this committee met to rewrite 60-year-old telecommunications laws.

Today we meet to review 60-year-old laws which are similarly hobbling American firms and workers in the global financial marketplace. Experts the world over are agreed that the Glass-Steagall Act is in dire need of modernization. In 1933, the segregation of commercial banks and securities firms didn't have all the anticompetitive effects that we can so clearly see today. In that era, these two types of firms offered quite different services, and the globalization of finance had not developed nearly to the degree that it exists today.

As we come to the close of the twentieth century, much has changed. The explosion in information technology has resulted not only in the convergence of the kinds of services offered by banks and securities firms, but also in a dramatic expansion of the services offered by both of these industries as well as other players in the financial services market.

The more the distinctions between the services of different financial firms become meaningless, the more Glass-Steagall becomes anticompetitive and works against market forces. It constructs artificial barriers between competition in similar kinds of activities. The result is increased costs for American consumers and loss of American market share in international competition. In a world

where capital moves across the globe instantaneously, Glass-Steagall imposes unnecessary pack weights on American firms. These are hardships not suffered by our growing international competition in capital markets.

As our laws increasingly prevent American customers from meeting their increasingly sophisticated needs with U.S. firms, these customers will increasingly take their business overseas. As early as 1983, the Council of Economic Advisors concluded that Glass-Steagall, quote, now makes no important contribution to the protection of the public against bank failures or undue concentrations of economic power. Instead, Glass-Steagall serves largely to protect foreign firms from American competitors. Reform is long overdue.

I thank you, Mr. Chairman, and I look forward to hearing the testimony of our distinguished witnesses this morning.

Mr. FIELDS. The Chair thanks the gentleman.

The distinguished ranking member of the full committee, Mr. Dingell of Michigan.

Mr. DINGELL. Mr. Chairman, I thank you. Mr. Chairman, I commend you and Chairman Oxley for conducting this hearing today. I would like to begin by welcoming our distinguished panel, particularly my friends Mr. Greenspan and Mr. Levitt.

Mr. Chairman, I can't help feeling that we have been down this road before or, as one of our baseball greats once put it, that this is "deja vu all over again." As I understand, the SEC will testify that, while it finds much that it can support in H.R. 1062, the bill nevertheless contains provisions which cause the SEC to have reservations about the bill. The SEC points out that the bill will impair capital formation, create regulatory overlap and duplication, impose unnecessary burdens on capital formation, and provide a situation where a two-way street is not available in equal fashion for all financial providers.

The Federal Reserve Board, on the other hand, supports the adoption of the bill as a major step in the evolution and strengthening of the financial system. The Board's testimony defends the significant powers vested in it as an umbrella supervisor and as gatekeeper for permissible financial activities. It applauds the concept of functional regulation and argues that a holding company structure creates the best framework for protecting the insured depository institution and the Federal safety net, including deposit insurance.

The Comptroller of the Currency's testimony indicates that the OCC detests the bill and says; "we see no compelling reasons to justify many of the provisions of H.R. 1062" and, contrary to the Federal Reserve, believes that the banks should be allowed to engage in a full range of securities activity in the bank or in direct operating subsidiaries of banks with no separation, an event which we tried in years past and led, as I recall my history, to having a major impact on the 1929 financial collapse.

Now, lest we forget this committee's insurance jurisdiction, the American Council of Life Insurance will testify that H.R. 1062 in its current form is not insurance neutral and must be strongly opposed by the insurance industry unless modified by the addition of H.R. 1317, the Bliley-Dingell insurance bill. They say that they will

forcefully oppose H.R. 1062 if a purported compromise on bank-insurer affiliations is attached.

Hopefully the testimony and questioning today and Thursday will help sort out these conflicts and define how this bill can best be perfected. Perhaps Martin Mayer has put it best, that we have lost sight of the doughnut and we are looking only at the hole.

At the end of the day, Congress should have devised an effective and efficient system that allocates capital to the companies that will produce goods and services and create jobs. The system should encourage savings and investment in a structure that maintains the safety and soundness of insured depository institutions, and the liquidity and depth of our capital markets, and that provides reasonable and adequate protections for investors and taxpayers. I look forward to working with my colleagues to achieve these goals.

I thank you, Mr. Chairman.

Mr. FIELDS. The Chair thanks the gentleman.

The Chair will now recognize the gentleman from Oklahoma, Mr. Coburn.

Mr. COBURN. Mr. Chairman, I have no opening statement. Thank you.

Mr. FIELDS. The Chair will recognize the gentleman from Kentucky, Mr. Whitfield.

Mr. WHITFIELD. I have no opening statement.

Mr. FIELDS. The Chair will now recognize the gentleman from New York, Mr. Frisa.

Mr. FRISA. I have an opening statement. Thank you, Mr. Chairman.

I would join in welcoming our panelists this morning. We look forward very much to your expertise and input on this important issue.

As we move forward in considering this legislation, I think there are several important purposes that we all would seek to fulfill. I think the first being that we will more closely reflect statutorily certain market realities. I think, second, we will seek to take a number of bold new steps forward to create various other financial opportunities and, third, trying to ensure that we maintain and provide for the continued integrity and stability of all of our financial institutions.

I think none of those are easily accomplished which I believe is why it is important for this hearing. This is not a pro forma activity, but one in which we do seek to take to heart your expertise and experiences and thoughts regarding the legislation.

Mr. Chairman, I thank you for the opportunity, and yield back the balance of my time.

Mr. FIELDS. The Chair will now recognize the gentleman from Florida, Mr. Stearns.

Mr. STEARNS. Good morning. Thank you, Mr. Chairman.

I want to thank you and also Chairman Oxley for holding these hearings on Glass-Steagall reform, and of course I would like to welcome our distinguished guest witnesses. I am looking forward to hearing their comments, concerns, and insights on modernizing current banking laws to enable banking institutions to offer a broader range of financial services while at the same time maintaining their financial soundness.

Despite the fact that in most of the world there is little or no separation of banking and investment activities, here in the United States our laws prohibit a blending of services. The competitive disadvantage placed on U.S. banks within our borders hurts them in the international arena. U.S. banks are playing on an uneven playing field.

According to the International Banking Act of 1978, foreign banks are not supposed to combine most depository and security services in America. Yet the Federal Reserve has allowed combinations in a couple of occasions. By dropping the 62-year-old prohibition against banks and security affiliations, the United States companies will be able to compete in the globalized financial marketplace.

One effect this ground-breaking legislation has is that it restructures the capital raising mechanism for banks. Banks will be able to grow and, therefore, compete on a level playing field with other foreign banking entities.

However, Mr. Chairman, we must also ensure that banks remain financially stable. Our constituents are the ones going to a bank, applying for loans or depositing savings, dealing with brokers to secure nest eggs to pay for college, a home, or eventually retirement.

Finally, our constituents are the ones buying the security products or using the banking services. By reforming antiquated banking laws and allowing banking institutions to participate in investment business, we will allow banks to provide more services to consumers often at lower cost and greater convenience. But we must enact legislation that contains appropriate limitations intended to avoid risk to the Federal Deposit Insurance Fund and to protect the safety and soundness of insured depository institutions.

Under the Financial Services Modernization Act, it is our hope that U.S. banking organizations and securities firms will be able to compete in an ever-changing and evolving global financial marketplace while at the same time maintaining their financial soundness.

Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Washington State, Mr. White.

Mr. WHITE. Mr. Chairman, I appreciate it, but I don't have an opening statement at this time.

Mr. FIELDS. Are there any other members wishing to make an opening statement? The Chair hearing none, we will now welcome our guests.

We appreciate all of you for coming and sharing with this subcommittee today. First, Mr. Arthur Levitt, the Chairman of the Securities and Exchange Commission; second, we will hear from Mr. Alan Greenspan, Chairman of the Federal Reserve System; third, Ms. Julie Williams, Chief Counsel, Office of the Comptroller of the Currency, the Department of the Treasury; and then finally on this panel, Ms. Ricki Helfer, Chairman, Federal Deposit Insurance Corporation.

The Chair will state that your statement will be in the record in its entirety. I would ask that if at all possible stay within 5 minutes. At 5 minutes, we will try to nudge you along just a little bit.

Chairman Levitt.

STATEMENTS OF ARTHUR LEVITT, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION; ALAN GREENSPAN, CHAIRMAN, FEDERAL RESERVE SYSTEM; JULIE WILLIAMS, CHIEF COUNSEL, OFFICE OF THE COMPTROLLER OF THE CURRENCY, DEPARTMENT OF THE TREASURY; AND RICKI HELFER, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. LEVITT. Chairman Fields, Chairman Oxley, members of the subcommittees, I appreciate the opportunity to testify on behalf of the SEC regarding H.R. 1062.

As the Commission stated in our testimony on H.R. 18, the forerunner of this bill, we support the bill's principal purpose—to modernize the financial services regulatory framework by reforming the 60-year-old Glass-Steagall Act. Chairman Leach's bill, by initiating the debate on Glass-Steagall reform this year, has made, I think, an important contribution. In particular, the bill proposes a number of useful changes to the securities laws, including a flexible and effective framework for addressing conflicts of interest that may arise when banks advise or sell mutual funds.

Chairmen Fields and Oxley, the testimony of my colleagues on this panel has described how Glass-Steagall reform could open the doors to even greater competition, improvement, and efficiency in the banking industry. I think they are far more competent than I to address the question of reform from the perspective of banking. As the Nation's chief securities regulator, however, and someone who spent the better part of a lifetime in the securities industry, I approach this issue with a somewhat different set of concerns.

Those concerns center on the needs of investors as well as the overall impact of reform on our U.S. markets. Ours are the deepest, most liquid markets in the world; in one recent year alone, 1993, they raised more than a trillion dollars. This capital was raised from investors through the entrepreneurial and risk-taking efforts of securities firms without the benefit of Federal deposit insurance. The continuing success of our capital markets requires that we preserve the securities industry's ability to assume risks, while still maintaining a strong system of investor protection to support public confidence in the securities markets.

For Glass-Steagall reform to achieve these ends, I think an appropriate balance should be struck between preserving bank safety and soundness and serving the needs of investors and the marketplace as a whole. Although there is a great deal we agree to in H.R. 1062, I think it falls somewhat short of striking that balance.

We have specifically four main areas of concern: The location of securities activities within the bank, the system of financial services regulation, the so-called two-way street, and the consequences of the differing philosophies of the banking and securities industry and their regulators. Let me describe each in turn.

On the question of location, H.R. 18 would have permitted some securities activities to be conducted in the bank and required banks to create distinct entities for other securities activities. H.R. 1062 adds the open-ended alternative of a "separately identifiable division or department" of a bank or a "SID" for "banking products" as well as asset-backed securities and private placements.

I certainly would be the first to admit that subjecting securities activities to some broker-dealer standards is certainly better than excluding banks from the broker-dealer requirements altogether. But I think it is no panacea.

Instead of establishing a single, high standard of protection for investors and depositors, the SID, along with the numerous exemptions for various securities activities, would seem to reinforce the existing system of multiple securities oversight. Unless SIDs are subject to comparable marginal capital requirements, banks would have an additional incentive not only to keep securities activities within the bank but also to move them there from securities affiliates.

One of the most compelling arguments against SIDs, however, is the way in which they could hamper the SEC's ability to examine their securities activities, whose capital and records would be dependent on, and intermingled with, those of the bank. Right now, if the Commission inspects an affiliate, we can follow the paper trail wherever it leads. We can obtain, in effect, the complete picture that we need. But in a SID, not only could the paper trail end at the point where it enters the bank, the bank in itself might be in a position to define that point. For these reasons and more, I think this issue bears revisiting. As I understand it, the SID is like an imaginary line running through a bank building, with banking activities on one side and securities activities on the other. But imaginary lines could bring imaginary protections. We believe that a distinct entity for securities transactions is preferable to the SID, but at the same time, if Congress is determined to maintain the exclusions from broker-dealer regulation and institute the SID, we will work with you to try to find ways to address these flaws.

Our second concern is closely related to the first. As we modernize financial services, we must also modernize their regulation. Investors will benefit if they can choose from a wider array of financial products and providers, but they should not be expected to give up basic safeguards in the process. The SEC continues to believe that the best way to ensure that protection is through a system of functional regulation under which all securities activities are overseen by expert securities regulators and all banking activities are overseen by expert bank regulators. The existing coordination among financial regulators offers an excellent framework upon which to build a more formal network.

Mr. FIELDS. Chairman Levitt, could we ask you to summarize, please.

Mr. LEVITT. Our third concern has to do with the burdens it would place on securities firms that acquire banks under two-way street provisions.

Thus far, I have addressed the specific aspects of H.R. 1062. Our final concern has more to do with the different philosophies and cultures of securities and banking industries and their regulators.

Despite the reservations I have raised, I want to emphasize that the Commission supports reform and encourages Congress to take the lead role. However, I do request that you proceed with caution.

The SEC appreciates the difficulty of the subcommittee's task. As you move ahead on this key issue, the SEC looks forward to continuing to work with you and our fellow regulators to meet our

shared goals of protecting investors and maintaining the soundness and preeminence of American markets.

Thank you.

[The prepared statement of Hon. Arthur Levitt follows:]

PREPARED STATEMENT OF HON. ARTHUR LEVITT, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Chairman Fields and Members of the Subcommittees:

I appreciate this opportunity to testify on behalf of the Securities and Exchange Commission regarding H.R. 1062, the "Financial Services Competitiveness Act of 1995." In March 1995, the Commission testified on an earlier version of this bill before the House Committee on Banking and Financial Services. Significant changes have been made in the bill since the time of the Commission's earlier testimony, and today I will outline our views on the revised bill.[1]

I. INTRODUCTION

As the Commission stated in its earlier testimony on H.R. 1062,[2] we support the bill's principal purpose—to modernize the financial services regulatory framework by reforming the 60 year-old Glass-Steagall Act. Glass-Steagall reform would provide the banking and securities industries with greater flexibility and new avenues for innovation. Reform also could improve financial services providers' competitiveness at home and abroad.

In weighing Glass-Steagall reform, however, Congress also needs to consider carefully the needs of investors, as well as the overall impact on the U.S. capital markets as a whole. The U.S. securities markets are the deepest, most liquid, and strongest in the world, with $830 billion raised in 1994 alone. This capital was raised from investors, through the entrepreneurial and risk-taking efforts of securities firms, without the benefit of federal deposit insurance. The continuing success of our capital markets requires that we preserve the securities industry's ability to assume risks, and maintain a strong system of investor protection to support public confidence in the securities markets.

The Commission finds much that it can support in H.R. 1062. Chairman Leach's bill, by opening up the present debate on Glass-Steagall reform this year, already has made an important contribution. In addition, the bill proposes a number of useful changes to the regulation of financial services—for example, a flexible yet effective framework for addressing conflicts of interest that may arise when banks advise or sell mutual funds.

Looking at H.R. 1062 as a whole, however, the Commission continues to have reservations regarding the bill. We feel that it still does not strike an optimal balance between preserving bank safety and soundness, and the needs of investors and the marketplace as a whole. Our primary concerns can be summarized as follows:

Investor Protection. The Commission is concerned that H.R. 1062 would impair investor protection by allowing banks to continue to conduct a wide range of securities activities outside the broker-dealer regulatory scheme under the federal securities laws. Over the past two decades, banks—by virtue of expansive regulatory interpretations of the Glass-Steagall Act—have dramatically increased the scope and volume of their broker-dealer activities.[3] Because of the 60 year-old bank exclusions, however, this piecemeal expansion has occurred largely outside the legal framework governing all other entities that engage in broker-dealer activities. H.R. 1062, rather than taking a fresh look at the bank exclusions, would preserve the range of securities activities that can be conducted in banks. As a result, investors who deal with banks would receive a different standard of protection than those who deal with securities firms.

[1] H.R. 1062, introduced on February 27, 1995, is a revised version of a bill originally introduced by Chairman Leach on January 4, 1995, as H.R. 18. H.R. 1062 was marked up by the House Banking Committee on May 9, 1995, and was subsequently referred to this Committee.

[2] Commission Testimony Concerning the "Financial Services Competitiveness Act of 1995" and Related Issues Before the House Committee on Banking and Financial Services, March 15, 1995 (hereinafter cited as "March 1995 Testimony").

[3] Bank securities powers originally were conceived as encompassing essentially brokerage services provided as an accommodation for existing bank customers and small town banks. Actually, however, bank securities powers long ago expanded beyond those bounds. *See* Reports on Bank Securities Activities of the Securities and Exchange Commission Pursuant to Section 11A(e) of the Securities and Exchange Act of 1934 (Public Law 94-29), August 1977.

In this connection, the Commission believes that H.R. 1062's creation of a "separately identifiable department" of a bank, or "SID," is not the same as full functional regulation. By establishing a SID, a bank could engage in significant securities activities directly, rather than in a separately incorporated broker-dealer. Because SIDs would not be subject to the Commission's net capital requirements, banks that trade securities would operate under a different standard than applies to their broker-dealer competitors. Bank SIDs could also present some practical problems relating to securities examination and enforcement efforts. Nonetheless, requiring securities activities to be performed in a registered broker-dealer SID is preferable to allowing these transactions to be conducted solely in the bank.

Impact on Capital Formation. The Commission is concerned that H.R. 1062 could significantly alter the climate that has fostered the successful capital-raising activities of the U.S. securities markets. The bill's proposed regulatory structure does not fully take into account some of the real differences between the securities and banking industries and the regulatory environment appropriate to each. Banks have traditionally operated subject to regulatory restrictions imposed in the interests of bank safety and soundness. The regulatory and enforcement programs of the federal banking agencies, similarly, focus on protecting the viability of banking institutions and the solvency of the federal deposit insurance system. Banking regulation uses the tools of "confidential supervision"[4] rather than market discipline: for example, it imposes pervasive restrictions on bank lending and other lines of business, and addresses violations of law largely through the confidential examination process rather than through widely publicized enforcement proceedings.

In contrast, the securities industry may be viewed as more market-oriented. Securities firms, and the securities markets generally, specialize in entrepreneurial and risk-taking activities.[5] For this reason, securities regulation does not, and should not, seek to insulate securities firms from the risks they incur in their business activities. Instead, the securities regulatory framework seeks to protect investors and maintain fair and orderly markets by imposing specific capital, supervision, disclosure, antifraud, and similar requirements on securities firms. Within these parameters, risk-taking is largely left to market control, not to governmental management.[6] H.R. 1062, however, proposes to bring securities affiliates within a complex regulatory structure that would include bank-type activity restrictions and could thereby rigidly constrain the operations of securities firms.[7]

The Commission, to summarize, does not oppose Glass-Steagall reform; to the contrary, we remain strong supporters of financial services modernization. On balance, however, we believe that the regulatory framework contemplated by H.R. 1062 could be improved. We believe that H.R. 1062, by sweeping certain securities activities within the umbrella of banking regulation and others out from the framework of the federal securities laws, would not best serve the interests of investors and the U.S. capital markets.

II. SUMMARY OF H.R. 1062

H.R. 1062 would amend the Glass-Steagall Act to allow affiliations between banks and securities firms through a bank holding company structure, subject to "firewalls" intended to protect bank safety and soundness and to address certain conflicts of interest. The bill would also authorize banks to engage directly in the underwriting of municipal revenue bonds. The bill attempts to create a "two-way street" for banks and securities by, among other things, creating a new class of "investment bank holding companies" with broader powers than are now available to bank holding companies (or securities firms). Similarly, H.R. 1062 would liberalize the permissible activities for bank holding companies (renamed "financial services

[4] *See* Alfred Dennis Mathewson, *From Confidential Supervision to Market Discipline: The Role of Disclosure in the Regulation of Commercial Banks*, 11 J. Corp. L. 139, 140-41 (1986).

[5] Banking activities, of course, also involve risk. *See* Testimony of Ricki Helfer, Chairman, Federal Deposit Insurance Corporation ("FDIC"), on the "Financial Services Competitiveness Act of 1995" and Related Issues Before the House Committee on Banking and Financial Services, Feb. 28, 1995, at 3-4. Inadequate loan diversification and overly-rapid growth in lending, for example, can affect the bank lending function and lie at the root of a significant number of bank failures. *See id.* at 8-9. But such risks are also subject to close monitoring and regulation by the banking agencies: bank regulatory restrictions limit bank loans to one borrower, loans to insiders, loan concentrations, and asset growth. By contrast, the risk-taking activities of securities firms are limited primarily by market discipline.

[6] The securities industry has generally managed to remain strong and healthy, notwithstanding the lack of all-encompassing safety and soundness regulation: for example, there were only two broker-dealer failures last year that required intervention by the Securities Investor Protection Corporation ("SIPC").

[7] *See* discussion *infra* at 19-24.

holding companies," or "FSHCs"), and would take steps to streamline Federal Reserve oversight over such companies.

H.R. 1062 would also make significant amendments to the federal securities laws. The bill would replace the existing blanket bank exclusions from broker-dealer regulation with numerous exceptions for specific securities activities. As a result, banks could engage in the excepted activities directly or (in some cases) through a "separately identifiable department or division" of the bank. In addition, H.R. 1062 would: make useful amendments to the Investment Company Act of 1940; amend the margin provisions of the Exchange Act of 1934 to ease broker-dealer borrowing for ordinary business purposes; and create a new, interagency committee charged with improving the regulation of the financial services industry.

III. FUNCTIONAL REGULATION

The Commission has given extensive testimony before this Committee regarding the need for functional regulation.[8] Under existing law, banks and securities firms that offer the same range of securities services are regulated differently, based on who they are rather than on what they do.[9] As a result, investors who buy securities from banks receive a different standard of protection than do investors who purchase securities from broker-dealers. The Commission believes that this distinction ill-serves investors; for almost a decade we have urged Congress to adopt a system of functional regulation for all participants in the securities markets in order to close the existing gaps in investor protection.[10]

The different regulatory schemes for bank and broker-dealer securities activities grew up around assumptions formed 60 years ago. At the time the federal securities laws were written, it was widely assumed that the Glass-Steagall Act barred banks from engaging in most securities activities.[11] Consistent with that understanding, banks were excluded from the definitions of "broker" and "dealer" in the Exchange Act. Banks were also excluded from Commission oversight under the Investment Advisers Act of 1940. The assumption underlying the bank exclusions, however, no longer holds true. Today, banks engage in a wide range of broker-dealer and investment advisory activities that are comparable to, and competitive with, the services of registered securities firms and investment advisers.[12] But because the bank exclusions remain, only federal banking law and the antifraud provisions of the federal securities laws apply to banks that engage directly in these activities.[13]

H.R. 1062 would move toward a system of functional regulation for certain new bank securities activities.[14] Banks that seek to engage in most corporate equity underwriting activities, for example, would have to do so through separately incorporated, separately capitalized, registered broker-dealers. H.R. 1062 would also eliminate the bank exclusion from the definition of investment adviser to a registered investment company. The Commission strongly supports these provisions.

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[8] *See, e.g.*, Commission Testimony Before the Subcommittee on Telecommunications and Finance of the House Energy and Commerce Committee Concerning H.R. 3447 and Related Functional Regulation Issues (April 14, 1994); Commission Testimony Before the Subcommittee on Telecommunications and Finance of the House Energy and Commerce Committee Concerning H.R. 797 (June 20, 1991); Commission Testimony Before the Subcommittee on Telecommunications and Finance of the House Energy and Commerce Committee Concerning Proposed Amendments to the Securities Exchange Act of 1934 (Aug. 2, 1990).

[9] Although direct bank securities activities fall largely outside the purview of the federal securities laws, banks also may engage in securities activities indirectly. For example, a bank may conduct its sales or investment advisory activities through subsidiaries registered with the Commission. The securities activities of bank subsidiaries—unlike internal bank securities activities—are subject to the federal regulatory schemes for broker-dealers and investment advisers.

[10] Bank municipal and government securities activities already are subject to separate, limited regulatory schemes under the Exchange Act. Those schemes were premised on the fact that bank dealers were not affiliated or able to be a part of a full-service brokerage business and had not developed the sales force that characterizes other aspects of the brokerage business. They were developed at a time when there was a small number (less than 300) of bank government securities dealers, who were in a business, that was largely dominated by fully regulated broker-dealers. The limited regulatory schemes that were developed, thus, were premised for the most part on limited bank activity.

[11] *See* March 1995 Testimony at 5.

[12] For example, in 1994, 119 banks provided investment advice or other services to over $312 billion in mutual fund assets (representing approximately 15% of total mutual fund assets). In the same year, over 1800 banking firms sold mutual funds to their customers. *See* March 1995 Testimony at 6.

[13] A bank exclusion is not contained in the Investment Company Act, however, and therefore bank advisory relationships with investment companies are subject to that Act.

[14] The bill also would authorize banks to underwrite municipal revenue bonds pursuant to the existing municipal securities regulatory scheme. The Commission supports this provision.

At the same time, however, H.R. 1062 would depart in several key respects from the principle of functional regulation. It would give banks numerous new exceptions from broker-dealer regulation with respect to specific securities activities. In addition, H.R. 1062 would permit banks to engage in significant securities activities (such as underwriting asset-backed securities) in "separately identifiable departments or divisions" of the banks. The bank exceptions from broker-dealer regulation—together with liberal capital and firewalls treatment of SIDs—could provide incentives for financial services firms to move securities activities out of broker-dealers and into affiliated banks, away from the regulatory framework established under the federal securities laws.[15] The exceptions would also put broker-dealers that are not part of banks, particularly small and regional brokerages, at an unfair competitive disadvantage.

1. Exceptions for bank broker-dealer activities

The Commission strongly supports removal of the bank exclusion from the broker and dealer definitions. Today, by virtue of the bank exclusion:

- banks do not have to register or provide information regarding their securities activities, or to satisfy special financial responsibility requirements as a condition of engaging in direct securities activities;
- bank securities salespersons do not have to meet specific qualification and continuing education requirements;
- bank securities salespersons with disciplinary histories are not subject to statutory disqualification from the securities business;
- long-established Commission and self-regulatory organization ("SRO") sales practice standards do not apply to banks, and banks are not subject to a statutory duty to supervise securities salespersons; and
- bank securities customers have no formal avenue of redress for complaints.[16]

H.R. 1062 would replace the blanket bank exclusions contained in existing law with eleven new exclusions for specific bank brokerage activities and five new exclusions for bank dealer activities.[17] The Commission has both general and specific concerns about these new exemptions.

Most significantly, the bill's numerous new exemptions would leave a significant number of bank securities activities outside the regulatory framework and investor protections established under the federal securities laws. Instead, H.R. 1062 would direct the federal banking regulators to adopt their own sales practice, disclosure, training and qualification, and other standards. Banks engaging in securities activities under this separate scheme would be subject to "standards" rather than enforceable rules; the bill, moreover, would not require those standards to be substantially similar to requirements under the federal securities laws.[18] Similarly, banks would

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[15] The Commission is concerned that the firewalls provisions of H.R. 1062 could provide further incentives for such a migration. As currently drafted, the firewall provisions apply only to bank transactions with securities affiliates and do not extend to direct bank securities activities. Thus, the bill generally would prohibit a bank from providing credit enhancements for a securities issue underwritten by its securities affiliate, but would allow a bank to provide credit enhancements for a securities issue that is underwritten by the bank itself (including issues underwritten by a bank SID). Yet the hazards that firewalls are designed to prevent—conflicts of interest, aggressive sales practices, or exposure of the insurance fund to losses—are still present when the bank engages in securities transactions directly. For these reasons, we believe the firewalls—and particularly the restrictions on extensions of credit—should apply to situations in which a bank effects securities transactions directly.

[16] *See* March 1995 Testimony at 9-10; *Proposed Mellon-Dreyfus Merger: Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 103d Cong., 2d Sess. 906-72 (1994).

[17] The bill's eleven limited exemptions from the definition of "broker" and five limited exceptions from the definition of "dealer" would permit banks to engage in many securities-related activities without being subject to securities regulation. Exemptions from the definition of "broker" are provided for: (i) banks that engage in brokerage activities in connection with "networking arrangements," (ii) certain trust activities, (iii) transactions in exempted and similar securities, including government securities, (iv) transactions in municipal securities, (v) transactions in connection with employee and shareholder benefit plans, (vi) "sweep" transactions, (vii) affiliate transactions, (viii) private placements, (ix) a *de minimis* number of transactions, (x) safekeeping and custody services, and (xi) transactions in securities that the Federal Reserve Board has determined are more appropriately treated as banking products. Exceptions from the definition of "dealer" are provided for banks that engage in transactions involving: (i) exempted and similar securities, (ii) municipal securities, (iii) bank and trust department transactions for investment purposes, (iv) (under limited circumstances) certain categories of asset-backed securities, and (v) securities that the Federal Reserve Board has determined are more appropriately treated as banking products.

[18] *See* H.R. 1062 § 111. This provision follows the approach taken by the federal banking agencies when they adopted "guidelines" in their 1994 Interagency Statement. As the Commission

not be charged with an express duty to supervise their employees' securities activities (a key investor protection). The practical effect would be that investors who buy securities through their banks would continue to receive a different standard of protection than other investors.

Moreover, the Commission is concerned that H.R. 1062 would place no aggregate limits on the number of transactions banks could conduct pursuant to the exceptions, and would in fact permit even a large broker-dealer affiliate of a bank to transfer a significant volume of exempted activities to the bank. For example, broker-dealers that became affiliated with banks would have a strong incentive to transfer their government securities business to the bank in order to gain access to the Fed Wire and the discount window.[19] Similarly, such broker-dealers would have an incentive to shift their asset-backed securities into the bank. Asset-backed securities are of growing importance in the securities market, particularly since they can be structured to pay interest in a way that replicates the performance of the equity markets. Thus, the unintended effect of H.R. 1062 could be to channel securities transactions to banks, with the result that more securities transactions would be done outside the basic securities regulatory system for broker-dealers than ever before. The potential for the movement of certain securities activities away from the securities regulatory scheme raises concerns with respect to fair and orderly markets and the protection of investors.

2. SIDs

Certain of the bank broker-dealer exceptions proposed by H.R. 1062 would allow a bank to conduct certain securities activities directly, through a "separately identifiable department or division" of the bank, even if the bank has a securities affiliate. For example, a bank with a securities affiliate could conduct activities in private placements and deal in certain asset-backed securities in a SID, rather than in its affiliate.[20]

The SID would be an artificial entity created by drawing an imaginary line around portions of the bank. According to H.R. 1062, a bank broker-dealer SID would be a unit (1) under the direct supervision of a specifically designated bank officer, (2) that maintains records that can be segregated from those of the bank, and (3) that would be subject to Commission rulemaking—but not to broker-dealer net capital rules. The SID itself would be required to register as a broker-dealer and would be subject to oversight by a securities self-regulatory organization.[21]

While the Commission would have the ability to regulate and examine the activities of SIDs, as a practical matter, effective oversight of the SID would be more difficult than oversight of a comparable separate broker-dealer. Currently, the Commission has the authority to inspect the whole range of a broker-dealer's activities.

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observed in earlier testimony, however, the guidelines provided in the Interagency Statement do not create a comprehensive securities regulatory scheme for banks. They are advisory rather than legally binding, and may not be legally enforceable by the bank regulators or by bank customers. Furthermore, the guidelines do not establish precise standards of conduct; banks are given wide latitude to establish procedures and policies to implement them. *See* March 1995 Testimony at 10. Finally, the guidelines create regulatory confusion and overlap because they purport to apply to registered broker-dealers that sell securities in association with banks. If H.R. 1062 goes forward in its present form, it should at a minimum expressly provide that the banking agency guidelines and standards apply only to direct bank securities activities.

[19] As of January 1995, 37 of the 38 primary dealers in government securities were registered with, and regulated by, the Commission. In addition, 2,156 registered broker-dealers dealt in government securities as part of a broader business. Only 310 banks dealt in government securities. The Office of the Comptroller of the Currency is the primary regulator for the majority of banks (198) that are bank government securities dealers.

[20] Specifically, a bank (with or without a securities affiliate) would have to use a SID if it sought directly to engage in (1) transactions involving securities that the Federal Reserve determined to be more appropriately treated as banking products, or (2) issuing or selling asset-backed securities, pursuant to H.R. 1062's new bank exceptions. A bank *with a securities affiliate* would have to use a SID if it sought to sell private placements directly (*i.e.*, other than through its securities affiliate); however, a bank with no securities affiliate could conduct such activities directly, without segregating them in a SID.

[21] Under current law, a separate SID structure already applies to banks that deal in municipal securities. The Securities Act Amendments of 1975 required municipal securities dealers (including bank SIDs) to register under Section 15B of the Exchange Act. Section 15B established the Municipal Securities Rulemaking Board ("MSRB") as a self-regulatory organization for broker-dealers in municipal securities. The MSRB has rulemaking authority over all municipal securities broker-dealers in the United States. Unlike other SROs, however, the MSRB does not have inspection and enforcement powers. Instead, the federal banking agencies have enforcement authority regarding the MSRB's rules over bank municipal securities dealers and the National Association of Securities Dealers ("NASD") has enforcement authority over non-bank dealers. The Commission has both rulemaking and enforcement authority over bank SIDs. The Commission does not object to the continuation of this scheme for municipal securities.

In contrast. the Commission's ability to effectively examine the SID would be limited.

For example, the activities of the SID would not be performed in a separate area of the bank, or as a separate part of a bank's organizational structure. A SID, for example, could take the form of an organizational chart that identifies individuals scattered over different business areas who engage in a particular type of securities activity. Banking activities and the SID's securities activities could be intermingled throughout the bank.[22]

Moreover, a bank might well conduct other excepted securities activities (for example, pursuant to H.R. 1062's other broker-dealer exceptions) within the bank but just outside the artificial boundaries that define the SID. These activities could influence, or be related to, the SID's activities, yet because of the SID's limited scope they would remain inaccessible to the securities regulators who examine the SID. Securities regulators would have to define the scope of their examinations according to the organizational plan adopted by the bank for its SID—and not according to the interrelated securities activities actually undertaken by the bank.

Similarly, because the SID might have little relation to the organizational structures that actually support the business activities of the bank, a SID's recordkeeping systems would reflect regulatory rather than business purposes. As such, they may be less comprehensive or less rigorous than systems maintained as an integral part of a firm's business operations.

In addition to these matters, broker-dealer SIDS under H.R. 1062 would be exempt from the Commission's net capital rule and the Commission's customer protection rule. Presumably, the bank SID, as a registered broker-dealer, would be subject to coverage under the Securities Investor Protection Act of 1970 ("SIPA"). The Commission's financial responsibility rules work in combination with the SIPA provisions to maintain the liquidity of a broker dealer, limit use of customer funds to finance the broker-dealer's proprietary trading in securities, and protect customer funds and securities if a broker-dealer fails.[23] If SIDs were excluded from the Commission financial responsibility rules, only the SIPA provisions would apply. Although the SID would be subject to bank capital standards focused on credit risk, it would not be subject to market risk-based capital requirements. Although the Commission is hopeful that recent efforts by the banking regulators will help address this concern, bank market risk standards are yet to be implemented following recent agreement of the Basle Committee on Banking Supervision.[24] In the event of the failure of a bank operating a SID, the interplay of the SIPC and FDIC bankruptcy provisions, with their potentially inconsistent customer and depositor protection standards, is unclear.

Moreover, although the bank SID would be subject to bank capital standards, exempting SIDs from net capital rules would be highly significant from the standpoint of fair competition in comparable activities. Broker-dealers constantly consider the consequences of their activities under the net capital rules: every deal, every major trade, is evaluated in light of its effect on capital. For banks to perform similar functions under different rules with different consequences on a per trade, per deal basis would create the potential for unfair and unequal competition. This, combined with the ability of broker-dealers and banks to affiliate, could lead to securities activities being shifted between entities purely on the basis of disparities in capital treatment. In our view, this potential capital arbitrage, combined with the inherent awkward-

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[22] The regulators' examination and enforcement efforts would be further complicated if a single bank established multiple SIDs in order to conduct different securities activities.

[23] When broker-dealers fall below mandated capital levels, they must cease securities activities until the capital deficiency is corrected. Because of the potential effects on customers or the public securities markets, they cannot continue to operate. In addition, strict limitations on broker-dealers' use of customer funds and securities have resulted in broker-dealer failures on average costing the SIPC fund very little. The largest single payout in the history of that fund was only $30.7 million. And the number of liquidations by the SIPC been very small, both quantitatively and in relationship to the number of SIPC members.

The operation of the Commission's net capital and customer protection rules, the examination and oversight mechanisms of the Commission and self-regulatory organizations, and annual auditing by independent public accountants have permitted the Commission and the self-regulatory organizations successfully to wind down broker-dealers, including large firms such as Drexel Burnham Lambert Inc. and Thomson McKinnon Securities Inc., without the need for SIPC intervention. In the Thomson self-liquidation, over 450,000 active customer accounts with property totaling $10 billion were transferred to other broker-dealers, thereby avoiding a SIPC liquidation.

[24] Basle Committee on Banking Supervision, *Proposal to Issue a Supplement to the Basle Capital Accord to Cover Market Risks* (April 1995).

ness of the SID structure, argues for requiring most bank securities activities to be conducted in a separately incorporated entity that is registered as a broker-dealer.[25]

The Commission's concerns about SIDs are exacerbated by the recent addition of an exemption to H.R. 1062 that would authorize the Federal Reserve to permit banks, through SIDs, to effect transactions in any security that the Federal Reserve determined is "more appropriately treated as a bank product." Because this exemption is largely within the Federal Reserve's discretion,[26] it could ultimately allow an unforeseeable range of securities products to be traded and brokered by bank SIDs. While the Commission strongly supports innovation in the securities markets, our concerns about SIDs are compounded by the potential breadth of their activities.

Finally, the Commission is concerned that its ability to take enforcement action against a SID could be compromised by concerns relating to bank safety and soundness. Because SIDs would not be separate entities, with separate capital, the capital of the bank as a whole would be at risk if the Commission brought an enforcement action against a SID that involved significant penalties and/or disgorgement on behalf of investors. By permitting banking and securities activities to be intermingled in this way, the bill could result in broadening the exposure of the deposit insurance fund to include risks associated with securities activities.

In summary, H.R. 1062 would represent progress toward functional regulation for some securities activities, particularly bank investment advisory activities. For other securities activities, however, H.R. 1062 would preserve the *status quo*, and would provide opportunities and incentives (less stringent capital requirements, relief from firewalls, and access to bank funding) for banks and securities firms alike to move activities out of registered broker-dealers and into banks. The Commission believes that more can be done to rationalize the financial services regulatory system.

IV. REGULATORY STRUCTURE

For financial modernization reform to be truly effective, it must allow securities firms and their financial services competitors to engage in the risk-taking activities so critical to the capital formation process. Reform also must provide equal opportunities for market participation to banks and securities firms alike, with competition occurring on the basis of market performance, not differential regulation. Moreover, wherever possible, reform legislation should seek to promote competition and should avoid imposing arbitrary limits on the business activities of financial services providers.

H.R. 1062 falls short of meeting these standards. The bill's regulatory provisions aim to fit securities firms that are affiliated with banks into a structure modelled on the traditional bank regulatory framework. The regulatory provisions, moreover, are highly complex and would create considerable new regulatory burdens. In their complexity and bank-orientation, the bill's regulatory provisions would continue to pose obstacles to a true "two-way street." Finally, H.R. 1062 does not go far enough to eliminate existing problems of overlap (and potential conflict) in the oversight and examination of bank-affiliated securities activities.

A. Consolidated regulation

Consistent with the Bank Holding Company Act ("BHCA") model, H.R. 1062 would give the Federal Reserve authority to define and restrict the permissible activities of securities firms affiliated with banks. Furthermore, the Federal Reserve could set consolidated capital requirements for FSHCs (perhaps even for securities affiliates)[27] and could limit holding company transfers of capital to securities affiliates.[28]

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[25] The Commission believes that a SID structure may be appropriate for a fee-based, advisory business, such as the investment advisory business, because such activities generally do not require capital or the handling of customer funds and securities to the same degree as a broker-dealer business and, therefore, may more easily be separated from the rest of the bank. Capital, however, is essential to the business of trading in securities and the capital requirements imposed on a broker-dealer are integral to the regulation of broker-dealer conduct.

[26] Thus, the Federal Reserve could determine to treat a particular security as a banking product to be effected in a SID based on considerations wholly unrelated to the purposes of the federal securities laws.

[27] *See* Report of the House Committee on Banking and Financial Services to Accompany H.R. 1062, Section-by-section analysis, at 24 ("It is expected that the Board will not require a securities affiliate to hold more capital than is required for securities broker-dealers, or *that is comparable to securities industry norms*") (emphasis added).

[28] At present, securities affiliate capital is not counted towards bank holding company capital. Although H.R. 1062 would generally follow this principle, some language in the bill suggests

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By following a bank holding company model, H.R. 1062 would focus on bank safety and soundness without fully taking into account the realities of the securities markets. For example, H.R. 1062 would impose restrictions on a securities firm on the basis of capital or management problems in an affiliated bank. Specifically, the bill would require the Federal Reserve to curb the activities of a securities firm in the event that an affiliated bank becomes undercapitalized or is determined to be poorly managed. This requirement would apply even if the broker-dealer were well-managed and well-capitalized—the "crown jewel" of the holding company. As a result, a provision intended to promote bank safety and soundness could, by penalizing the healthy broker-dealer, actually undermine the condition of the holding company as a whole.

The Commission, of course, recognizes that bank affiliations with securities firms may raise bank safety and soundness issues. However, it would be misguided to seek to control these risks by imposing an overlay of bank-type "safety and soundness" regulation on bank securities affiliates—as consolidated bank holding company regulation does. For one thing, such an approach is likely to fail. As the Treasury Department noted just four years ago:

> [I]t is practically infeasible for a bank supervisor to effectively regulate a complex and diverse range of businesses. Bank regulation should be concentrated on the bank, which can be effectively regulated, and not on protecting a diversified [financial services holding company] that should be subject to normal market discipline.[29]

In addition, imposing bank-oriented, safety and soundness regulation on securities affiliates would constrain their ability to respond quickly to market movements; this in turn could change the character of the securities business and affect the capital formation process.

With respect to the "two-way street," the Commission recognizes that H.R. 1062 would present securities firms with a number of options they do not have today. Among other things, H.R. 1062 would create a new category of "investment bank holding companies" ("IBHCs") that could engage in a wider range of activities than is generally permitted for bank holding companies.[30] In another effort to provide for a true "two-way street," the revised bill would take steps to streamline Federal Reserve supervision of FSHCs and IBHCs engaged primarily in nonbanking activities.[31]

While these provisions move in the direction of a "two-way street," they do not go far enough. The provisions are highly complex and would impose arbitrary limitations on the business of firms that affiliate with banks. Moreover, even though H.R. 1062 would provide some relief from the restrictions and supervisory provisions contained in existing bank holding company law, it would still closely follow the BHCA approach. That model of consolidated, "top-down" regulation is not well-suited for securities firms and other companies that seek to compete vigorously in new lines of business and fast-moving markets. Prior notice and approval requirements, limits on merchant banking activities and commercial investments, and similar requirements of H.R. 1062 would create significant new regulatory obstacles for securities firms used to competing in a rapidly changing, market-oriented environment. Furthermore, securities firms that already are subject to comprehensive regulation by the Commission under the federal securities laws would, under H.R. 1062, have to submit to new regulatory costs entailed by additional Federal Reserve examination, reporting requirements, and supervision.

In lieu of consolidated holding company regulation, the Commission believes it would be preferable to rely on strong functional regulation, with banking and securi-

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that a portion of a securities affiliate's capital could in fact be counted toward the holding company's capital requirements. We request clarification of the bill's language on this point.

[29] U.S. Department of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (Feb. 1991) at 61 (emphasis in original).

[30] IBHCs could be approved to engage in any activity the Federal Reserve determines to be financial in nature. Such companies would be barred from controlling "retail" banks (*i.e.*, banks that accept insured deposits); they could control only "wholesale financial institutions," defined as uninsured state banks that are regulated by the Federal Reserve. Wholesale financial institutions would have access to Fed Wire and the Federal Reserve's discount window; moreover, transactions between these institutions and their securities affiliates would not generally be subject to the firewalls that apply in the bank holding company context.

[31] This would include (i) FSHCs with bank (and foreign bank) assets less than 10% of the consolidated total risk-weighted assets of the holding company and that are less than $5 billion or (ii) IBHCs with bank assets less than 25% of the consolidated total risk weighted assets of the holding company and that are less than $15 billion, provided that all depository institutions controlled by such entities are well-capitalized and well-managed.

ties functions conducted in separate entities; on effective firewalls between banking and securities activities; and on enhanced regulatory coordination.

Under this approach, each entity in the holding company complex would be separately incorporated and regulated by its expert regulator in accordance with the principle of functional regulation. The federal banking regulators (consistent with their special expertise) would apply their requirements to banks in order to contain the potential risks to safety and soundness (and the federal deposit insurance fund) that may arise as a result of bank affiliations with other entities. The Commission and the SROs, consistent with our statutory mandate and particular expertise, would regulate any securities entities, enforcing investor protection and providing market oversight. In this manner, duplicative and potentially inconsistent regulation could be avoided.

In order to address issues of systemic risk, the functional regulator should be able to receive information concerning the activities and exposures of related entities. This would enable the functional regulator to monitor the risks to which the regulated entity is exposed.[32] Thus, a bank regulator would have access to "risk-assessment" information about a securities entity or an information technology affiliate. A bank regulator could not, however, dictate or restrict business activities of securities entities. Instead, the bank regulator would use risk-assessment information, together with back-up authority to conduct targeted examinations of related entities, in order to monitor and regulate a bank's exposure to risks arising from those entities' activities.

B. Regulatory overlap and duplication

The Commission has stressed in prior testimony that existing law requires bank-affiliated securities firms and investment companies to comply with overlapping and potentially inconsistent regulatory requirements and examinations.[33] For example, the Office of the Comptroller of the Currency ("OCC")—in implementation of the recent guidelines—has begun to examine registered broker-dealers that sell securities in association with national banks. This kind of duplication confuses the industry, imposes unnecessary costs, impairs industry competitiveness, and wastes scarce government resources.

The Commission and the federal banking agencies have taken some steps to address the problem of overlapping regulation through better cooperation and coordination. For example, the Commission staff has had ongoing discussions with the NASD and the banking regulators regarding procedures to facilitate the coordination of examination efforts. In January 1995, the NASD and the federal banking regulators announced that they had reached an agreement in principle to facilitate the coordination, and enhance the effectiveness, of their examination efforts. Similarly, the Commission and the OCC have agreed in principle to a framework for conducting joint examinations of mutual funds and advisory entities in which both agencies have regulatory interests. We also expect the Commission's arrangement with the OCC to serve as a model for future discussions with other banking regulators.

The Commission hopes that these efforts will improve coordination and communication with the banking agencies, resulting in more efficient oversight of bank securities activities. At the same time, however, we recognize that these efforts cannot, in the long run, substitute for institutional relationships grounded in sound public policy and written into law.

H.R. 1062 would make some progress in this area. By requiring banks to conduct certain securities activities in separate affiliates, subject to Commission regulation, the bill would improve the regulation of those specific activities. Other provisions in the bill would also facilitate coordination between bank and securities regulators in a way that would promote functional regulation. For example, Section 104 of H.R. 1062 would create an information-sharing and compliance program to enforce compliance with the bank holding company provisions of H.R. 1062, most notably the firewall provisions, as well as the bank broker-dealer exceptions to the securities

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[32] A model for such a system already exists in the federal securities laws. Pursuant to the Market Reform Act of 1990, the Commission adopted rules establishing a risk assessment program that requires broker-dealers to file quarterly reports on their affiliates within a holding company group whose business activities are reasonably likely to have a material impact on the financial and operational condition of the broker-dealer. Under the Commission's risk assessment rules, the Commission receives essentially the same information that an affiliated bank holding company of a registered broker-dealer is required to file with the Federal Reserve Board. We view the information gathered under the risk assessment program as a significant complement to the Commission's existing broker-dealer authority.

[33] *See, e.g.*, March 15 Testimony at 10-11; Testimony Concerning H.R. 3447, *supra* note 8, at 11-12.

laws. This provision would also seek to coordinate examinations of entities that are regulated by both banking and securities regulators, as well as enforcement actions. The Commission strongly supports the thrust of these provisions.[34]

The Commission is concerned, nonetheless, that many of the inefficiencies and overlap inherent in today's regulatory structure for bank securities activities would carry forward under H.R. 1062. We understand that the banking agencies have a valid interest in obtaining information about related entities' operations to the extent that such operations affect a bank's safety and soundness. But it is not necessary to subject regulated affiliates to further, comprehensive examination by the banking regulators of their securities activities (as may currently occur under the banking regulators' interpretation of their guidelines). In our view, H.R. 1062 should more directly address this issue.

In particular, the bill should clearly detail how, how often, and to what extent, bank regulators can examine a regulated securities entity that is related to a bank. We recommend that the bill require the banking regulators to use Commission and SRO examinations to the fullest extent possible in their oversight of bank-related securities entities. The bill should further provide that if a banking regulator needs additional information, the regulator should (as a first step) ask the Commission to obtain such information before making its own examination of the securities entity.

H.R. 1062 would also create an interagency "Financial Services Advisory Committee," composed of Treasury, the federal banking regulators, the Commission, and the Commodity Futures Trading Commission, with the aim of improving supervision of the financial services industry. As a general matter, the Commission is concerned that the disproportionate representation of banking regulators on the Committee would effectively tilt the Committee's mandate toward bank safety and soundness rather than investor protection. This in turn could undermine the Commission's independence and ability to maintain an appropriate regulatory framework for broker-dealers, including financial responsibility standards and other requirements designed to further investor protection and market oversight rather than bank safety and soundness. Finally, the Commission notes that the formal interagency council, as contemplated by H.R. 1062, would unnecessarily duplicate the activities of the President's Working Group on Financial Markets. The Working Group already serves as an effective vehicle for interagency coordination on issues surrounding the evolution of the financial markets.

V. BANK INVESTMENT ADVISORY ACTIVITIES

H.R. 1062 would amend the Investment Company Act and the Advisers Act to address a number of issues raised when banks manage and provide other services to registered investment companies. Most importantly, the bill would amend the Advisers Act to remove the exclusion for banks and bank holding companies that provide investment advice to funds. Because banks currently are not required to register with the Commission as investment advisers, Commission examiners may not have access to all the books and records normally available when the adviser is registered. In addition, under existing law, banks are not subject to a number of substantive requirements applicable to other investment advisers, including regulation of performance fees, procedures to prevent misuse of non-public information, and the Advisers Act anti-fraud provisions.[35] Under H.R. 1062, a bank or a holding company that serves as an adviser to a fund would be regulated in the same manner as any other investment adviser to a fund. The Commission strongly supports this change.

The bill would allow a bank to segregate its fund investment advisory activities in a separately identifiable department or division, and to register the SID (rather than the bank as a whole) as an investment adviser.[36] The Commission's objections

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[34] The Commission believes, however, that these provisions (particularly those that deal with examinations) are currently inconsistent with similar provisions added later to the Bank Holding Company Act. We recommend that these provisions be strengthened by importing the concepts and language used in the later provisions.

[35] Commission records indicate that approximately 58% of bank-affiliated investment companies are managed by investment advisers not subject to full Commission oversight. Thus, even though they provide advisory services to funds identical to those provided by registered advisers, most banks are not subject to registration and regulation under the Advisers Act.

[36] The primary benefits of requiring banks and SIDs that advise investment companies to register under the Advisers Act would be the application of the following provisions: (1) the regulation of performance fees under Section 205; (2) the requirement of Section 204A to establish procedures designed to prevent the misuse of non-public information; and (3) the Section 206 anti-fraud provisions, which are somewhat broader than the anti-fraud standards under other applicable securities laws. Registration would also improve the Commission's ability to inspect bank-advised funds by requiring banks and SIDs to provide the Commission with additional information regarding the investment management of these funds.

to the use of broker-dealer SIDs (as noted above) do not apply in this instance because an advisory business does not pose the same kind of supervisory issues as do broker-dealer operations: a fee-based advisory business does not require the same kind of capital,[37] or involve the handling of customer funds and securities to the same degree as a broker-dealer business. Therefore, the Commission supports the measure in H.R. 1062 that would provide for the registration of banks or their investment advisory SIDs.

H.R. 1062 also would add provisions to the Investment Company Act that are designed to address conflicts of interest and other potential abuses that may exist when banks advise registered investment companies. Because the Investment Company Act and the Advisers Act did not contemplate that banks would be active participants in the fund industry, the statutes do not specifically address these conflicts of interest. The Commission agrees that these statutes should be updated to reflect the greater involvement of banks in the fund business.

We are pleased that H.R. 1062 has been modified, as we urged in our March testimony,[38] to provide the Commission with the tools necessary to address conflicts of interest involving funds and affiliated banks without imposing rigid statutory prohibitions. As currently drafted, the bill would give the Commission authority to define and deal with those conflicts by rule or order. This authority would allow the Commission to strike a balance between protecting investors from abusive conflict of interest situations and enabling funds to engage in transactions that could be beneficial to shareholders. This approach would also avoid the necessity of time-consuming case-by-case applications for exemptions from outright prohibitions, which could be expensive for regulated entities and could drain Commission resources. We strongly support the conflict of interest provisions of H.R. 1062 as reported by the House Banking Committee.

In addition, H.R. 1062 would address the issue of investor confusion by (1) giving the Commission explicit authority to adopt rules to prevent the use of misleading names by investment companies, and (2) authorizing the Commission to adopt rules or issue orders to prevent or limit funds and their affiliated banks from sharing common names.[39] The bill also would amend the Investment Company Act to authorize the Commission to mandate disclosures by investment companies that securities they issue are not deposits, are not insured by the FDIC, and are not otherwise obligations of any bank. Again, the Commission strongly supports the flexible approach of H.R. 1062 in this area.

The House Banking Committee, however, adopted one amendment to H.R. 1062's investment company provisions that we view as problematic. As originally drafted, H.R. 1062 would have largely codified the Commission's long-standing interpretation of the bank common trust fund exception in the Investment Company Act. Specifically, the bill would have excepted a bank common trust fund from the definition of "investment company" only if the bank, among other things, did not charge the common trust fund any fees that would cause the total fees paid by a participant account to exceed those that the account would have paid absent an investment in the fund. The bill would have permitted a fund to be charged for the bank's expenses for the prudent operation of the fund consistent with determinations by the federal banking regulators. This approach was consistent with the Commission's interpretation that a bank relying on the common trust fund exception must operate the fund solely as an administrative device for serving bona fide pre-existing trust clients of the bank.

As reported by the House Banking Committee, H.R. 1062 would permit a bank to charge a common trust fund any fees and expenses consistent with state and federal fiduciary law. We believe that this provision is not only inconsistent with the purpose of the bank common trust fund exception, but also may create an incentive for banks to place fiduciary accounts into these funds in order to generate additional fees. We urge the Committee to modify this provision to restrict the fees that banks

[37] In recent years, several fund advisers, including banks, have purchased from funds certain instruments that had precipitously declined in value or that arguably were unsuitable for the fund. These transactions may place the adviser's capital at risk. Such purchases, however, are relatively infrequent and generally are not legally required. Rather they are undertaken voluntarily by the adviser to preserve the value of a fund's portfolio.

[38] March 1995 Testimony at 23.

[39] This issue has long concerned the Commission. Two years ago, the Commission staff advised investment companies that the use of common names is presumptively misleading. *See* Letter to Registrants from Barbara J. Green, Deputy Director, SEC Division of Investment Management (May 13, 1993). This letter noted that the presumption could be rebutted through appropriate disclosure. The letter requires bank-sold and bank-advised funds to disclose prominently in their prospectuses that fund shares are not deposits or obligations of, or guaranteed or endorsed by, the bank and that the shares are not federally insured.

may charge to common trust funds that are not subject to the Investment Company Act.

VI. MARGIN PROVISIONS

Section 204 of H.R. 1062 would remove current restrictions on lending to broker-dealers collateralized by securities for use in the ordinary course of the broker-dealers' business. The bill would preserve restrictions on lending to broker-dealers to purchase securities for their own accounts. In addition, H.R. 1062 would permit broker-dealers to borrow using securities as collateral from any person agreeing to observe applicable rules of the Federal Reserve Board. The evolving nature of our financial markets, including greater reliance on non-bank sources of financing, has made current limitations on broker-dealer borrowing collateralized by securities unnecessary. We believe H.R. 1062 appropriately loosens the restrictions on lending to broker-dealers to finance their securities operations and expands the sources from which broker-dealers may borrow.

We would suggest certain changes to H.R. 1062. We believe the amendments to the lending restrictions should apply only to loans to broker-dealers: (1) a substantial portion of whose business consists of transactions with customers other than brokers or dealers or (2) to finance the activities of brokers or dealers as market makers or as underwriters. Federal Reserve regulations already permit loans to broker-dealers, collateralized by securities, for the purpose of securities market making or underwriting. We believe the bill further should permit loans to broker-dealers collateralized by securities for other purposes. We believe, however, that the Federal Reserve should retain the authority to restrict such lending to those purposes which are consistent with the broker-dealer's role in serving a public securities market or for purposes of protecting the safety and soundness of the financial markets.

VII. CONCLUSION

The Commission supports the goal of financial services modernization, as well as many of the specific ideas and provisions contained in H.R. 1062—for example, the functional regulation of bank investment advisers to registered investment companies. Overall, however, we are concerned that the bill does not go far enough to accommodate the needs of investors and the markets. Functional regulation and investor protection would be furthered by eliminating provisions of H.R. 1062 granting banks extensive exemptions from broker-dealer regulation. Moreover, H.R. 1062 should do more to simplify the regulatory framework for financial services firms and, in so doing, address existing problems of regulatory overlap and duplication. Finally, H.R. 1062 should provide a more effective "two-way street" for securities firms that seek to acquire banks, to avoid the risk that the operation of the U.S. capital markets could be adversely affected through inappropriate constraints on risk-taking activities.

The Commission looks forward to working with the Commerce Committee on this important initiative. We will forward to you some suggestions for improving the bill which both move in the direction suggested by this testimony and are consistent with the objectives of H.R. 1062 as reported by the Banking Committee.

Mr. FIELDS. Thank you, Chairman Levitt. Again, your statement will be printed in its entirety.

Chairman Greenspan.

STATEMENT OF ALAN GREENSPAN

Mr. GREENSPAN. Thank you very much, Mr. Chairman.

I am pleased to be here on behalf of the Board of Governors of the Federal Reserve System to offer our strong support for H.R. 1062. We are here today to discuss the need to remove outdated separations between commercial and investment banking and thereby take the next logical step in rationalizing our system for delivering financial services in a more efficient manner.

The Board is of the view that the risk to banks and the safety net from securities and most other financial activities are manageable using the holding company framework proposed in H.R. 1062. But there is another risk, the risk of transference to affiliates of

the subsidy implicit in the Federal safety net, deposit insurance, the discount window, and access to the Fed wire, with the attendant moral hazard and risk of loss to the taxpayers. The Board believes that the holding company structure creates the best framework for limiting the transference of that subsidy.

An additional safeguard to protect the bank from any risk from wider financial activities is the adoption of prudential limitations through firewalls and rules that prohibit or limit certain bank and affiliate transactions. While firewalls may temporarily bend under stress, they nonetheless serve a useful purpose.

It would be counterproductive, if not folly, if in order to avoid the risk of failure of firewalls we sought to establish prohibitions and firewalls so rigid that they would eliminate the economic synergies between banks and their affiliates. Moreover, if we create such inflexible firewalls, we run the risk of reducing the safety of the financial system by inhibiting its ability to respond to shocks.

Clearly there is a need for balance here. The bill before you retains reasonable firewalls and other prudential limitations, but provides the Board with the authority to adjust them up or down. Some are concerned that an umbrella supervisor is incompatible with a financial services holding company encompassing an increasing number of subsidiaries that would be unregulated if they were independent.

The Board, too, is concerned that if bank-like regulation were applied to an expanded range of activities, the market would believe that the government is as responsible for their operations as it is for banks, but we must keep in mind that the purpose of the umbrella supervisor is to have an overview of the risks in the organization so that the risks to the bank, the entity with access to the safety net and taxpayer funds can be evaluated and, if needed, addressed by supervisors. The umbrella supervisor, it seems to us, becomes more crucial, not less, as the risk management and policy control moves from the bank to the parent.

My statement provides details on the provisions of H.R. 1062 designed to eliminate unnecessary regulatory constraints and burdens on banks and securities firms. Such provisions would greatly enhance the so-called two-way street by eliminating unnecessary regulatory burden and red tape. It is worth underlining, however, that there is nothing in the bill that reduces the prudential supervision of the bank subsidiaries, whether insured or uninsured.

Indeed, H.R. 1062, quite properly, emphasizes the necessity of the parent holding company of insured or uninsured banks to maintain the strength of their banks if they wish to maintain their securities affiliate. If unable or unwilling to do so, they must exit either the banking or the securities business.

Let me conclude by emphasizing that the Board believes that H.R. 1062 authorizes the next logical step in the modernization of our financial system, providing benefits to commercial and investment banking firms but, most importantly, to the U.S. consumers of financial services. The Board believes its adoption would be a major step in the evolution and strengthening of our financial system which sadly now operates under increasingly outdated restrictions and prohibitions.

Thank you.

[The prepared statement of Hon. Alan Greenspan follows:]

PREPARED STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

I am pleased to be here today to present the views of the Board of Governors of the Federal Reserve System on expanding permissible affiliations between banks and other financial services providers. The bill before the subcommittees, Mr. Chairman, the "Financial Services Competitiveness Act of 1995," H.R. 1062, would authorize the affiliation of banks and securities firms, as well as permit banks to have affiliates engaged in most other financial activities.

This bill would reform outdated statutory prohibitions established for a financial system that no longer exists, continuing the modernization of our financial system begun with last year's passage of the landmark interstate banking legislation. It provides Congress with the opportunity to make the financial system more competitive and more responsive to consumer needs, all within a framework that would maintain the safety and soundness of insured depository institutions and permit both banks and securities firms to operate more efficiently. The Board believes that modern global financial markets call for permitting financial organizations to operate over a wider range of activities. Distinctions among financial products and institutions have become increasingly difficult to make, undermining the statutory and regulatory structures established over three generations ago. The approach contained in the bill before you would be a major step, providing realistic reform, facilitating a wider range of activities for both securities firms and banking institutions, and thus has the strong support of the Board of Governors of the Federal Reserve System.

There is, I think, general agreement on the forces shaping our evolving financial system—forces that require that we modernize our statutory framework for financial institutions and markets. The most profound is, of course, technology: the rapid growth of computers and telecommunications. Their spread has lowered the cost and broadened the scope of financial services, making possible new products that would have been inconceivable a short time ago, and, in the process, challenging the institutional and market boundaries that in an earlier day seemed so well defined. The business of financial intermediation has always been the measurement, acceptance, and management of risk. In the past, commercial and investment banks performed these basic functions with quite different tools and strategies. Today, the tools and strategies increasingly overlap, blurring traditional distinctions between commercial and investment banks.

Examples abound. Securities firms have for some time offered checking-like accounts linked to mutual funds, and their affiliates routinely extend significant credit directly to business. On the bank side, the economics of a typical bank loan syndication do not differ essentially from the economics of a best-efforts securities underwriting. Indeed, investment banks are themselves becoming increasingly important in the syndicated loan market. With regard to derivatives instruments, the expertise required to manage prudently the writing of OTC derivatives, a business dominated by banks, is similar to that required for using exchange-traded futures and options, instruments used extensively by both commercial and investment banks. The list could go on. It is sufficient to say that a strong case can be made that the evolution of financial technology alone has changed forever our ability to place commercial and investment banking into neat separate boxes.

Technological innovation has accelerated the second major trend—financial globalization—that has been in process for at least three decades. Both developments have expanded cross-border asset holdings, trading, and credit flows and, in response, both securities firms and U.S. and foreign banks have increased their cross-border operations. Foreign offices of U.S. banking organizations have for some time been permitted, within limits, to meet the competitive pressures of the local markets in which they operate by conducting activities not permitted to them at home. In the evolving international environment, these off-shore activities have included global securities underwriting and dealing, through subsidiaries, an activity in which U.S. banking organizations have been among the world leaders, despite limitations on their authority to distribute securities in the United States. Similarly, foreign offices of securities firms have engaged in banking abroad.

Such a response to competition abroad is an example of the third major trend reshaping financial markets—market innovation—which has been as much a reaction to technological change and globalization as an independent factor. These developments make it virtually impossible to maintain some of the rules and regulations established for a different economic environment. As a result, there is broad agree-

ment that statutes governing the activities of banking organizations increasingly form an inconsistent patchwork.

For example, under federal standards, banking organizations may act as agents in private placements of securities and, in fact, have done so quite successfully, accounting recently for one-third of all corporate bonds and one-seventh of all equity privately placed. Banking organizations may also act as brokers of securities, and as investment advisers for individuals and mutual funds. For many years, they have acted as major dealers in U.S. government and municipal general obligation bonds. Banking organizations are also the leading innovators and dealers in derivatives, and banking organizations operate futures commission merchants as holding company subsidiaries. As just noted, banking organizations underwrite and deal in securities abroad and, since 1987, banking organizations with the necessary infrastructure may apply for authority to engage in limited underwriting and dealing of securities through special bank holding company subsidiaries under a Federal Reserve Board interpretation of Section 20 of the Glass-Steagall Act.

In a pattern that is reminiscent of interstate branching developments, the states for some time have been removing restrictions on the activities of state-chartered banks. The FDIC, as required by the Federal Deposit Insurance Corporation Improvement Act, reviews such activities, but has not rejected an application to exercise any of these powers from adequately or well-capitalized banks. According to the most recent report of the Conference of State Bank Supervisors, seventeen states—including several large ones—had authorized banks to engage in securities underwriting and dealing, with about half requiring such activity in an affiliate. At the federal level, the OCC has proposed a process to allow national bank subsidiaries to conduct activities not permitted for the bank.

And so it goes on. Technological change, globalization, and regulatory erosion will eventually make it impossible to sustain outdated restrictions without mounting inefficiencies and dead-weight costs, and these forces will be supplemented by piecemeal revisions to federal regulation and sweeping changes in state laws. This was the pattern that we observed in the evolution of interstate banking and branching, a pattern that finally led the Congress to repeal artificial restrictions on the ability of banking organizations to expand geographically. And this is what we are here today to discuss—the need to remove outdated separations between commercial and investment banking and thereby take the next logical step in rationalizing our system for delivering financial services in a more efficient manner. I might note that in this regard the United States is, as it was with geographical restrictions, behind the rest of the industrial world. Virtually all the other G-10 nations now permit banking organizations to affiliate with securities firms and with insurance and other financial entities. We are among the last who have not statutorily adjusted our system. That might be acceptable, or even desirable, if there was a good reason to do so. We do not think there is such a reason.

Let me be clear that the Board's position in favor of expanding the permissible range of affiliations for banking and securities organizations is not a reflection of a concern for banks, securities firms, their management, or their stockholders. Managements of U.S. financial organizations have been quite creative—indeed have led others—in developing and using both technology and the globalization of financial markets for profitable innovations that have greatly benefitted their customers. Rather, the Board's support for the expansion of permissible activities for both banks and securities firms reflects the desirability of removing outdated restrictions that serve no useful purpose, that decrease economic efficiency, and that, as a result, limit choices and options for the consumer of financial services. Such statutory prohibitions result in higher costs and lower quality services for the public and should be removed. That their removal would permit both commercial and investment banking organizations to compete more effectively in their natural markets is an important and desirable by-product, but not the major objective, which ought to be a more efficient financial system providing better services to the public. Removal of such prohibitions moves us closer to such a system.

Indeed, the Board urges that, as you consider the reforms before you, the focus not be on which set of financial institutions should be permitted to take on a new activity, or which would, as a result, get a new competitor. As I noted, all are doing similar things now and are now in competition with each other, offering similar products. The Board believes that the focus should be: do the proposed bills promote a financial system that makes the maximum contribution to the growth and stability of the U.S. economy? Are existing restraints serving a useful purpose? Do they increase the compatibility of our laws and regulations with the changing technological and global market realities in order to ensure that these goals are achieved? Are they consistent with increased alternatives and convenience for the public at a manageable risk to the safety net? Are buyers of securities—particularly retail

buyers—continuing to be protected by clear and full disclosures and anti-fraud rules?

Banking organizations are in a particularly good position to provide underwriting and other financial services to investors. They are knowledgeable about the institutional structure of the market and skilled at evaluating risk. Moreover, for centuries, banks' special expertise has been to accumulate borrower-specific information that they can use to make credit judgments that issue-specific lenders and investors cannot make. Overcoming such information asymmetries has been the value added of banking on the credit side. It is also clearly true that securities firms have built up a considerable information base on their investment and merchant banking customers. Accordingly, the financial innovations of recent years have facilitated investment banks' development of commercial banking expertise through money market and other mutual funds, bridge loans, and loan syndications. And their expertise has been applied to affiliated financial firms in the United States and abroad.

An increasing number of customers of commercial banks and securities firms want to deal with a full-service provider that can handle their entire range of financing needs. This preference for "one-stop shopping" is easy to understand. Starting a new financial relationship is costly for companies and, by extension, for the economy as a whole. It takes considerable time and effort for a company to convey to an outsider a deep understanding of its financial situation. This process, however, can be short-circuited by allowing the company to rely on a single organization for loans, strategic advice, the underwriting of its debt and equity securities, and other financial services. As evidence that there are economies from this sharing of information, most of the Section 20 underwriting has been for companies that had a prior relationship with the banking organization.

Our discussions with Section 20 officials suggest that the economic benefits of "one-stop shopping" are probably greatest for small and medium-sized firms, the very entities that contribute so much to the growth of our economy. These firms, as a rule, do not attract the interest of major investment banks, and regional brokerage houses do not provide the full range of financial services these companies require. Rather, their primary financial relationship is with the commercial bank where they borrow and obtain their services. Thus, from the firm's perspective, it makes sense to leverage this relationship when the time comes to access the capital markets for financing. It is reasonable to anticipate that if securities activities are authorized for bank affiliates, banking organizations, especially regional and smaller banking organizations, would use their information base to facilitate securities offerings by smaller, regional firms, as well as local municipal revenue bond issues. Many of these banking organizations cannot engage in such activities now because they do not have a sufficient base of eligible securities business revenue to take advantage of the Section 20 option that limits their ineligible revenues to 10 percent of the total. Investment banking services are now available for some of these smaller issues, but at a relatively high cost. Section 20 subsidiaries at regional banks indicate that they are eager to expand their investment banking services to small and moderate-sized companies. These Section 20 subsidiaries view such firms as underserved in the current market environment and see an opportunity to provide a greater range of services at lower prices than those now prevailing.

Some financial organizations in recent years have found that providing the full range of financial services is not compatible with either their management expertise or their market position. There are, as a result, frequent reports of divestitures and an increasing number of niche participants operating alongside wide-ranging financial supermarkets. The authorization to engage in broader activities does not necessarily mean that all banks will engage in securities activities or that all securities firms will engage in banking. But efficient markets providing better services should permit market participants to choose the best way for them to distribute financial services.

Organizations that choose to offer new services may do so in part to diversify their risks. Indeed, almost all bank holding companies that have set up Section 20 subsidiaries believe that the diversification of revenues will result in lower risks for the organization. While the empirical literature is inconclusive, and the Section 20's themselves have not been around very long, and have operated under significant restrictions, it seems likely that some bank holding companies could achieve risk reduction through diversification of their financial services.

To be sure, with the benefits of expanded powers comes some risk, but I read the evidence as saying that the risks in securities underwriting and dealing are manageable. Underwriting is a deals-oriented, purchase and rapid resale, mark-to-market business in which losses, if any, are quickly cut as the firm moves to the next deal. Since the enactment of the Securities Acts of 1933 and 1934—with their focus on investor protection—the broker/dealer regulator, the SEC, is quick to liquidate

a firm with insufficient capital relative to the market value of its assets, constraining the size of any disturbance to the market or affiliates. The SEC now applies such supervision to Section 20 affiliates, and it would do so to securities affiliates under the bill before you. Section 20 affiliates have operated during a period in which sharp swings have occurred in world financial markets, but they still were able to manage their risk exposures well with no measurable risks to their parent or affiliated banks. Indeed, in order to limit the exposure of the safety net, the supervisors have insisted that securities affiliates have risk management and control systems that ensure that risk can be managed and contained. As would be the case with H.R. 1062, the Federal Reserve has required that such an infrastructure exist before individual Section 20 affiliates are authorized, and that organizations engaging in these activities through nonbank affiliates have bank subsidiaries with strong capital positions.

The bill passed overwhelmingly by the House Banking Committee continues the holding company framework, which we believe is important in order to limit the direct risk of securities activities to banks and to the safety net. The Board is of the view that the risks from securities and most other financial activities are manageable using the holding company framework proposed in that bill. But there is another risk: the risk of transference to affiliates of the subsidy implicit in the federal safety net—deposit insurance, the discount window, and access to Fedwire—with the attendant moral hazard and risk of loss to the taxpayers. The Board believes that the holding company structure creates the best framework for limiting the transference of that subsidy. We recognize that foreign subsidiaries of U.S. banks have managed such activities for years virtually without significant incident. Nonetheless, we have concluded that the further the separation from the bank the better the insulation. We are concerned that conducting these activities without limit in subsidiaries of U.S. banks does not create sufficient distance from the bank. Moreover, even though the risks of underwriting and dealing are manageable, any losses in a securities subsidiary of a bank would—under generally accepted accounting principles—be consolidated into the bank's position, an entity protected by the safety net. While it is true that the profits of a bank subsidiary would directly strengthen the bank, the profits of a holding company subsidiary can be rechanneled to the bank without exposing the bank to the risk of subsidiary losses.

An additional safeguard to protect the bank from any risk from wider financial activities is the adoption of prudential limitations through firewalls and rules that prohibit or limit certain bank and affiliate transactions. While firewalls may temporarily bend under stress, they nonetheless serve a useful purpose. It would be counterproductive, if not folly, if in order to avoid the risk of failure of firewalls, we sought to establish prohibitions and firewalls so rigid that they would eliminate the economic synergies between banks and their affiliates. Moreover, if we create such inflexible firewalls we run the risk of reducing the safety of the financial system by inhibiting its ability to respond to shocks. Clearly, there is a need for balance here. The bill before you retains reasonable firewalls and other prudential limitations, but provides the Board with the authority to adjust them up or down. Such flexibility is highly desirable because it permits the rules to adjust in reflection of both changing market realities and experience. H.R. 1062 also makes exceptions to firewalls and other prudential limitations if the bank affiliates are well-capitalized. Such banks can tolerate additional risk.

H.R. 1062 attempts to accommodate the merchant banking business currently conducted by independent securities firms. Both bank holding companies with Section 20 subsidiaries and independent securities firms engage in securities underwriting and dealing activities. However, independent securities firms also directly provide equity capital to a wide variety of companies without any intention to manage or operate them. The bill would permit securities firms that acquire commercial banks, as well as securities firms acquired by bank holding companies, to engage in all of these activities—underwriting and dealing in securities, as well as merchant and investment banking through equity investment in any business without becoming involved in the day-today operations of that business. These powers are crucial to permit securities firms to remain competitive domestically and internationally. Under the bill, the Board could establish rules to ensure that these activities do not pose significant risks to banks affiliated with securities firms or serve as a "back door" to the commingling of banking and commerce.

Some are concerned that an umbrella supervisor is incompatible with a financial services holding company encompassing an increasing number of subsidiaries that would be unregulated if they were independent. The Board too is concerned that, if bank-like regulation were applied to an expanded range of activities, the market would believe that the government is as responsible for their operations as it is for banks. This subtle transference of the appearance of safety-net support to financial

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affiliates of banks creates a kind of moral hazard that is corrosive and potentially dangerous.

Nonetheless, it is crucial to understand that both the public and management now think—and will continue to think—of bank holding companies (and financial services holding companies, if authorized) as one integrated unit, especially if they enjoy the economic synergies that are the purpose of the reform proposals. Moreover, experience and the new computer technology are already adding centralized risk management to the existing centralized policy development for bank holding companies. The purpose of the umbrella supervisor is to have an overview of the risks in the organization so that *the risks to the bank*—the entity with access to the safety net—can be evaluated and, if needed, addressed by supervisors. The umbrella supervisor, it seems to us, becomes more crucial, not less, as the risk management and policy control moves from the bank to the parent. But the umbrella supervisor need not be so involved in the affairs of the nonbank affiliates and the parent that regulatory costs are excessive, or that the market perceives that the safety net has been expanded to the nonbank activities of the organization. Indeed, we applaud the continuation of functional regulators embodied in H.R. 1062.

In an effort to eliminate unnecessary regulatory constraints and burdens, the bill before you would require the banking agencies to rely on examination reports and other information collected by functional regulators. In addition, it would require the banking agencies to defer to the SEC in interpretations and enforcement of the federal securities laws. The bill goes further and eliminates the current application procedure for holding company acquisitions by well-capitalized and well-managed banking organizations whose proposed nonbank acquisitions or *de novo* entry are both authorized and pass some reasonable test of scale.

The bill would also require no consolidated capital supervision of the holding company, and minimal non-bank supervision so long as the *uninsured* bank subsidiaries have in total less than $15 billion of risk-weighted assets and the banks are less than 25 percent of consolidated risk-weighted assets. Similar treatment is available to holding companies if the *insured* bank subsidiaries have less than $5 billion in risk-weighted assets and are less than 10 percent of consolidated risk-weighted assets. More stringent consolidated supervision would be imposed if the banks increase to a size that raises systemic concerns, or if the Fed concludes that the holding company would not honor its guarantee of the insured bank subsidiaries, as required in H.R. 1062, or if the bank portion of the total organization is so large that the rest of the organization might have difficulty supporting the bank. That is to say, organizations that have bank subsidiaries with access to the safety net, which is available in part even for the wholesale uninsured banks, are made subject to more supervision when their banks approach sizes that may pose systemic risk should they fail, or when there is concern that the overall organization might be unable to adequately support its banks. The bill approved by the Banking Committee also streamlines the process for evaluating the permissibility of new financial activities for holding companies with strong banks. In addition, organizations with uninsured bank subsidiaries are authorized a basket of investments in activities not permitted to those holding companies with insured bank subs.

These are extremely important modifications both for existing bank holding companies and for securities firms that wish to affiliate with banks. Such provisions would greatly enhance the "two-way street" provisions by eliminating unnecessary regulatory burden and red tape. We believe that this concept could also quite usefully be extended to bank acquisition proposals. It is worth underlining, however, that there is nothing in the bill that reduces the prudential supervision of the bank subsidiaries—whether insured or uninsured. Indeed, H.R. 1062 quite properly emphasizes the necessity for the parent holding company of insured or uninsured banks to maintain the strength of their banks if they wish to maintain their securities affiliate. If unable or unwilling to do so, they must exit either the banking or the securities business. Entities unwilling to accept the responsibility of maintaining strong bank subsidiaries are thus provided incentives to consider whether they should enter and/or maintain their banking business.

In conclusion, on more than one occasion bills to permit at least securities affiliates were approved by the banking committees in both houses, as well as by the full Senate on several occasions. In the meantime, technological change, globalization, and market innovations have continued. In such a context, modernization of our financial system should be of high priority in order better to serve the U.S. public. H.R. 1062 authorizes the next logical step in the modernization of our financial system, providing benefits to commercial and investment banking firms, but most importantly to the U.S. consumers of financial services. The Board believes its adoption would be a major step in the evolution and strengthening of our finan-

cial system, which sadly now operates under increasingly outdated restrictions and prohibitions.

Mr. FIELDS. Thank you very much, Mr. Chairman.

Julie Williams, Chief Counsel, Office of the Comptroller of the Currency, Department of the Treasury.

STATEMENT OF JULIE WILLIAMS

Ms. WILLIAMS. Thank you, Chairman Fields, Chairman Oxley, and members of the subcommittee for the opportunity to discuss H.R. 1062, the Financial Services Competitiveness Act of 1995. You are to be commended for moving so quickly to hold hearings on this important initiative which is aimed at a goal we all share—eliminating artificial and anticompetitive restrictions that limit the ability of banks and other firms to serve the financial needs of their customers and support the economy.

I am here this morning on behalf of the Comptroller of the Currency, Eugene Ludwig, who is fulfilling a long-standing commitment to participate in a meeting of the Basle Committee on Banking Supervision in Switzerland. Comptroller Ludwig has a detailed written statement that I am submitting for the record. In the interest of time, I will summarize that statement.

We all support the fundamental goals of Glass-Steagall reform. We want to improve the long-term health of the banking system which supports our Nation's economic growth by permitting banks, their subsidiaries and their affiliates to diversify into other financial activities within prudential limits. We want to increase access to capital for small and midsize businesses. We want to enhance competition and improve customer service by reducing regulatory burden and by eliminating unnecessary artificial segmentation of the financial services industry. These are admirable goals that few would question.

Unfortunately, H.R. 1062 presents significant concerns about the means chosen to achieve those goals. At a time when Congress and the administration are working to reduce government interference and lower regulatory burdens on the private sector, this legislation would impose substantial new regulatory requirements and limitations on all banks, including those banks that are not engaged in any new securities activities.

Our concerns fall into three categories. First, the legislation imposes restrictions on bank activities and product innovation. In an era when it is technologically possible to apply for and receive a loan over the Internet, none of us here today can predict the future of the financial services industry. We can predict, however, that establishing legislative restrictions such as those in H.R. 1062 would limit banks' ability to provide innovative products and services to meet customer demands in the future. Far from enhancing the strength of the banking system, an inability to diversify restricts banks to a narrow market segment and leads to a loss of their better customers, making even traditional banking activities less safe.

Second, H.R. 1062's limitations on the activities of banks and their subsidiaries would frustrate important public policy objectives. These restrictions are unlikely to improve access to capital for small- and medium-sized businesses. Midsized banks are precisely the financial institutions that have the most experience deal-

ing with smaller businesses. Under the current provisions of H.R. 1062, however, these banks may find that the cost of establishing a holding company securities affiliate prevents them from entering local securities underwriting markets.

Clearly, we should forgo the benefits of broadening bank securities activities if the risks are unacceptably high, but many of the activities that H.R. 1062 would restrict for banks and their subsidiaries are no riskier than activities in which banks have engaged safely for some time. U.S. banks have safely conducted a variety of securities activities for years through foreign branches and subsidiaries as well as through holding company affiliates.

To the extent that H.R. 1062 requires or induces banking organizations to conduct their securities activities in holding company affiliates, the bill precludes a potentially important source of earnings flowing to banks and deprives banks of product line diversification. This could have a significant impact on the health of the banking system. Over the past 15 years, banks have derived increasing strength from new products and services. In 1994, noninterest income accounted for more than a third of bank operating revenues compared to just 19 percent in 1980.

Overreliance on structure as a protection against risk also is conceptually unsound. It ignores the differences in risk of different products as well as the need for strong supervision to ensure that banks properly manage the risks of their activities. Experience has shown that the location of an activity in a banking organization structure matters little when the organization decides whether to support the activity if it runs into trouble. Further, the location of an entity in an organization's corporate structure has been shown to be irrelevant when courts consider whether to pierce the corporate veil to reach one entity's assets——

Mr. FIELDS. Ms. Williams, could we ask you to summarize also, please.

Ms. WILLIAMS. [continuing] to cover the loss of a related entity.

Third, this legislation would impose new regulatory burdens on virtually all banks, even banks without securities activities. Attached to the Comptroller's written statement is a chart that summarizes just the basic steps that a bank would go through under this bill to determine if and how it could provide a new financial product to its customer. There are other attachments that summarize how the requirements of the bill would affect different types of banking organizations.

In sum, we strongly support the goals of H.R. 1062, but we have serious reservations about the means to achieve these goals laid out in this legislation. We need a judicious combination of prudent activities diversification for banks, strong supervision, and firewalls tailored to specific activities. Instead, H.R. 1062 would impose new regulatory burdens and restructuring requirements and would also restrict banks' ability to provide innovative products to meet the needs of a changing economy and changing customer demands. We recognize the value of prudential limits and safeguards on the range of permissible bank activities, but in its current form the bill goes well beyond what is needed.

Mr. Chairman, I would be happy to answer any questions you have.

[The prepared statement of Eugene Ludwig as submitted by Julie Williams follows:]

PREPARED STATEMENT OF EUGENE A. LUDWIG, COMPTROLLER OF THE CURRENCY

Chairman Fields, Chairman Oxley, and members of the Subcommittees, I commend you for initiating these hearings on H.R. 1062, the Financial Services Competitiveness Act of 1995. We share common goals: eliminating artificial and anticompetitive restrictions that limit the ability of banks and other firms to serve the financial needs of their customers and support the economy. Allowing banking organizations to expand their activities can lead to improved, more convenient, and less costly services for consumers of financial services and can foster enhanced access to capital for small and mid-sized businesses. Competitive financial services markets are the most efficient financial services markets, and the best able to serve and benefit all customers.

For banks, activities diversification is an essential complement to the geographic diversification authorized by Congress last year. Together, they form the necessary cornerstones of a vigorous banking system. Both types of diversification are needed to ensure that our banks can meet the needs of their local customers and communities as well as remain competitive in international financial markets.

Eliminating artificial and anticompetitive restrictions are goals that few would question. Unfortunately, H.R. 1062 presents significant concerns about the means chosen to achieve those goals. At a time when Congress and the Administration are working together to reduce government interference and lower regulatory burdens on the private sector, this legislation would impose substantial new regulatory requirements and limitations on *all* banks—including banks that wish only to continue doing what they have done safely for years. Our concerns on this score fall into three basic areas:

First, by imposing restrictions on bank activities and product innovation, the legislation would intrude deeply into the realm of market decisions. More than 130 years ago, the New York Court of Appeals, in a case involving the powers of New York state banks, declined to impose rigid limits on bank activities "because no human capacity can foresee what implied powers may, in the progress of time, the discovery and perfection of better methods of business, and the ever varying attitude of human relations, be required to give effect to the express powers" of banks. These words were written in 1857. They are wise counsel for us today. The current Glass-Steagall framework is indeed antiquated. But to replace it with an even less workable structure would be to step in the wrong direction.

In an era when it's possible to apply for and receive a loan over the Internet, none of us here today can predict the future of the financial services industry. We can predict, however, that establishing legislative restrictions such as those in H.R. 1062 will curtail banks' ability to provide innovative products and services their customers will demand in the future. These restrictions will lead to a loss of banks better customers, making even traditional banking activities less safe.

For example, consider the ability of banks to securitize commercial loans. Today, banks securitize a wide range of residential mortgages and consumer loans. They are beginning to securitize *commercial* mortgages, and the markets are now exploring how to facilitate securitization of other types of business loans. The ability to securitize their loan assets gives banks a tool to manage their liquidity and the risks they retain in their loan portfolio. It also provides a source of funding for additional loans. Yet H.R. 1062 restricts not just the ability of banks to securitize commercial loans, but also the ability of bank securities affiliates to securitize certain types of loans they acquire from affiliated banks. What purpose is served by precluding banks from participating in marketplace innovations that can enhance their ability to fund commercial loans, improve liquidity, and better manage their risk?

Second, H.R. 1062's limitations on activities of banks and their subsidiaries frustrate important public policy objectives, such as increasing access to capital and improving safety and soundness. These restrictions will likely prevent the bill from improving small and medium-sized business access to capital. Medium-sized banks are precisely the financial institutions that have the most experience in dealing with smaller businesses. Under H.R. 1062 in its current form, these banks may find the cost of the bill s holding company requirements prevents them from entering local securities underwriting markets.

We should be willing to forego the benefits of broadening bank securities activities if the risks are unacceptably high. But the restrictions H.R. 1062 would impose may actually increase risk in the banking system. To the extent that it requires or induces banks to conduct their securities activities in holding company affiliates, H.R.

1062 precludes a potentially important source of bank earnings and deprives banks of product line diversification.

Many of the activities H.R. 1062 would limit are no riskier than similar activities in which banks have safely engaged for years. For example, current law expressly authorizes national banks to purchase and hold—indefinitely—high grade corporate debt securities that qualify as "investment securities." We should not assume—as H.R. 1062 apparently does—that holding this corporate debt for a matter of *hours* or *days* as an underwriter or dealer is more risky than holding those securities in a portfolio for *months* or *years*.

In fact, the overwhelming weight of evidence suggests that non-traditional financial activities—specifically securities activities—need not threaten bank safety and soundness. U.S. banks, through foreign branches and subsidiaries, as well as holding company affiliates, have safely engaged in a variety of securities activities abroad for many years. Chairman Greenspan has publicly indicated that banks securities activities are consistently profitable.

Banks in most of the G-10 countries also have engaged in a broad range of financial services activities for many years. No evidence suggests that these activities have diminished the safety and soundness of these institutions. On the contrary, foreign bank supervisors consistently report that income from non-traditional financial activities has been a key support to bank safety and soundness during periods of financial stress.

Over-reliance on structure as a protection against risk also is conceptually unsound. It ignores the differences in risk of different products, as well as the need for strong supervision to ensure that banks properly manage the risks of their activities. Experience teaches that the location of an entity in a banking organization's corporate structure matters little when a banking organization decides whether to support its affiliate. For example, reputation risk has been a strong incentive for banks to bail out troubled *holding company affiliates*—regardless of structural barriers. Further, the location of an entity in an organization's corporate structure has been shown to be irrelevant to whether a court will "pierce the corporate veil" to reach one entity's assets to cover the losses of a related entity.

The long-term viability of our banking system depends upon the ability of banks (directly and through their subsidiaries) to be strong and competitive financial services providers. A key factor in achieving that result is ensuring that banking organizations can make reasonable choices as to the most efficient corporate structures for conducting their businesses. Unless compelled by reasons of safety and soundness—which is not the case for most securities activities—banking organizations should be allowed to innovate as they and the market deem appropriate, not the government. It is illogical to suggest that requiring or inducing banks to shift into holding company affiliates will somehow make banks stronger.

Long-term safety and soundness in the banking industry depends upon a judicious combination of prudent activities diversification and strong supervision and firewalls tailored to the activity in question, which are not imposed on a one-size-fits-all basis. Secretary Rubin, in his March 1, 1995 testimony before the House Banking and Financial Services Committee, has outlined such an approach. The Comptroller s Office fully subscribes to the principles the Secretary set forth.

Third, the legislation imposes costly new regulatory burdens. Banks (and their lawyers) will spend substantial time trying to figure out what new rules apply to what activities and which regulator interprets and implements them.

Multiple new regulatory requirements also will compel substantial restructuring within potentially thousands of banks that have no interest in expanding their securities activities. For example, many banks will face additional regulators, the need to establish new divisions, affiliates, or holding companies; the need to set up new internal systems; and the need to satisfy new audit and reporting requirements. If the bank wanted to make a customer aware of a "nonbanking" product offered by the bank or any affiliate of the bank, *e.g.*, insurance, the bank will be subject to new standards implemented by the Federal Reserve Board.

These requirements—and others—would increase costs for banks and undermine their ability to compete efficiently. Artificial separations between "securities" and "banking" activities may also lead to disruption of long-standing customer relationships. This type of restructuring could actually hurt, rather than promote, the safety and soundness of the banking system.

Attached to my testimony is a chart that summarizes just the basic steps that a bank would have to go through under this bill to determine if—and how—it could provide a new financial product to its customers. Also attached are several examples of how the new requirements in the bill would affect different types of banking organizations. These examples illustrate why we have concerns about the new regulatory burdens contained in the bill.

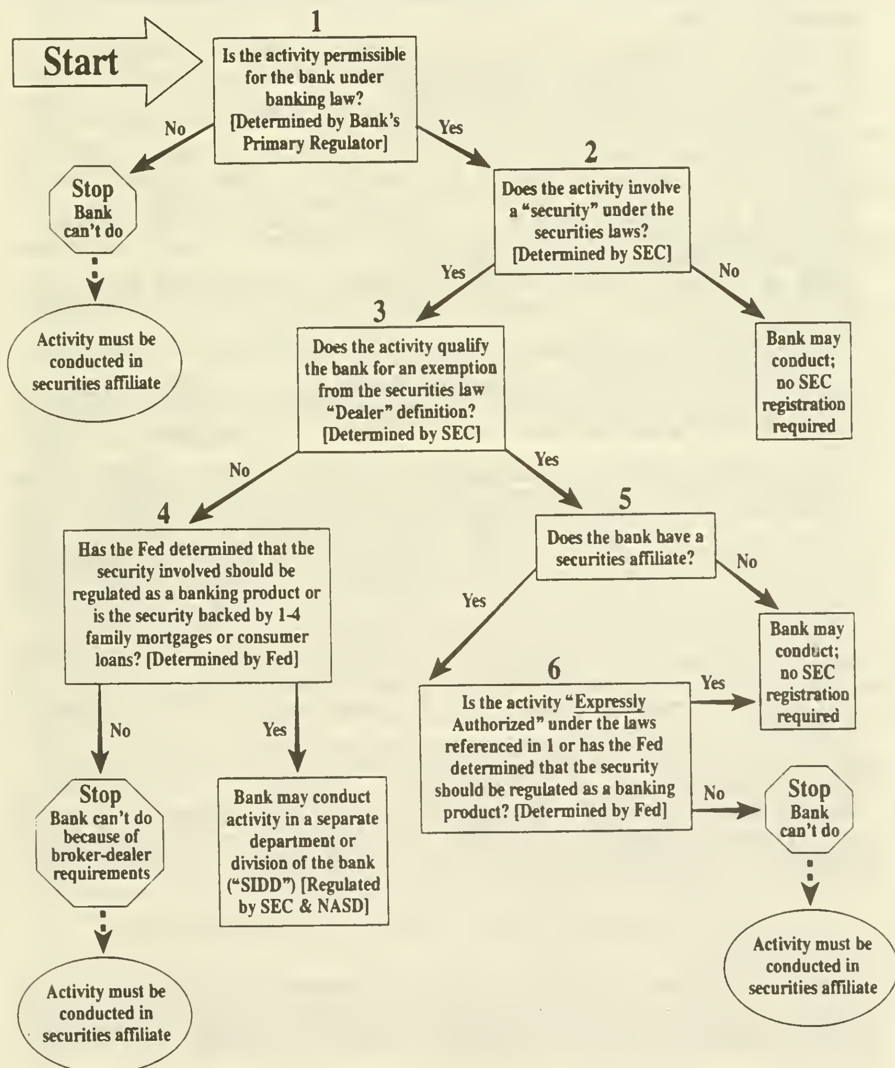
In sum, the Comptroller's Office supports reconsidering archaic and counter-productive product restrictions and removing unnecessary impediments on corporate structure. We are grateful for the opportunity to testify on these issues and once again commend your leadership in this area. However, we have serious reservations about H.R. 1062 in its current form.

The bill would impose new regulatory burdens and restructuring requirements on virtually all banks—including banks that do not undertake new securities activities. It would also restrict banks' ability to provide innovative products to meet the needs of a changing economy and evolving customer base. The bill in its current form would therefore hinder the banking system s long-term safety and soundness and limit its ability to support economic growth.

Only compelling public policy reasons can justify such a large government intrusion into the private sector. We see no such compelling reasons for many of the provisions in H.R. 1062.

ATTACHMENT #1

REGULATION OF BANK UNDERWRITING AND DEALING UNDER H.R. 1062



ATTACHMENT #2

IMPACT OF H.R. 1062

The following provides a preliminary analysis of the effects of the statutory changes made by H.R. 1062 on the currently permissible securities activities of banks. The examples illustrate how the changes in the law would affect hypothetical banks that are engaging in securities activities typical for their size. For purposes of this preliminary analysis, it is assumed that the number of the banks' securities brokerage and private placement transactions exceed the *de minimis* thresholds in the bill and that the brokerage services are publicly advertised or the bank receives incentive compensation for these services.

HYPOTHETICAL COMMUNITY BANK

Current Activities

Securities Brokerage. Sales of Shares in Unaffiliated Mutual Funds. Sales of U.S. Government Bonds and Municipal Bonds. Trust Services, Including Managed Agency Accounts and Common Trust Funds. Agency Sales of Credit Life Insurance.

Impact of H.R. 1062

Securities Brokerage: The bank must register as a broker and comply with all SEC requirements, or move its securities brokerage business to a subsidiary or separate division or department of the bank (SIDD).

The subsidiary or SIDD must register as a broker with the SEC, satisfy all applicable SEC rules, and be subject to SEC regulation.

In order for bank employees to offer brokerage services, the bank will have to enter into "networking arrangements" with its SIDD or subsidiary, subject to restrictions on the role, qualifications and compensation of bank employees.

If defined by the Federal Reserve as a nonbanking product, the bank cannot express any opinion about the product unless new disclosures are made and the customer acknowledges receiving these disclosures.

Sales of Shares in Unaffiliated Mutual Funds: This brokerage activity also must be moved to a SIDD or separate subsidiary, subject to all SEC requirements and regulations.

Additional SEC regulated disclosures must be made regarding the relationship of the mutual fund and the bank.

Sales of U.S. Government Bonds and Municipal Bonds: These sales may continue in the bank, but if the Federal Reserve considers these products to be "nonbanking products" additional disclosures and customer acknowledgements will be required.

Trust Services, Including Managed Agency Accounts and Common Trust Funds: With regard to common trust funds, the bank will have to register the fund as an investment company and the bank will be subject to SEC broker-dealer regulation unless: (i) the common trust fund is employed by the bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for a fiduciary purposes; (ii) interests in such funds are not advertised except in connection with ordinary advertising of the bank's fiduciary services; and (iii) fees and expenses charged are not in contravention of Federal and state fiduciary law.

With regard to managed agency accounts in which funds are invested in mutual funds, the bank will have to comply with standards governing sales practices, required disclosures, compensation, advertising, and training of bank personnel.

Additional SEC regulated disclosures must be made regarding the relationship of the mutual fund and the bank.

If defined by the Federal Reserve as a nonbanking product, the bank cannot express any opinion about the product unless new disclosures are made and the customer acknowledges receiving these disclosures.

Agency Sales of Credit Life Insurance: The Federal Reserve will prescribe new disclosure requirements in connection with the sale of credit life insurance if deemed to be a "nonbanking product" by the Federal Reserve. Customers must acknowledge receipt of these disclosures.

HYPOTHETICAL REGIONAL BANK WITHOUT A SECTION 20 AFFILIATE

Current Activities

Securities Brokerage Through a Subsidiary. Investment Advisory Services For Investment Companies. Dealing in Government Securities and Bank Eligible Money Market Instruments. Collective Investment and Common Trust Funds. Sweep Customer Accounts to Mutual Fund. Securities Custodial and Transfer Agent Services.

Securitization of Consumer Loans and Mortgages. Sales of Annuities and Credit Life Insurance.

Impact of H.R. 1062

Securities Brokerage Through a Subsidiary: The subsidiary may continue to engage in brokerage activities.

In order for bank employees to offer brokerage services, the bank will have to enter into "networking arrangements" with its subsidiary, subject to restrictions on the role, qualifications and compensation of bank employees.

If defined by the Federal Reserve as a nonbanking product, the bank cannot express any opinion about the product unless new disclosures are made and the customer acknowledges receiving these disclosures.

Restrictions are placed on the transfer of non-public customer information between the bank and the brokerage subsidiary.

Investment Advisory Services For Investment Companies: This activity must be moved from the bank to a SIDD, subsidiary, or affiliate of the bank, or the bank itself will have to register as an investment adviser.

The investment company may not use the bank's name or a similar name.

The bank cannot lend to the investment company in contravention of SEC rules.

The investment company may not purchase securities of an issuer that has a material lending relationship with the bank in contravention of SEC rules.

The banking agencies must provide the SEC with the results of any examination or report dealing with the investment advisory services of the bank or SIDD.

Dealing in Government Securities and Bank Eligible Money Market Instruments: The bank may continue to engage in these activities. If the Government or municipal securities are considered to be "nonbanking products" by the Federal Reserve, new disclosure requirements will apply before these securities may be sold to customers, and must be acknowledged.

After consultation with the SEC, the banking regulator may require the bank to submit information necessary to justify and monitor its exception from the securities laws. Reported information must be shared with the SEC upon request.

Collective Investment and Common Trust Funds: The bank must register the funds as investment companies under the Investment Company Act, and the bank will be subject to SEC broker-dealer regulation unless: (i) the fund is used by the bank only as an aid to its administration of trust accounts, (ii) the fund is not advertised or offered for sale to the general public except in connection with the ordinary advertising of the bank's fiduciary services, and (iii) the fees and expenses charged by the fund are not in contravention with fiduciary principles established under Federal or State law.

If the collective investment or common trust fund activities are deemed the sale of a nonbanking product by the Federal Reserve, the bank must make Federal Reserve regulated disclosures to the customer and obtain the customer's written acknowledgement that the disclosures were received.

Sweep Customer Accounts to Mutual Fund: If part of a program to invest bank deposits in a registered money market fund, the bank may continue to engage in these activities. Otherwise, it would be required to move the activities into an SEC regulated SIDD.

If the money market fund investment is deemed the sale of a nonbanking product by the Federal Reserve, the bank must make Federal Reserve regulated disclosures to the customer and obtain the customer's written acknowledgement that the disclosures were received.

The bank must comply with SEC regulated and enforced disclosure requirements governing sales of securities issued by registered investment companies.

The bank will be subject to the new joint regulations that must be issued by the banking agencies, in consultation with the SEC, governing sales practices, disclosures, advertising, and compensation and training of bank personnel engaged in the buying and selling of securities issued by an investment company.

After consultation with the SEC, the banking regulator may require the bank to submit information necessary to justify and monitor its exception from the securities laws. Reported information must be shared with the SEC upon request.

Securities Custodial and Transfer Agent Services: The bank could continue to perform these activities in the bank without registering under the securities laws.

After consultation with the SEC, the banking regulator may require the bank to submit information necessary to justify and monitor its exception from the securities laws. Reported information must be shared with the SEC upon request.

The bank will be subject to new SEC regulatory and enforcement authority with respect to banks acting as custodians of affiliated management investment companies.

Securitization of Consumer Loans and Mortgages: This activity may remain in the bank so long as the loans being securitized are 1-4 family residential mortgages and consumer receivables.

If the bank has a securities affiliate, however, the activity must be moved to a SIDD, or subsidiary of the bank, registered with the SEC as a broker/dealer.

If the Federal Reserve determines that these securities are non-banking products, the bank will have to comply with disclosure requirements and customer acknowledgment.

After consultation with the SEC, the banking regulator may require the bank to submit information necessary to justify and monitor its exception from the securities laws. Reported information must be shared with the SEC upon request.

Sales of Annuities and Credit Life Insurance: The Federal Reserve will prescribe new disclosure requirements in connection with the sale of annuities and credit life insurance if deemed to be a "nonbanking product" by the Federal Reserve. Customers must acknowledge receipt of these disclosures.

Sales of annuities (even if they are not deemed to be securities) by a bank are subject to new joint agency regulations governing sales practices, consumer disclosure, advertising, sales personnel compensation, and personnel training requirements. Sales of variable annuities would be treated as securities brokerage.

HYPOTHETICAL REGIONAL BANK WITH SECTION 20 AFFILIATE

Current Activities

Securities Brokerage Through Subsidiary. Sweep Account Services. Custodian and Transfer Agent Services. Proprietary Mutual Funds. Collective Investment Funds. Underwriting of Bank Ineligible Municipal Revenue Bonds in Section 20 Affiliate. Underwriting of U.S. Government and Municipal General Obligations.

Impact of H.R. 1062

Securities Brokerage Through Subsidiary: The subsidiary may continue to engage in brokerage activities.

In order for bank employees to offer brokerage services, the bank will have to enter into "networking arrangements" with its subsidiary, subject to restrictions on the role, qualifications and compensation of bank employees.

If deemed a nonbanking product, the bank and its employees will have to make new disclosures, implemented by the Federal Reserve, in connection with the sale or promotion of these brokerage activities and the customer must acknowledge receiving these disclosures.

Restrictions are placed on the transfer of customer information between the bank and the brokerage subsidiary.

Sweep Account Services: If part of a program to invest bank deposits in a registered money market fund, the bank may continue to engage in this activity. Otherwise, it would be required to move the activities into an SEC regulated SIDD.

If the money market fund investment is deemed the sale of a nonbanking product by the Federal Reserve, the bank must make Federal Reserve regulated disclosures to the customer and obtain the customer's written acknowledgement that the disclosures were received.

The bank must comply with SEC regulated and enforced disclosure requirements governing sales of securities issued by the registered investment companies.

The bank will be subject to the new joint regulations that must be issued by the banking agencies, in consultation with the SEC, governing sales practices, disclosures and advertising, and training of bank personnel engaged in the buying and selling of securities issued by an investment company.

The bank would be subject to new reporting requirements (which will be available to the SEC) concerning these transactions to ensure that the bank is complying with the securities laws.

Custodian and Transfer Agent Services: A bank could continue to perform these activities in the bank without registering under the securities laws.

After consultation with the SEC, the banking regulator may require the bank to submit information necessary to justify and monitor its exception from the securities laws. Reported information must be shared with the SEC upon request.

The bank would be subject to new SEC regulatory and enforcement authority with respect to banks acting as custodians of affiliated management investment companies.

Proprietary Mutual Funds: This brokerage activity would have to be moved to a SIDD or subsidiary.

Bank investment advisory activities with regard to the proprietary label mutual fund must be moved to a SIDD or subsidiary, registered as an investment advisor.

If the fund is advised by the bank SIDD or affiliate, the fund may not have the same or similar name of the bank.

The mutual fund may not purchase securities from an issuer that has a material lending relationship with the bank in contravention of SEC rules.

New SEC rules will govern loans between the bank and the mutual fund being advised by the bank SIDD or affiliate.

Banking agencies must provide reports to the SEC relating to investment advisory activities.

Collective Investment Funds: The bank must register the funds as investment companies under the Investment Company Act, and the bank will be subject to SEC broker-dealer regulation unless: (i) the fund is used by the bank only as an aid to its administration of trust accounts, (ii) the fund is not advertised or offered for sale to the general public except in connection with the ordinary advertising of the bank's fiduciary services, and (iii) the fees and expenses charged by the fund are not in contravention with fiduciary principles established under Federal or State law.

If the collective investment fund activities are deemed the sale of a nonbanking product by the Federal Reserve, the bank must make Federal Reserve regulated disclosures to the customer and obtain the customer's written acknowledgement that the disclosures were received.

After consultation with the SEC, the banking regulator may require the bank to submit information necessary to justify and monitor its exception from the securities laws. Reported information must be shared with the SEC upon request.

Underwriting of Municipal Revenue Bonds: May be conducted by the bank.

Underwriting of U.S. Government and Municipal General Obligations in Section 20 Affiliate: May be conducted in the bank.

HYPOTHETICAL MONEY CENTER BANK WITH SECTION 20 AFFILIATE

Current Activities

Securities Brokerage. Variable Annuities. Proprietary Mutual Funds. Underwriting and Dealing in Government and Other Eligible Securities, Including Acting As a Primary Dealer, in a Section 20 Affiliate. Underwriting and Dealing in Ineligible Securities in the U.S. Through a Section 20 Affiliate. Derivative and Hedge Instruments, Including Options and Swaps. Sweep Accounts Services. Deposit Accounts Linked to a securities or Commodity Index. Custodian, Transfer Agent and Clearing Agent Services. Collective Investment Funds Offered to Fiduciary Customers, Including Collective IRA Funds. Serving as Investment Adviser. Securitization of Consumer Obligations. Private Placements. Riskless Principal Transactions. Commercial Paper Programs. Agency Sales of Credit Life Insurance.

Impact of H.R. 1062

Securities Brokerage: Bank subsidiary may continue this activity (it is already a registered broker-dealer).

In order for bank employees to offer brokerage services, the bank will have to enter into "networking arrangements" with its SIDD or subsidiary, subject to restrictions on the role, qualifications and compensation of bank employees.

The bank and its employees will have to make new disclosures, implemented by the Federal Reserve, in connection with the sale or promotion of these brokerage activities. The customer must acknowledge receiving these disclosures.

Restrictions are placed on the transfer of customer information between the bank and the brokerage subsidiary.

Variable Annuities: This would be considered a securities brokerage activity that would have to be moved to a SIDD or subsidiary. If considered to be a nonbanking product by the Federal Reserve, disclosures relating to such products would have to be made.

Proprietary Mutual Funds: New SEC disclosure requirements, as well as Federal Reserve disclosure requirements for nonbanking products, may apply to brokerage of and investing fiduciary accounts in funds.

Underwriting and Dealing in Government and other Eligible Securities In a Section 20 Affiliate: Most activity could be returned to the bank, but some derivative instruments that are securities will not be permitted in the bank.

If the Government or municipal securities are considered to be "nonbanking products" by the Federal Reserve, new disclosure requirements will apply before these securities may be sold to customers.

Underwriting and Dealing in Ineligible Securities in the U.S. Through a Section 20 Affiliate: A subsidiary of a bank holding company that the Federal Re-

serve approves as a securities affiliate may continue these activities under safeguards and if affiliated banks are generally well-capitalized and well-managed.

Derivative and Hedge Instruments, Including Options and Swaps: To broker the many options that are considered to be securities by the SEC, a bank will be required to establish a SIDD or subsidiary. To deal in these options, the bank will be required to register as a broker-dealer.

A bank with a securities affiliate will be prohibited from dealing in any options that are not "expressly authorized" securities in 12 U.S.C. §24(Seventh), unless the Federal Reserve deems the options to be traditional bank products.

The Federal Reserve may regulate disclosures if it deems these products to be nonbanking products.

A bank should be able to continue its swap activities, unless the SEC determines that the instruments are securities.

Sweep Accounts: If part of a program to invest bank deposits in a registered money market fund, the bank would not be required to register as a "broker" or move these activities out of the bank. Otherwise, it would be required to move the activities into an SEC regulated SIDD or subsidiary.

If the money market fund investment is deemed the sale of a nonbanking product by the Federal Reserve, the bank must make Fed regulated disclosures to the customer and obtain the customer's written acknowledgement that the disclosures were received.

The bank must comply with SEC regulated and enforced disclosure requirements governing sales of securities issued by the registered investment companies.

The bank will be subject to the new joint regulations that must be issued by the banking agencies, in consultation with the SEC, governing sales practices, disclosures and advertising, and training of bank personnel engaged in the buying and selling of securities issued by an investment company.

The bank would be subject to new reporting requirements (which will be available to the SEC) concerning these transactions to ensure that the bank is complying with the securities laws.

Deposit Accounts Linked to a Securities Index: A bank will be able to continue to offer these products, unless the SEC determines that they are securities.

Custodian, Transfer Agent and Clearing Agent Services: A bank could continue to perform these activities in the bank without registering under the securities laws.

After consultation with the SEC, the banking regulator may require the bank to submit information necessary to justify and monitor its exception from the securities laws. Reported information must be shared with the SEC upon request.

The bank would be subject to new SEC regulatory and enforcement authority with respect to banks acting as custodians of affiliated management investment companies.

Collective Investment Funds Offered to Fiduciary Customers, Including Collective IRA Funds: The bank must register the collective investment funds as investment companies under the Investment Company Act, and the bank will be subject to SEC broker-dealer regulation unless: (1) the fund is used by the bank only as an aid to its administration of trust accounts, (2) the fund is not advertised or offered for sale to the general public except in connection with the ordinary advertising of the bank's fiduciary services, and (3) the fees and expenses charged by the fund are not in contravention with fiduciary principles established under Federal or State law.

If the collective investment fund activities are deemed the sale of a nonbanking product by the Federal Reserve, the bank must make Federal Reserve regulated disclosures to the customer and obtain the customer's written acknowledgement that the disclosures were received.

Serving as Investment Adviser: Investment adviser activities must be moved to a SIDD or subsidiary, registered as an investment adviser.

An investment company advised by the SIDD or by a bank affiliate may not have a name similar to the bank's name.

The investment company may not purchase shares from an issuer that has a material lending relationship with the bank.

New SEC regulations will govern the manner in which banks may serve as custodians of investment companies advised by the bank SIDD or subsidiary.

New SEC rules to govern loans between the bank and investment company being advised by the bank SIDD or subsidiary.

Banking agencies must provide examination reports to the SEC with respect to investment advisory activities.

If the bank has a controlling interest in the advised investment company in a fiduciary capacity, the voting rights must be transferred to an independent third party.

Securitization of Consumer Obligations: This activity may remain in the bank so long as the loans being securitized are 1-4 family residential mortgages or consumer receivables.

If the bank has a securities affiliate, the activity must be moved to a SIDD, or subsidiary of the bank, registered with the SEC as a broker/dealer.

If the Federal Reserve determines that these securities are non-banking products, the bank will have to comply with disclosure requirements before it can state an opinion on the advisability of purchasing the security.

After consultation with the SEC, the banking regulator may require the bank to submit information necessary to justify and monitor its exception from the SEC Act. Reported information must be shared with the SEC upon request.

Private Placements: The bank would have to register as a broker or would have to move its private placement activities to a SIDD or subsidiary.

Riskless Principal Transactions: The bank must register as a broker-dealer with the SEC, unless the Federal Reserve determines that the activity is a traditional banking product. In that event, the bank could move the activity to a SIDD in order to avoid registering the entire bank.

If these securities transactions are considered "nonbanking products" by the Federal Reserve, new Federal Reserve disclosure requirements will apply.

Commercial Paper: The bank may continue to place commercial paper, provided it does not offer the credit enhancements that are frequently required in this market.

If the bank moves the activity to a securities affiliate, the affiliate will be allowed to underwrite commercial paper, but the safeguards restrict the bank from providing enhancements unless the bank is a well-capitalized bank affiliate.

The activity may be subject to Federal Reserve disclosure requirements if the Federal Reserve deems it a "nonbanking product."

Agency Sales of Credit Life Insurance: The Federal Reserve will prescribe new disclosure requirements in connection with the sale of credit life insurance and any other product deemed to be a "nonbanking product" by the Federal Reserve. Customers must acknowledge receipt of these disclosures.

HYPOTHETICAL FOREIGN BANK OPERATING AN UNINSURED BRANCH AND SECTION 20 AFFILIATE IN THE U.S.

Current Activities in Uninsured Branch

Trust Services, Including Managed Agency Accounts. Trading in Foreign Exchange, Money Market Instruments, Precious Metals. Derivatives Activities, Including Swaps and Trading in Foreign Exchange and Other Options.

Impact of H.R. 1062

Securities Broker-Dealer Activities: Because foreign banks generally are not "banks" for purposes of the securities laws, the repeal of the broker-dealer statutory exemption for U.S. banks in the securities laws would not affect foreign banks. It is not known what changes the SEC would make in its regulations exempting foreign banks engaged in certain activities from registration requirements under the U.S. securities laws to conform with the repeal of the exemption for U.S. banks.

Section 20 Affiliate: The foreign bank would not be required to establish a U.S. bank holding company to operate a securities affiliate in the U.S. and most of the firewalls restricting transactions between the uninsured branch and the securities affiliate may not be applicable.

Mr. FIELDS. Thank you very much.

Chairman Ricki Helfer, Federal Deposit Insurance Corporation.

STATEMENT OF RICKI HELFER

Ms. HELFER. Thank you very much, Mr. Chairman.

I welcome this opportunity to testify on structural reform of our financial system and on H.R. 1062, the Financial Services Competitiveness Act of 1995. Structural reform is of great importance to the future of our financial system.

I commend you, Chairman Fields and Chairman Oxley, for your leadership in giving structural reform the priority that it deserves.

I would like to submit my written statement for the record and, in the next few minutes, I will summarize three important points.

Point one, the Federal Deposit Insurance Corporation has supported repealing Glass-Steagall restrictions on the securities activities of commercial banks since 1987, and it continues to do so. Repealing Glass-Steagall restrictions would strengthen banking organizations by allowing them to diversify their sources of income. Repeal would allow banks to serve their customers more effectively and would promote an efficient and competitive evolution of U.S. financial markets.

In making banking more competitive, repeal may also make banking safer. Large corporations meet their funding needs by issuing commercial paper, debt securities and equity securities, and by borrowing from banks. Glass-Steagall restrictions prevent most banking organizations from providing the full range of funding options to their customers. Bank lending to large corporations has in fact been declining for decades.

There is also indirect evidence to suggest that as banks have lost their best business customers, they have turned to some extent to riskier ventures, such as construction, finance, and commercial real estate loans. Rather than making banking safer, it appears that Glass-Steagall restrictions have had the unintentional effect of making it riskier.

Securities activities encompass a range of financial risks that banks understand and have the experience and expertise to address. The marketplace has outstripped the Depression-era restrictions of the Glass-Steagall Act. These restrictions can safely be repealed because we have in place today a regulatory structure of comprehensive banking and securities regulation that did not exist in 1933.

Securities activities of banking organizations should be subject to the regulation of the Securities and Exchange Commission. As securities activity increases in the banking industry, so will the role of functional regulation and the need to coordinate the distinct regulatory approaches.

Supervision has been the keystone of the regulation of commercial banking, while disclosure and market discipline have been the key elements of securities regulation. The challenge will be to combine these approaches in a seamless fashion that permits no gaps that might threaten the insurance funds and yet avoids burdening banks with regulatory overlap. By the same token, care should be taken to confine deposit insurance protection appropriately.

Point two, the FDIC as insurer of bank and thrift deposits has special concerns regarding how these restrictions are repealed. The integrity of the deposit insurance funds requires that repeal be accompanied by adequate safeguards for insured institutions. Recent experience in the late 1980's illustrates why safeguards are necessary to protect the deposit insurance funds and the financial system when expanding lines of business for insured institutions.

Point number three, the Financial Services Competitiveness Act recognizes the need for prudential protections for insured institutions, and we believe it strikes a reasonable balance between these necessary safeguards and the risks of investment banking activities.

The time has come to move ahead. The FDIC stands ready to assist the Congress in this important effort in the weeks and months ahead.

Thank you. I look forward to responding to your questions.

[The prepared statement of Hon. Ricki Helfer follows:]

PREPARED STATEMENT OF HON. RICKI HELFER, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

INTRODUCTION

Chairman Fields, Chairman Oxley and members of the Subcommittees, I appreciate and welcome this opportunity to present the views of the Federal Deposit Insurance Corporation on the Financial Services Competitiveness Act of 1995, and related issues. I commend you for placing a high priority on the need for structural reform of our financial system.

The FDIC supports a repeal of the Glass-Steagall restrictions on the securities activities of commercial banking organizations, provided that this is accompanied by the appropriate protection to the deposit insurance funds. In the financial and regulatory environment of today, the Glass-Steagall restrictions do not serve a useful public purpose. Repeal of the restrictions would strengthen banking organizations by allowing diversification of income sources and better service to customers, and would promote an efficient and competitive evolution of U.S. financial markets.

History demonstrates, however, that expansion of the activities of banking organizations must be accompanied by adequate safeguards. The controls that exist today to protect insured institutions from the risks of related nonbanking entities have generally proven satisfactory in the normal course of business. When banking organizations have experienced severe financial stress, however, interaffiliate transactions have occurred that have resulted in material losses to the deposit insurance funds, although these have not been solely responsible for any bank failures. The FDIC has a special interest in the adequacy of safeguards to protect the deposit insurance funds. My testimony contains several specific comments in this area.

Financial markets have changed dramatically since 1933, when the Glass-Steagall Act first imposed a separation between banking and securities underwriting activities, and since 1956, when the Bank Holding Company Act further limited the activities of bank affiliates. To a greater extent than ever before, nonbanking firms now are offering financial products that were once the exclusive domain of banks. Improvements in information technology and innovations in financial markets make it possible for the best business customers of banks to have access to the capital markets directly, and, in the process, to bypass traditional financial intermediaries.

Large corporations meet their funding needs through the issue of commercial paper, debt securities, equity and through loans. The Glass-Steagall restrictions prevent most banking organizations from providing the full range of funding options to their customers. The shrinking role of banks in lending to business is illustrated by the declining proportion that bank loans represent of the liabilities of nonfinancial corporations. This share declined from about 22 percent in 1974 to 13.7 percent at year-end 1994, the lowest proportion since these data were first collected in the early 1950s. Similarly, it is noteworthy that banks have grown much less rapidly than other financial intermediaries during the past ten years. For example, banking assets grew at an average annual rate of 4.8 percent, compared to growth rates of 26.7 percent and 14.1 percent for mutual funds and securities firms, respectively. Attachment A shows average annual growth rates of the assets of various types of financial institutions for the past ten years.

There is indirect evidence which suggests that as banks have lost their best business customers, they have to some extent turned to riskier ventures such as construction finance and commercial real estate loans. Although the banking industry has experienced record profits recently, the wide swings in past performance indicate increased risks in the industry. In the last ten years, the banking industry achieved both its lowest annual return on assets (approximately 0.09 percent in 1987) and its highest return on assets (1.20 percent in 1993) since the implementation of deposit insurance. As discussed in Attachment B, the volatile swings in the health and performance of the industry may result in part from constraints that limit alternatives for generating profits. Restrictions that resulted in the loss of many of their best corporate loan customers, combined with the need to maintain profit margins and keep market share, led many banks to increase their concentrations in alternative high-yield assets. Some of these investments, such as construction and real estate development loans, loans to developing-country borrowers and

loans to finance highly leveraged commercial transactions, carried higher, sometimes unfamiliar, credit risks. Other investments, including longer-term fixed-rate securities and home mortgage loans, as well as securities derivatives, increased the interest-rate risk of banks.

Some might ask whether we are forgetting the lessons of an earlier time—the 1920s and 1930s. Congress imposed the restrictions of Glass-Steagall in reaction to the abuses of bank securities affiliates and the perception that the abuses contributed substantially to the banking crisis of the 1930s. Attachment C to my testimony describes the historical evidence on this subject. The evidence generally suggests that the concerns that bank securities activities played a major causal role in the banking crisis were overblown, and that remedies other than the Glass-Steagall restrictions would have addressed the abuses more effectively.

When the historical debate is finished, however, we come to this: we have in place today a regulatory structure of comprehensive banking and securities regulation that did not exist in 1933, including restrictions on interaffiliate transactions. Moreover, the marketplace has moved well beyond the Glass-Steagall restrictions. Financial products, regardless of the labels, are converging. The Glass-Steagall Act stands like a dam in the middle of a mighty river that is finding other channels for its inevitable currents. On balance, I believe the risks of eliminating the Glass-Steagall prohibitions can be contained and that the benefits of an evolving marketplace outweigh the costs.

Finally, I would argue that an easing of the broad range of restrictions on activities of banking organizations beyond those that are financial in nature should proceed in a cautious, incremental manner. Banking organizations have expertise in managing financial risks. We should develop a body of experience to evaluate the safety-and-soundness implications of any new financial affiliations, before allowing broader affiliations with firms exposed to a different range of risks. Setting aside real estate development, the limited, but generally successful, experience of the affiliation of savings associations with commercial firms may provide a useful starting point for such an evaluation in the future. However, it does not provide a clear model for intermingling the more comprehensive risk profile of banking with commercial activities.

My testimony will first summarize the special concerns of the FDIC, as deposit insurer, with respect to expanded activities of bank subsidiaries and affiliates. Next, I will discuss the safeguards that are necessary to protect the deposit insurance funds and the financial system. I will then review the advantages and disadvantages of particular organizational structures with respect to the location of new securities activities. The balance of my testimony will focus on specific provisions of the Financial Services Competitiveness Act of 1995.

PERSPECTIVE OF THE DEPOSIT INSURER

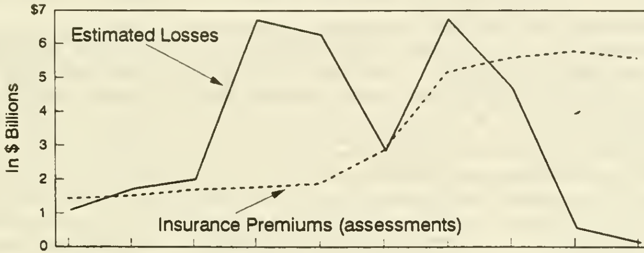
As the deposit insurer, the FDIC has a vital interest in the safety and soundness of insured institutions and the integrity of the deposit insurance funds. Events of the past decade have demonstrated how costly deposit insurance can be. The Bank Insurance Fund (BIF) and the banking industry have spent almost $33 billion to resolve failing banks in the period from 1985 to 1994 (see Figure 1). The thrift crisis, in contrast borne by the taxpayers, has been estimated to cost $150 billion.

We cannot attribute all of the insurance losses to economic events or poor management of depository institutions. A significant share of the responsibility must be assigned to poorly planned efforts to deregulate financial services and ineffective supervision in some areas. Thus, it is imperative that we proceed deliberately as we contemplate a substantial expansion of the powers available to banking organizations.

In the ten-year period ending December 1994, there were 1,368 failures of institutions insured by the BIF, accounting for almost two-thirds of the 2,121 failures that have occurred since the inception of federal deposit insurance in 1933. These failed banks had combined assets of $236 billion, and cost an estimated $32.8 billion to resolve. The number of failures reached an annual record level of 221 in 1988, while the losses and combined assets of failed banks peaked in 1991. The 13 bank failures in 1994 were the fewest since ten banks failed in 1981, and speak to the significantly improved financial condition of the banking industry.

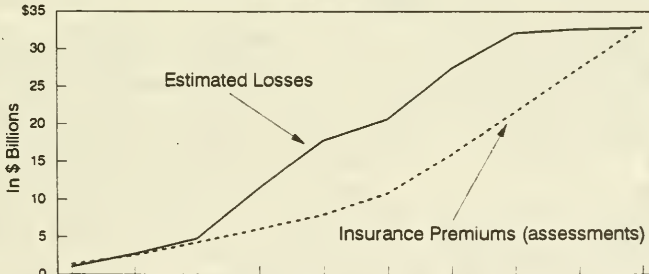
FIGURE 1

Deposit Insurance Cost - Ten Years Ending 1994
FDIC Bank Insurance Fund



(In $ Millions)	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 *
Estimated Losses	1,099	1,722	2,007	6,721	6,273	2,856	6,739	4,695	570	139
Insurance Premiums (assessments)	1,433	1,517	1,696	1,773	1,885	2,855	5,161	5,588	5,784	5,591 *

Cumulative Deposit Insurance Cost - Ten Years Ending 1994
FDIC Bank Insurance Fund



(In $ Millions)	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994 *
Estimated Losses	1,099	2,821	4,828	11,549	17,822	20,678	27,417	32,112	32,682	32,821
Insurance Premiums (assessments)	1,433	2,950	4,646	6,419	8,304	11,159	16,320	21,908	27,692	33,283 *

* The 1994 figure reflects rebates to some institutions that appealed their 1993 assessments.
Sources: 1993 FDIC Annual Report and FDIC Failed Bank Cost Analysis, 1986 - 1993.

While a number of factors contributed to the rise and decline of bank failures during this period, two elements—the phenomenon of "rolling regional recessions," coupled with constraints on geographic diversification in some regions—are reflected in the geographic patterns of failures. The agricultural Midwest, the Southwestern oil states, New England, and California all experienced sharp increases in bank failures in the past decade, stemming in large part from regional economic downturns. In general, the largest losses to the FDIC occurred in those states where regional recessions have been most severe.

The most costly failures can be linked to excessive concentrations in commercial real estate lending and construction and land development loans. Rapid accumulation of these loans preceded the rise in failures in the Southwest and Northeast, the regions where the FDIC losses were greatest. An FDIC study published in 1990 found that failing banks in Texas increased their concentrations in these assets long after the decline in local real estate markets had begun. Failed savings banks in New England also had much higher proportions of their balance sheets invested in construction and land development loans, where they had little previous experience.

There are two lessons to be drawn from these experiences. First, inadequate diversification of income sources is dangerous for banking organizations. This is an argument in favor of the repeal of the Glass-Steagall restrictions. Second, rapid growth in lending by insured institutions—particularly in unfamiliar activities—can result in significant losses. This emphasizes the need for strong supervision and monitoring by the regulators using adequate safeguards to protect insured financial institutions.

The Demise of the FSLIC

The experience of the thrift industry in the 1980s serves as an even stronger reminder of the importance of maintaining safety-and-soundness standards. The highlights of the experience bear repeating as we consider the expansion of activities of banking organizations. In the early 1980s, most of the thrift industry was economically insolvent due to interest-rate-induced losses from lending longer term at lower interest rates and borrowing short-term at higher interest rates. Rather than address the problems directly, the political and regulatory response was to relax capital and accounting standards, forbear from closing insolvent institutions, and expand the powers available to thrifts.

Federal legislation in the early 1980s significantly liberalized the permissible assets of thrifts. By 1982, thrifts could make commercial mortgage loans of up to 40 percent of assets, consumer loans up to 30 percent of assets and commercial loans and leases each up to 10 percent of assets. By midyear 1983, the Federal Home Loan Bank Board (FHLBB) allowed federally chartered savings and loan associations to invest up to 11 percent of their assets in high-risk bonds. Direct equity investments in real estate, equity securities and in subsidiary service corporations were permitted up to 3 percent of assets. Several states permitted state-chartered institutions significantly greater scope for direct investments. The attempt by many troubled institutions to use the new powers to "grow themselves out of their problems" added substantially to the cost of the thrift crisis.

Some might argue that the experience of thrifts in the 1980s is irrelevant today. I would disagree. Wherever there is a government guarantee, there will be some who attempt to exploit it inappropriately. Mechanisms must be in place to contain these risks. In addition, the supervisory staff that has been trained to detect losses from traditional activities will need to become familiar with the risks and potential losses associated with the new activities.

We also must keep in mind the extent to which a strong deposit insurance system depends on a sound regulatory structure as we eliminate the Glass-Steagall barriers. Securities activities of banking organizations should be subject to the regulation of the Securities and Exchange Commission (SEC). As securities activity increases in the banking industry, so will the role of functional regulation and the need to coordinate the distinct regulatory approaches. Supervision has been the keystone of the regulation of commercial banking, while disclosure and market discipline have been the key elements of securities regulation. The challenge will be to combine these approaches in a seamless fashion that permits no gaps that might threaten the insurance funds, and yet avoids burdening banks with regulatory overlap.

Finally, as banking organizations enter new activities, care should be taken to confine deposit insurance protection appropriately. Securities markets in the United States are dynamic and innovative; they have expanded the growth potential of the economy and have become the envy of the world. Our securities markets do not need the backing of the deposit insurance guarantee, nor do they need the added requirements of bank regulation that come with it. To promote the continued efficiency of

securities markets, as well as to protect the insurance funds from undue risk, it is critical to separate the insured entity from the securities units of the banking firm. This will be addressed more extensively in the following discussion of necessary safeguards to the insurance funds and the appropriate structure for the conduct of new activities by banking organizations.

PROTECTION FOR THE INSURANCE FUNDS

My testimony has emphasized that in expanding the securities activities of banking organizations, we must not lose sight of the need to maintain the safety and soundness of insured institutions. This requires protection against inappropriate transactions between insured institutions and their securities subsidiaries and affiliates.

In general terms, there are two areas of concern from an insurance standpoint with respect to transactions between an insured institution and a related securities firm. The first involves the inappropriate use of an insured institution to benefit a related securities firm in the course of business. A second arises when an insured institution is in danger of failure. In the latter situation, there is an incentive for the owners and creditors of the related entities to extract value from the insured entity prior to its failure in order to maximize the share of losses borne by the FDIC and minimize their own losses. The FDIC's experience suggests useful lessons regarding necessary protections for the insurance funds in both areas.

There are numerous ways an insured institution could benefit a related securities firm in the course of business. These include: direct equity injections to a securities subsidiary; upstreaming of dividends to a parent that are used to inject equity to a securities affiliate; purchasing of assets from, or extensions of credit to, the related firm; issuing a guarantee, acceptance or letter of credit for the benefit of the related firm; extending credit to finance the purchase of securities underwritten by the related firm; and extending credit to the issuers of securities underwritten by the related firm for purposes of allowing the issuers to make payments of principal, interest or dividends on the securities.

There are three main dangers in such transactions from the standpoint of the deposit insurer. First is the danger that the consolidated entity will attempt to use the resources of the insured institution to promote and support the securities firm in a way that compromises the safety and soundness of the insured institution. An equally important concern is that the business relationship between the insured entity and the securities firm will create a misperception that the investment products of the securities firm are federally insured. Finally, there is the danger that the business and operating relationship will cause the courts to "pierce the corporate veil"—that is, to hold the insured entity responsible for the debts of the securities firm in the event the securities firm fails.

Current law provides a number of safeguards against these dangers. Attachment D provides a summary of some of the major provisions. We must be concerned with how well these safeguards will work after Glass-Steagall restrictions are lifted. The experience with the involvement of banks with securities activities has to this point been limited, but generally favorable. Since 1987, the Federal Reserve has allowed limited securities activities in so-called "Section 20 subsidiaries" of bank holding companies. The Federal Reserve indicates that there have been no instances in which a Section 20 subsidiary adversely affected an affiliated bank. There are currently 36 bank holding companies that have Section 20 subsidiaries; these subsidiaries range in size from a few million dollars in assets to tens of billions of dollars in assets. There has been one failure of an insured institution affiliated with a Section 20 subsidiary. The Section 20 subsidiary played no role in causing the failure.

U.S. banks also are permitted to engage in securities activities overseas within various limitations. Typically these activities are conducted by subsidiaries of Edge Corporations, which, in turn, are generally subsidiaries of U.S. banks. Federal Reserve staff indicate that these activities have not posed any significant safety-and-soundness problems for U.S. banks.

The FDIC permits institutions it supervises to engage in securities activities through "bona fide subsidiaries"—that is, subsidiaries that meet certain criteria designed to ensure corporate separateness from the insured banks. A detailed description of the bona fide subsidiary structure and the FDIC's regulatory safeguards in place to insulate the insured institution is included in Attachment D. More limited activities are permissible to subsidiaries that do not meet the "bona fide" subsidiary test.

The experience of banking organizations conducting securities activities through such subsidiaries has been limited. Currently, only one FDIC-supervised institution owns a subsidiary actively engaged in the full range of securities activities per-

mitted by the FDIC. There are, however, over 400 insured nonmember banks that have subsidiaries engaged in more limited securities-related activities. These include management of the bank's securities portfolio, investment advisory activities, and acting as a broker/dealer. With one exception, none of these activities has given cause for a significant safety-and-soundness concern.

There has been one failure of an insured institution supervised by the FDIC that conducted securities activities through a subsidiary. While not the sole cause of the failure, the business relationship with the securities subsidiary added to the cost of the failure. The bank made a substantial unsecured loan that was used to benefit the securities subsidiary. This transaction was in compliance with the restrictions on affiliate transactions of Section 23A of the Federal Reserve Act because Section 23A does not specifically apply to transactions between a bank and its subsidiary. Given the Federal Reserve's residual rulemaking authority with respect to Sections 23A and 23B, we will work with the Federal Reserve to determine whether the provisions of Sections 23A and 23B should be extended to apply to these subsidiaries. We would also support an amendment to the legislation to assure coverage of these kinds of transactions.

The experience with bank-sponsored mutual funds has also been free of substantial safety-and-soundness concerns. Nevertheless, this experience demonstrates that the mixing of banking with securities activities is not without risk. Within the last year, 12 banking organizations have elected to provide financial assistance to their proprietary money-market mutual funds. The assistance has ranged from $1 million to about $83 million. The decisions to provide assistance presumably reflected business judgments that weighed the cost of the assistance against the loss of reputational capital that these organizations would have sustained if investors in their mutual funds had suffered losses.

None of these episodes posed any serious safety-and-soundness concerns to the insured entities. In all but two cases, the assistance was provided by the holding company rather than the bank, and in no case did the assistance exceed approximately one percent of the consolidated capital of the holding company. Nevertheless, the instances serve as a reminder that banking organizations can have an incentive to manage their businesses as a unit, and the result may involve the transfer of resources among affiliates that can adversely affect the insured entity.

The affiliation of banking and securities activities as it currently exists in both bank subsidiaries and bank affiliates has, in general, not presented significant safety-and-soundness concerns. This experience suggests that current safeguards are for the most part adequate and that any reform of Glass-Steagall should include similar safeguards against dealings between the insured bank and a securities affiliate.

Although the experience thus far has been generally positive, it has been limited. As mentioned above, we have not seen the combination of a failed or severely distressed bank that was associated with significant securities activity. This is important from the perspective of the deposit insurer because the past decade provided examples where distressed banks breached statutory or regulatory protection of the insured bank to the detriment of the FDIC.

While none of the interaffiliate transactions were solely responsible for the failure of any insured institutions, there were a number of instances where "deathbed transactions" were proposed or consummated that served to advantage the holding company or an affiliate at the expense of the insured bank. The transactions often involved sums in the tens of millions of dollars. Not all of these transactions required regulatory approval. The regulators often, but not always, denied those that did.

Unpaid tax refunds arose as an issue in more than one case. Bank holding companies generally receive tax payments from and downstream tax refunds to their banking subsidiaries, acting as agent between the bank and the Internal Revenue Service. The FDIC has observed that in some cases unpaid tax refunds accumulated on the books of failing bank subsidiaries, leaving the cash with the holding company. This practice occurred without regulatory approval.

Consolidation of nonbank activities at the parent level is another way to transfer value away from insured bank subsidiaries. One notable case involved the consolidation of trust operations at the subsidiary banks into a single parent-owned company that was later sold at a profit. When service company affiliates carry out data processing or other activities for banks, the issue of intercompany pricing also is raised. In one case the FDIC observed a large and retroactive increase in charges by an asset management company to troubled bank affiliates. In other cases, service company affiliates failed to provide promised overhead reimbursement for the use of bank premises.

Linked deals involving the sale of purchased mortgage servicing rights have in some cases been used either to subsidize the sale of a holding company asset or to

allow the bank subsidiary to book an accounting gain. The effect of a linked deal may be to either transfer value to the parent or delay the closing of a subsidiary without the benefit of needed fresh capital.

Finally, there have been instances of "poison pills" created by interaffiliate transactions. In one case, key bank staff were transferred to the holding company payroll, apparently to reduce the attractiveness of bringing in an outside acquirer. Interaffiliate data processing contracts also have been structured so as to limit the availability of information to the FDIC or an acquirer after the bank was closed, thereby making regulatory intervention more costly.

To summarize, factors other than interaffiliate transactions typically have caused the failure of FDIC-insured subsidiaries of bank holding companies. However, such transactions were used in several cases to extract value from the insured bank just prior to its failure at the expense of the deposit insurance fund. This generally did not come about through excessive dividends or the transfer of blatantly misvalued assets. They more often occurred through the pricing of services traded between affiliates, early retirement of subordinated debt and linked deals involving third parties. These transactions probably added tens of millions of dollars to the losses realized in resolving these large banking organizations.

Some of the most spectacular examples of inappropriate intercompany transactions come from the thrift industry in the 1980s. Thrifts have traditionally spawned a variety of subsidiary service corporations to perform tasks such as mortgage servicing, brokerage, title insurance and other types of insurance. With the liberalization of federal and state restrictions on direct real estate investment in the early 1980s, the real estate development subsidiary became a common vehicle for these activities. However, while federally chartered institutions in the early- to mid-1980s were limited to investing 3 percent of assets in these activities, state-chartered institutions in California and Texas could make virtually unlimited direct investments.

Two factors made this liberalization of powers particularly conducive to creating losses for the Federal Savings and Loan Insurance Corporation (FSLIC) and later the Resolution Trust Corporation (RTC). First, under regulatory accounting practices, direct investments in subsidiaries were carried on the books of the parent thrift at historical cost, instead of their market value, which was often considerably lower. Second, thrift regulators as a rule neglected to conduct detailed examinations of subsidiary operations. Under these conditions, thrift managers were free to invest in residential and commercial real estate development activities with which they had little experience, and when these projects became problematic they could use a variety of transactions to hide the losses. The thrift could make unsound loans to help sell new properties built by the subsidiary. In some cases the thrift would sell the note to the subsidiary, removing it from the balance sheet for a period.

Our review of the examples described above suggests that, for the most part, the problem has not been that the existing protections were inadequate. Instead, it appears that the regulatory community has been reluctant at times to enforce these protections. This reluctance is understandable to some extent, given the considerable uncertainties that surround banks in distress and the desire to mitigate market pressures that may unnecessarily aggravate the plight of those banking organizations that have a chance to survive.

What steps can be taken to encourage more vigilant enforcement of protections? First, the enforcement of safeguards against transactions between an insured bank and its securities affiliates should allow for few exceptions. Congress should consider whether the perspective of the FDIC as insurer would be useful in identifying, through guidelines or other means, those limited areas where exceptions to the safeguards may be beneficial without creating the potential for losses to the insurance funds. In addition or in the alternative, it may be useful to develop an interagency codification of the standards for enforcing Sections 23A and 23B of the Federal Reserve Act, so that insured financial institutions and all regulatory agencies will have clear notice and fuller understanding of the nuances of these safeguards. Second, while sound business judgment should dictate when healthy, well-capitalized banks provide support to related entities, such support should come through the transfer of excess bank capital—beyond the capital required for a well-capitalized bank—not through the relaxation of safeguards such as those discussed earlier. For bank holding companies, this means the well-capitalized bank could provide dividends that allow the parent to provide support to nonbank subsidiaries. For banks conducting activities in subsidiaries, the bank could make additional equity investments in the subsidiary and those investments should be deducted from bank capital before determining whether the insured bank meets the standard of being well-capitalized.

In addition, bank regulators may want to consider whether to require prompt reporting of intercompany transactions under certain conditions, as the SEC does in

some contexts. These requirements may be tied to the capital level of the bank, the size of the transaction, or other relevant factors.

As the deposit insurer, it is the FDIC's responsibility not only to protect depositors when a bank fails, but also to learn from the failure of that bank. The FDIC is prepared to provide information and analysis to fellow regulators where there is evidence that intercompany transactions have contributed to the failure of, or increased the cost of resolving, an insured institution. Such reports would contribute to an increased understanding and awareness of these issues, and we believe ultimately would promote improved enforcement of the safeguards.

STRUCTURAL ISSUES

An important consideration in the deliberations concerning the possible combination of traditional commercial banking and securities activities is the organizational structure under which such combinations would be permitted. The perspective of the deposit insurer focuses on two issues: the ability to insulate the insured bank from the risks of the securities underwriting activities and the burdens and inefficiencies associated with a particular regulatory structure. The following analysis addresses these issues.

There are two organizational structures with which we have experience in the United States that can be used to combine commercial and securities underwriting activities. These are: (1) the conduct of each activity in separate organizations owned and controlled by a common "parent" organization (the "bank holding company" model); and (2) the conduct of each activity in a separate organization, one of which owns and controls the other entity (the "bona fide subsidiary" model). A third model—the conduct of both activities within the same entity (the "universal banking" model)—has been used in some other developed countries. For reasons discussed in Appendix B, I believe that universal banking is not a model that would best fit the dynamic financial marketplace in the United States or provide sufficient protection for the deposit insurance funds against the effects of potential conflicts of interest between banking and nonbanking functions in an insured entity.

The Bank Holding Company Model

Since the adoption of the Bank Holding Company Act of 1956, one of the primary methods of expanding permissible activities beyond those associated with traditional commercial banking has been through formation of affiliated entities within the bank holding company umbrella. Within this framework, banking organizations have been permitted to engage in an increasing array of financial services. Most recently, some bank holding companies have been permitted by the Federal Reserve to engage in corporate securities underwriting activities through so-called "Section 20" subsidiaries. Attachment E describes in detail the prohibitions and restrictions on securities activities that are imposed by Section 20 of the Glass-Steagall Act and by the Bank Holding Company Act.

In terms of the criteria for safeguards set forth earlier, the bank holding company model has considerable merit. The advantages include:

- Provision of a good framework for monitoring transactions between insured and non-insured affiliates and for detecting transfers of value that could threaten the insured institution; and
- Maintenance of a meaningful corporate separation between insured and non-insured organizations to assure that nonbank affiliates have no competitive advantages from the insured status of the bank.

The disadvantages of the bank holding company model include:

- In distressed situations, the parent will have the incentive to transfer or divert value away from the insured bank, leaving greater losses for the FDIC if the bank ultimately fails; and
- The holding company model requires bank owners to establish and maintain an additional corporation. This may add costs, inefficiencies, complexity and, in some cases, an additional regulator.

Bona Fide Subsidiary Model

From a practical perspective, there has been less experience with the "bona fide" subsidiary form of organization than with the bank holding company form. However, the experience discussed earlier in this testimony supports the view that direct ownership of a securities firm by an insured bank need not be significantly different from the bank holding company model in terms of affording protections to the deposit insurance funds, and may have some additional advantages.

Analytically, there are several factors that make this approach different from the bank holding company model. The advantages of the bona fide subsidiary approach include:

- The residual value of the subsidiary accrues to the bank, not the holding company; and
- The bank, rather than the parent, controls the allocation of excess capital of the organization. This may mean that in making corporate investment decisions, greater weight will be given to the needs of the insured bank. Financial investments will be structured to diversify the risks of the bank's portfolio, while investment in systems and physical capital will benefit the operations of the bank.

However, on the negative side:

- While corporate separateness theoretically can be maintained regardless of organizational structure, in practice, a bank holding company structure may be a more effective vehicle for this purpose;
- Inappropriate wealth transfers may be more easily executed if made directly to a subsidiary, rather than indirectly to the parent and then to an affiliate; and
- Consolidated earnings of a bank that includes a fully consolidated securities firm may exhibit more volatility than the bank alone. This may be negatively perceived by the market, and might inhibit the ability of banks to raise capital or attract funds at market rates.

Based on these observations, it is clear that there are advantages and disadvantages to both models. Furthermore, the safeguards that are necessary to protect the insured bank and ultimately the insurance funds can be similar for either structure. If these safeguards are in place and enforced, either approach will work. If safeguards are inadequate or there is not a strong commitment to enforcing them, the deposit insurance funds, the financial system and the public will suffer, regardless of which model is used.

In the final analysis, I favor allowing financial institutions to choose the model that best suits their business needs, as long as strong safeguards are in place to protect the insurance funds. Legislation based on a progressive vision of the evolution of financial services need not mandate a particular structure. A combination of flexibility and sound regulation has contributed to the successful development of the U.S. financial system, and these key elements should be present in any proposal for reform.

COMMENTS ON THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995

I want to commend the Subcommittee Chairmen again for holding this hearing to serve as a focus for debate on how best to achieve financial services reform. The Financial Services Competitiveness Act of 1995, as reported from the Committee on Banking and Financial Services ("the bill"), is designed to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks and securities firms. It accomplishes this by eliminating current statutory restrictions on these affiliations and establishing a comprehensive framework for affiliations within a holding company structure overseen by the Federal Reserve with functional regulation of securities activities by the SEC.

As discussed earlier in my testimony, the protections against inappropriate intercompany transactions provided in the bill are sound. I would expect that any exceptions to these restrictions that could be made pursuant to the legislation would be structured to protect the deposit insurance funds from potential losses. Moreover, provided the appropriate protections are in place, I would support an approach that allows a commercial bank the flexibility to conduct securities activities in an affiliate of its holding company where the bank has a holding company or wishes to organize one, or in a subsidiary of the bank where that approach more effectively conforms to the business plan of the organization. I recognize, however, that the bill would permit additional securities activities to be conducted only under the holding company structure. While I do not believe the advantages of the bank holding company structure are so pronounced as to justify imposing additional costs on the banking system by mandating a particular structure, I support the bill as a reasonable balancing of the competing considerations of safety and soundness and additional flexibility for banking organizations.

Criteria for Approval

Turning to a more detailed discussion of the bill, any expanded authority may be exercised only through a financial services holding company structure and only

when the Federal Reserve has concluded that certain procedural safeguards have been met. The criteria outlined in the bill are sensible and appropriate.

Only financial services holding companies that are adequately capitalized are eligible to acquire a securities affiliate. For purposes of determining whether a financial services holding company is adequately capitalized, the holding company's capital and total assets are reduced by the holding company's equity investment in any securities affiliate, and further reduced by certain extensions of credit to any securities affiliate.

The lead bank within the holding company must be well-capitalized before the holding company is eligible to acquire a securities affiliate. Moreover, 80 percent of the aggregate total risk-weighted assets of the holding company's depository institutions must be controlled by well-capitalized institutions, excluding certain recently acquired depository institutions. All subsidiary depository institutions controlled by the holding company must be well-capitalized or adequately capitalized.

Well-capitalized financial services holding companies may elect alternative capital treatment, however. A financial services holding company and its depository institution subsidiaries will be deemed to have satisfied the capital requirements prescribed by the bill if the holding company files a notice of its election for alternative capital treatment with the Federal Reserve; all of the holding company's depository institutions are at least adequately capitalized; and the holding company is well-capitalized and would continue to be well-capitalized immediately after the acquisition of the securities affiliate. Any holding company that elects such alternative capital treatment will be liable for any loss incurred by the FDIC in connection with the default of any insured depository institution controlled by the holding company.

We support these provisions. I believe these provisions help to preserve a strong capital cushion for the bank and the financial services holding company as a possible source of strength for its banking subsidiaries. It is appropriate to impose losses incurred by the FDIC on holding companies that elect the alternative capital treatment described above.

The bill properly provides an incentive to financial services holding companies and their depository institutions to maintain adequate capital levels after they have been allowed to affiliate with a securities company. In the event the lead depository institution drops below the well-capitalized category, or if well-capitalized institutions cease to control 80 percent of the aggregate total risk-weighted assets of the depository institutions within the holding company, the holding company must execute an agreement with the Federal Reserve to meet the prescribed capital requirements within a reasonable period of time or to divest control of the depository institution within 180 days (or such additional period of time as the Federal Reserve may determine is reasonable). If the holding company fails to execute such an agreement or fails to comply with such an agreement, the securities affiliate cannot agree to underwrite or deal in any securities starting 180 days after the capital deterioration, with limited exceptions. While there are certainly instances where, as provided for in the bill, the securities affiliate should be barred from agreeing to underwrite or deal in any securities, such a blanket prohibition may not be prudent in all cases. For example, a profitable securities affiliate may serve as a source of strength to a holding company and its bank subsidiary.

At the same time, however, we note that the bill gives the Federal Reserve the authority to waive the capital safeguards for up to two years if the financial services holding company submits a recapitalization plan for the banks. We have an interest in assuring that a waiver will be granted only in situations where greater safety and soundness can be expected to result and losses to the insurance fund are not likely to be increased. For that reason, we want to work with the Federal Reserve on an interagency basis to develop guidelines on when waivers of these safeguards would be appropriate.

In addition to capital conditions, the bill imposes a broad array of managerial safeguards and internal controls. The holding company and all of its depository institutions must be well-managed. The financial services holding company must have the "managerial resources" necessary to conduct the securities activities safely and soundly. The holding company must have adequate policies and procedures in place to manage any potential financial or operational risks. In addition, the holding company must have established adequate policies and procedures to provide reasonable assurance of maintenance of corporate separateness within the financial services holding company. Finally, the acquisition must not adversely affect the safety and soundness of the financial services holding company or any depository institution subsidiary of the holding company. These operational safeguards, particularly the emphasis on maintaining corporate separateness, are well-designed to insulate federally insured banks from the risks of securities activities.

The bill provides that a holding company's acquisition of a securities affiliate must not result in an undue concentration of resources in the financial services business. The bill also provides that the lead depository institution subsidiary as well as the depository institutions controlling at least 80 percent of the aggregate total risk-weighted assets of all depository institutions controlled by the holding company must have achieved a satisfactory record of meeting community credit needs during the most recent examination. We support these provisions.

The bill also places several interaffiliate safeguards on the relationship between a securities firm and its affiliated bank or parent holding company. For example, a depository institution affiliated with a securities affiliate is prohibited from extending credit to the securities affiliate, issuing a guarantee, acceptance, or letter of credit for the benefit of the securities affiliate or, with certain exceptions, purchasing assets of the securities affiliate for its own account. I support these safeguards. In moving from a framework based on prohibition to one based on regulation, prudential safeguards such as those set forth in the bill will avert the hazards Glass-Steagall was intended to prevent.

In addition, the bill provides for some exceptions to the safeguards for well-capitalized banks. For example, a well-capitalized institution may extend credit for the purpose of enhancing the marketability of a securities issue underwritten by its securities affiliate but only if the depository institution has adopted limits on its exposure to any single customer whose securities are underwritten by the affiliate and the transaction is on an arm's-length basis. This appears to be a reasonable exception to the safeguards. The FDIC would like to work with the Federal Reserve to assure that in practice, any additional exceptions to the safeguards will not present substantial risks to the deposit insurance funds.

Some may argue that the safeguards provided for in this bill would hamper the ability of a financial services holding company to compete against non-regulated entities and would impede its ability to realize business synergies. The potential for risks associated with the conduct of such activities by an entity affiliated with insured depository institutions, however, carries with it the need for some protections for the insured institution. The bill draws an appropriate balance between these competing considerations.

I also support the additional safeguards for director and senior executive officer interlocks. Finally, I support the various public disclosures included in the bill. In particular, I strongly support the requirement that customers be informed that the securities offered or sold by securities affiliates of insured banks are not federally insured deposits. This is an important protection for these customers and for the deposit insurance funds.

Existing Bank Securities Activities

The bill provides that, subject to discretionary determinations by the SEC or the Federal Reserve, banks could continue to conduct some existing securities activities within the bank. Some of these activities must be moved to a Separately Identifiable Department (SID) and some activities must be moved to an affiliate—both of which would be functionally regulated by the SEC.

While there is no separate capital requirement for SIDs, the risk associated with the activities conducted through the SID is included currently in the assessment of the bank's overall capital adequacy. In addition, bank regulators are in the process of developing a proposed amendment to more formally incorporate market risks associated with underwriting and dealing activities into their capital adequacy requirements.

Concerns have been raised about the provisions of the bill that provide for discretionary determinations of the SEC and the Federal Reserve with respect to what is a security or a bank product and where such activities can be conducted. Such determinations could result in limitations or unnecessary regulatory burdens on activities that have been conducted within the bank for many years without posing significant safety-and-soundness problems. We believe that there may be some room for further refinement of these provisions in order to avoid unnecessary organizational or regulatory burdens.

Functional Regulation

With respect to regulation, the bill calls upon the banking agencies and the SEC to work together to ensure compliance with the securities laws. As I mentioned earlier in my statement, functional and supervisory regulation must be seamless to be effective. By calling for the banking agencies and the SEC to share information, the bill promotes this goal by facilitating coordination among the regulatory agencies. Further refinement may need to be made to the provisions of the bill with respect

to SEC and Federal Reserve discretion in order to avoid the possibility of duplicative supervisory and reporting burdens.

Securities Firms

The bill creates the possibility for securities firms to become affiliated with banks by acquiring an insured bank and becoming a financial services holding company. In circumstances where more than 50 percent of a company's business involves securities activities, the bill allows the company five years, with the possibility of an additional five-year extension, to divest its nonfinancial activities. In addition, such a company could be permitted to continue holding any subsidiaries engaged in financial activities that the Federal Reserve has not authorized if the company acquired the subsidiaries more than two years prior to its becoming a financial services holding company and the aggregate investment by the company in these subsidiaries does not exceed 10 percent of the total consolidated capital and surplus of the company. The company would not be permitted to engage in any new activities not otherwise authorized by the bill once it becomes a financial services holding company. This means that some securities companies that become financial services holding companies could be permitted to engage in activities not otherwise permitted generally to financial services holding companies.

I support in general the approach of the bill with respect to the affiliation of a securities firm with an insured institution. If it is understood that prudential restrictions may be imposed by the Federal Reserve where necessary to protect the safety or soundness of an insured institution with respect to a grandfathered affiliate's activities, I see no reason to go further and require divestiture. Further, it should be clear that each of the banking agencies should be able to apply the full panoply of enforcement powers, ranging from cease-and-desist actions to deposit insurance termination, in order to protect an insured bank and the deposit insurance funds.

Wholesale Financial Institutions

The bill provides the additional option of an "investment bank holding company" (IBHC) that would be allowed to engage in a broader range of financial activities and could conduct banking activities through a "wholesale financial institution" (WFI). WFIs would be uninsured state member banks that could, with certain exceptions, only take initial deposits over $100,000. This provision allows for a wholesale banking operation to conduct a broader range of financial services activities without exposing the deposit insurance funds to the risks of these activities.

The IBHC concept may prove attractive to some financial firms and may even cause some FDIC-insured banks to consider terminating their deposit insurance. The proposed IBHC appears to the FDIC to be sound as long as there is clear disclosure to the public of the uninsured nature of commercial bank operations and the exceptions for initial deposits of $100,000 or less are appropriately limited and clearly defined for public disclosure purposes.

Holding Company Supervision

The bill provides a different supervisory structure for holding companies engaged primarily in nonbanking activities. Certain financial services holding companies and investment bank holding companies, that have relatively smaller percentages of consolidated risk-weighted assets in depository institution assets, would be under limited reporting and examination requirements and minimal approval requirements for new activities. As insurer, the FDIC finds this approach reasonable, and adequate, to provide for the identification of risks associated with nonbanking activities. Capital requirements and guarantee provisions protect the insured depository institutions and maintain a degree of supervision that while appropriate, does not unduly disadvantage financial services holding companies or investment bank holding companies with respect to unregulated entities.

Voluntary Termination of Insured Status

In order to facilitate transition by existing insured depository institutions to WFI status, the bill adds a new section governing voluntary termination of deposit insurance and repeals certain provisions of the FDI Act with respect to such termination. The bill would permit an "insured State bank" or a national bank to voluntarily terminate its status as an insured depository institution upon six months' written notice to the FDIC, the Federal Reserve, and the institution's depositors. Before a bank may terminate its insurance under this provision, the deposit insurance fund must equal or exceed the fund's designated reserve ratio (DRR) of 1.25. In addition, the FDIC must confirm that the insurance fund will continue to equal or exceed the fund's DRR for the two semiannual assessment periods following notification of the institution's intent to terminate insurance. If the insurance fund does not meet its

DRR, the bank must pay an exit fee and obtain the approval of the FDIC and the Federal Reserve. The FDIC is required to prescribe procedures for assessing any such exit fee by regulation.

The FDIC currently has in place procedures governing the termination of insurance. The legislative provisions described above appear to be intended to prevent the dilution of the fund for which coverage would be terminated. However, because a termination of insurance has the effect of increasing, not decreasing, the reserve ratio of the affected fund, Congress may wish to reconsider this provision. Moreover, the requirement that the FDIC confirm that the insurance fund would not fall below the DRR for one year following notification of the intent to terminate insurance would be very difficult to satisfy. Thus, the provision could have the unintended effect of precluding the transition of insured institutions to WFI status and of preventing voluntary terminations of insured coverage where no disadvantage to the deposit insurance fund would necessarily result.

Savings associations as well as insured depository institutions excepted from the Bank Holding Company Act definition of "bank" would no longer be eligible voluntarily to terminate insured status. We believe these institutions, which are presently authorized under the law to leave the federal deposit insurance system, should continue to have that option.

The primary purpose of this provision of the bill is presumably to protect depositors when insured institutions convert to non-insured status. We agree that depositor protection must be paramount when any insured institution voluntarily relinquishes its insured status.

Under current law, an insured depository institution must obtain prior written consent of the FDIC before it may convert to non-insured status. The FDIC weighs several factors prescribed by statute in deciding whether to grant or withhold such consent. The bill does not amend or repeal these provisions; the FDIC's power to disapprove any institution's conversion from insured to non-insured status would continue without change. The voluntary termination procedures specified in the bill, however, differ somewhat from these consent requirements found elsewhere in the FDI Act. Consequently, it would be appropriate to clarify the bill to assure consistency of the various termination provisions. The bill could in part be clarified by including a provision that the bill does not override the provisions of Section 18(i) of the FDI Act.

The bill provides that a depository institution that voluntarily elects to terminate its insured status shall no longer receive insurance of any of its deposits after the specified transition period. It also should be made clear that this provision is not intended to bar a formerly insured institution from reapplying for federal deposit insurance.

Under the bill, any institution that voluntarily terminates its status as an insured depository institution is prohibited from accepting deposits unless the institution becomes a WFI. If the institution becomes a WFI, it may not accept any initial deposit that is $100,000 or less other than on an incidental and occasional basis. These prohibitions limit the flexibility non-insured institutions now have under federal law. It is not clear why the law should compel institutions that have voluntarily terminated insurance to obtain WFI status so that they can accept deposits where state law permits other kinds of uninsured entities. The flexibility non-insured institutions enjoy under current federal and state laws should not be diminished without good cause. The bill can be improved by clarifying the termination provisions along the lines I have outlined. The FDIC will be pleased to work with members of Congress in making reasonable modifications to these provisions to avoid unintended consequences.

In conclusion, on balance the bill represents a thoughtful approach to easing the restrictions between commercial and investment banking. It provides for prudential safeguards and appropriate restrictions designed to insulate insured institutions from the risks inherent in investment banking activities. It is an important foundation for considering the most effective and efficient approach by which appropriate financial services reform can be achieved.

CONCLUSIONS

The restrictions of the Glass-Steagall Act do not serve a useful purpose. Their repeal would strengthen banking organizations by helping them to diversify their income sources, and would promote the efficient, competitive evolution of financial markets in the United States. History demonstrates, however, that a significant expansion of the powers available to insured institutions must be accompanied by appropriate safeguards for the insurance funds. Chairman Leach and other members

of the House Committee on Banking and Financial Services have recognized the need for such safeguards in the bill.

Existing experience with the combination of banks and securities firms suggests that, in general, current safeguards have been adequate to prevent significant safety-and-soundness concerns in the normal course of business. This experience has been limited, however; in particular, we have not seen a severely distressed banking organization that had significant securities activities.

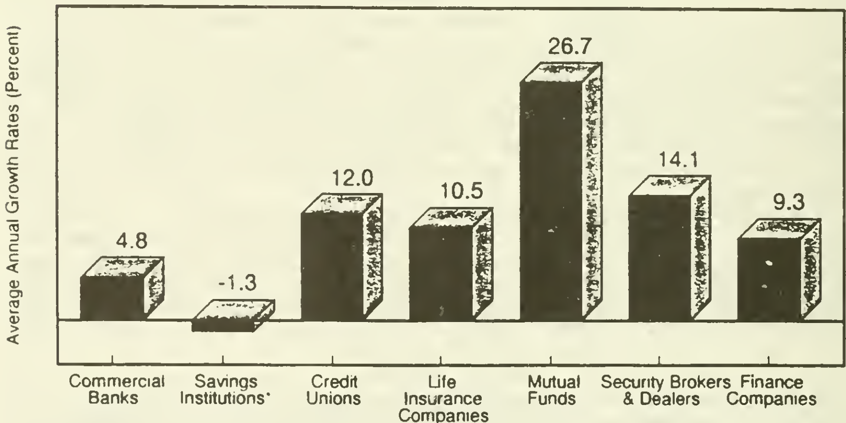
The experience of the FDIC has been that in times of financial stress, banking organizations may attempt to engage in transactions that transfer resources from the insured entity to the owners and creditors of the parent company or nonbanking affiliates. In some cases the FDIC has suffered material loss as a result of such transactions. We seek to assure that reform of Glass-Steagall is not the vehicle for more such episodes.

My general comments on the safeguards against inappropriate intercompany transactions in the proposed bill are as follows. First, exceptions to the safeguards should be allowed only after taking account of potential losses to the insurance funds. While there should be room for supervisory discretion and the exercise of good business judgment in determining whether a healthy bank may support an affiliate, such support should be provided through transfers of excess capital—beyond that required for a well-capitalized bank—not through relaxations of restrictions on intercompany transactions. Second, it could be useful to develop an interagency codification of the standards for enforcing Sections 23A and 23B of the Federal Reserve Act. To promote improved enforcement of the safeguards, the FDIC is prepared to provide information and analysis to fellow regulators on instances where intercompany transactions contributed to the failure of, or increased the cost of resolving, an insured institution.

There are two United States models for conducting the new securities activities within banking organizations—the holding company model and the bona fide subsidiary model. There are advantages and disadvantages both to housing the securities activities in bank subsidiaries, and to housing the activities in holding company affiliates. On balance, I do not believe the case for either approach is strong enough to warrant dictating to banks which approach they must choose.

In general, I believe that banks should be able to chose the corporate structure that is most efficient for them, provided adequate safeguards are in place to protect insured financial institutions and the insurance funds. H.R. 1062 is a sound and constructive approach to evaluating how best to reform our financial system. The FDIC stands ready to assist the Subcommittees with this important effort.

ATTACHMENT A



* FDIC-Insured Savings Institutions, Includes savings banks, savings associations snd S&Ls.
Source: Flow of Funds, Federal Reserve System; FDIC Research Information System; National Credit Union Administration.

Asset growth rates are expressed as annual average for the 10-year period 12/31/84 to 12/31/94, adjusted for compounding.

ATTACHMENT B

THE CHANGING FINANCIAL MARKETPLACE

Banking was a simpler business in the early decades of the Federal Deposit Insurance Corporation. Interest rates were regulated and stable. Competition from nonbanking companies was limited. Banks were the primary source of borrowed funds for even the strongest, best-established businesses. In more recent years, the financial services industry, technology and capital markets have evolved, creating new risks and new opportunities. Bankers have had to manage the risks, but the Glass-Steagall Act and other legislation limit the ability of bankers to mitigate risk by diversifying their sources of income.

Credit-risk exposure has increased dramatically since enactment of the Glass-Steagall Act. In 1935, approximately one-third of the industry's balance sheet was concentrated in assets that bear significant credit risk. Now, over 60 percent of banking assets are exposed to credit risk.

Beginning in the mid-1960s and lasting through the mid-1980s, the industry experienced rapid asset growth, typically exceeding ten percent per year. In that 20-year span, the assets of the industry increased nearly tenfold, from $345 billion to almost $3 trillion. This growth was achieved by increasing credit risk and decreasing the proportion of lower risk investments. During this period, commercial banks built up large portfolios of loans with concentrated credit risk including loans with large balances at risk to a single borrower.[1]

In 1935, about one-quarter of the balance sheet was invested in loans with "credit-risk concentrations." That level increased to almost 45 percent in 1984 (prior to the wave of recent bank failures), and has declined to 34 percent as of December 1994. Until the early 1980s, asset growth was fueled by commercial and industrial ("C&I") loans. C&I loan concentrations reached their highest level in 1982, peaking at nearly 25 percent of the industry's balance sheet. There were some notable lending excesses during these boom years, including real estate investment trusts, less-developed-country loans, and energy credits.

In the early 1980s, the largest commercial borrowers learned to bypass banks and replace loans from banks with lower-cost commercial paper. Burgeoning loan demand from energy-related businesses supported continued C&I loan growth for a time, but by December 1994, C&I loans had declined to 15.4 percent of the industry's total assets.

When C&I loans began to decline, many banks turned to commercial real estate loans and construction loans for new—but high risk—profit opportunities. In the mid- to late-1980s, growing concentrations in commercial real estate loans and construction loans offset shrinkage in C&I loans. In 1976, commercial real estate loans and construction loans together comprised about five percent of the balance sheet. In ten years, the concentration increased to nearly nine percent of assets. It reached its highest level—11 percent—in 1990. Banks were not the only providers of these loans. Savings and loan associations and other nonbank lenders also financed the speculative real estate development. Consequently, real estate markets in many regions became overbuilt, credit losses soared and commercial real estate loan demand diminished.

Loan growth since 1990 has been concentrated in loans where credit risk is more diversified. Credit card, consumer and home mortgage loans extend relatively small and often collateralized balances to a relatively large number of borrowers. Failure of a single borrower to repay does not have a significant impact on a bank's earnings or capital. Most of the growth in "credit-risk-diversified" loans has come from home mortgages. Concentrations in home mortgage loans have nearly doubled since 1984, increasing from 7.7 percent of the industry's balance sheet to nearly 15 percent as of year-end 1994. Credit card loans constitute 4.9 percent of assets and other "consumer" loans constitute 7.8 percent.

Beginning in 1990, the industry's risk profile began to change direction. Banks were able to take advantage of a widening difference between shorter- and longer-term interest rates to improve earnings while reducing credit risk. They shortened the average maturity of their liabilities and increased their concentrations of fixed-rate securities and residential mortgages. In effect, the industry replaced some of its credit risk with higher levels of interest-rate risk. The industry's asset composi-

[1] Credit-risk-concentrated loans include commercial and industrial loans, commercial real estate and construction loans, and loans secured by multifamily residential properties.

tion has changed since the deregulation of deposit interest rates. In the early 1990s, the growth of investment securities held by banks—primarily mortgage-backed instruments and U.S. Treasury securities—accelerated. Market conditions also favored the growth of home mortgages, which have more than doubled since 1986, increasing from $223 billion at year-end 1986 to $568.9 billion as of December 31, 1994. While about 46 percent of these loans in the portfolios of banks carry adjustable rates, there is still interest-rate exposure, due to repricing lags, as well as caps that limit the amount by which the interest rates on the loans can increase.

In recent years, increased market volatility has made it more important for banks to manage risks other than credit risk, such as interest-rate risk, prepayment risk, and foreign-exchange risk. Banks have responded to this challenge by devoting considerable resources to asset-liability management and other risk management systems.

The tools for managing these risks have expanded considerably over the past decade, particularly with the increasing use of off-balance-sheet instruments such as swaps, options, and forward contracts. While smaller banks for the most part still use on-balance-sheet instruments to manage risk, these off-balance-sheet instruments have become an integral part of risk management for most large banks.

Banks are not only end users of these swaps, options, and forwards. Several large banks are major dealers of over-the-counter instruments. This activity has provided an important source of revenue and allowed these banks to respond to the needs of their customers. Nevertheless, a series of recent losses has raised concerns about the potential risks of these investments.

Record bank failures in the 1980s and early 1990s were quickly replaced with record earnings as the economy improved in a very favorable interest-rate environment. In the last ten years, the industry achieved both its lowest annual return on assets (about 0.09 percent in 1987) and its highest return on assets (1.20 percent in 1993) since the implementation of deposit insurance in 1933. Declining loan losses account for the wide swing in earnings. Declining loan-loss provisions have added roughly 25 basis points (pre-tax) to the industry's return on assets in 1992 and 1993, and 18 basis points in 1994. Interest margins have improved steadily since 1934, but these improvements have had relatively little impact compared with the reduced burden of loan-loss provisions. Ten-year growth in noninterest income has outstripped noninterest expense growth by a narrow margin, providing a relatively small boost to the industry's bottom line.

Bankers were not able to obtain expanded powers when the industry was in trouble, as in the late 1980s, owing to concerns about adding new potential risks to an industry struggling with existing risks. Now, opponents may argue that expanded powers are not needed, given the record profits the industry has reported for the last three years. Volatile swings in the health and performance of the industry may result in part from constraints that limit alternatives for generating profits. The data show that credit risk, interest-rate risk and competition have all increased since the enactment of Glass-Steagall. While the earnings trend recently has been positive, the wide swings in past performance indicate heightened uncertainty and increased risks in the industry.

International Developments

Global competitive pressures also present a compelling need to reconsider the Glass-Steagall prohibitions between investment and commercial banking. Domestic financial deregulation in major industrialized nations, the development of new financial instruments, and advances in communication and computer technologies have contributed to the rapid integration of international financial markets during the past two decades. These changes in the financial marketplace, both domestic and international, have led several major industrialized nations to change their laws governing financial institutions, with the goal of creating a more level competitive playing field. In particular, there has been a growing worldwide trend toward easing traditional distinctions among the three major segments of the financial services industry—commercial banks, investment firms, and insurance companies.

It should be noted that commercial and investment banking have long been combined in countries with universal banking systems, such as Germany and most of western Europe. Universal banks have the authority to offer the full range of banking and financial services—including securities underwriting and brokering of both government and corporate debt and equity—within a single legal entity, the bank. Although some financial services are provided through subsidiaries, the bank or financial services holding company structure is virtually unknown in other countries.

In contrast to the universal banking structure allowed in Continental European countries, Canada, Japan and the United Kingdom traditionally maintained barriers and restrictions against combining commercial and investment banking activities.

These restrictions have been largely removed by legislation in each of these countries. For example, British banks were permitted to join the stock exchange in 1986 and to acquire or develop investment banking subsidiaries. These affiliations are important to the ability of British banks to compete within the European Union's single market.

Canada amended its laws governing financial institutions in 1987 and 1992, removing many of the statutory barriers separating banks, trust companies, insurance companies and securities firms, to allow greater latitude in bank ownership of institutions in the other financial sectors. As a result, most of the major Canadian securities firms are now owned by banks. Additionally, banks were permitted to offer more services "in-house," and to set up networking arrangements through which their branches sell the products of institutions in other sectors of the financial industry.

In 1992, Japan approved the "Financial System Reform Act," amending Japan's Securities and Exchange Law, and effectively removing the barriers between investment and commercial banking. By law since 1993, banks and securities companies have been allowed to enter each other's businesses through subsidiaries, although the establishment of securities subsidiaries by Japan's City Banks was delayed until July 1994. Additionally, the Ministry of Finance has elected to restrict the range of powers permissible for new subsidiaries of banks and securities firms. Thus, new trust banking subsidiaries are not permitted to manage pension funds and new securities subsidiaries of banks are only permitted to underwrite corporate bonds. In any event, Japan has had a moratorium on new equity offerings, with the exception of initial public offerings, since 1990.

As a result of these legislative changes in other countries, the United States stands alone among the 25 nations comprising the Organization for Economic Cooperation and Development (OECD) in continuing to impose domestic legal restrictions on affiliations between commercial banks and securities firms. Efforts to quantify the effect of these restrictions on the international competitiveness of U.S. banks are hampered by cross-border differences in accounting practices, tax laws, and other regulations governing financial institutions. Moreover, the data may be misleading due to currency fluctuations. Therefore, while we hesitate to provide any statistics regarding international competitiveness, some anecdotal evidence may be instructive.

Among the advantages of universal banking often cited are the cost savings derived from the ability to cross-sell a wider range of products and to offer highly-competitive products at a lower cost by subsidizing them with higher margins on less-competitive products. Universal banks may have a significant competitive advantage in customer loyalty through their ability to provide customers with all their financial services needs. Finally, universal banks have greater opportunities to spread risk and to smooth out income fluctuations in different areas of their business.

Not surprisingly, universal banks tend to be large and profitable institutions. The degree to which they dominate domestic market share varies according to the number, powers, and other structural characteristics of countries with universal banks. In Germany, for example, the four largest universal banks controlled less than 10 percent of total domestic bank assets in 1991; during the same year, the four largest Swiss banks controlled nearly 50 percent of domestic bank assets. These differences may be attributed to differences in their respective domestic markets: German banks directly compete with approximately 200 regional banks, over 700 government-owned savings banks, and nearly 3,000 cooperative banks, many of which are also universal banks; in Switzerland, which has only about 600 institutions, most of the regional banks are small savings banks that specialize in mortgage lending.

There are several disadvantages inherent to universal banking as well. The one most often cited is the obvious potential for conflicts of interest among different areas of business. Another disadvantage is that capital markets are not as developed in countries with universal banking. It should be noted here that universal banks typically are permitted to own fairly sizeable equity positions in nonfinancial firms.

Banking and commerce links also exist in Japan, where banks are permitted to own equity investments in up to five percent in any one company. Studies comparing the German-style universal banking system and Japan's "keiretsu" form of industrial organization with the segmented U.S. banking system have concluded that the former may provide several important economic benefits. While these banking and commerce links no doubt have contributed to the industrial growth in these countries in the postwar era, they do raise serious concerns over concentration of power.

In Japan, these concerns are addressed through limitations on equity investments and the absence of bank personnel in the day-to-day management of nonfinancial

firms. In contrast to Japan, where banks typically interfere only in cases of corporate distress, Germany not only permits banks to own shares, but also to serve on the supervisory boards of corporations and to exercise proxy rights over large blocks of shares through bank-managed portfolios. Other countries with universal banking have tended to curb bank control over industrial firms in recent years. Proposals to do so in Germany recently have been introduced as a result of the near-failure of several of Germany's nonfinancial firms.

These highly publicized cases were more of an embarrassment to Germany's major banks than a threat to their safety and soundness. These banks have been able to withstand losses due to their sheer size and strength, and to the very conservative accounting practices that allow equities to be carried at historical cost and allow banks to transfer portions of income to hidden reserves.

In fact, there are no cases in recent memory of a major bank failing in another country due to its securities activities or affiliations with commercial firms. The majority of banking problems in industrialized countries have been the result of traditional banking activities. For example, losses from foreign-exchange trading have caused isolated cases of bank failures, while real estate lending in "boom" years led to system-wide banking crises in the United Kingdom, most of the Scandinavian countries and Japan, in addition to the well-known problems encountered by U.S. banks and savings and loan institutions.

If other problems have occurred, and no doubt there have been some, they have been dealt with quietly and effectively, without recourse to deposit insurance funds. This is largely due to the differences in the supervisory structure of countries that permit such affiliations, and to differences in failure-resolution methods and the role of deposit insurance. For example, while deposit insurance coverage is roughly comparable between the United States and Japan, the private sector plays a larger role in the operation of deposit insurance in many other countries. Consequently, the direct link to the government's "full faith and credit" is less explicit than in the United States. Major banks in other countries also are called upon more often to help in "bailouts" of other banks, voluntarily or otherwise, due to a traditionally close relationship with the central bank and more highly concentrated banking systems.

Given the greater potential for conflicts of interest between insured and uninsured functions, the governmental nature of deposit insurance in the United States, and the more dynamic and diverse financial marketplace in the United States, the universal banking model does not seem to be as suited to the current U.S. environment as other Models with which the United States has experience.

ATTACHMENT C

HISTORICAL BACKGROUND

Information concerning the principal abuses that arose during the 1920s and early 1930s in connection with the investment banking activities of commercial bank affiliates is largely limited to the extensive Senate investigation into stock exchange practices, which included the highly publicized Pecora hearings. A substantial portion of these hearings, which were held in 1933 and 1934, dealt with the activities of the securities affiliates of the country's two largest commercial banks, National City Bank and Chase National Bank.

The Glass-Steagall Act, which to a certain extent was the result of these hearings, was enacted primarily for three reasons. First, Congress believed the Act would help to protect and maintain the financial stability of the commercial banking system, and would strengthen public confidence in commercial banks. Second, Congress wanted to eliminate the potential for conflicts of interest that could result from the performance of both commercial and investment banking operations. The final Congressional concern was a belief that the securities operations of banks tended to exaggerate financial and business fluctuations and undermine the economic stability of the country by channeling bank deposits into "speculative" securities activities.

The actual and potential abuses that were revealed during the Senate investigation can be categorized as follows: first, abuses that were common to the entire investment banking industry; second, abuses that may be attributed to the use of affiliates for the personal profit of bank officers and directors; and third, abuses related to conflicts of interest that resulted from the mixing of commercial and investment banking functions. The primary types of abuses relevant to each of these categories are discussed below. Analyses of the appropriate remedies for these abuses are presented, together with comments directed toward examining the degree to which the Glass-Steagall Act was an effective or desirable solution.

Abuses Common to the Investment Banking Business

The principal types of abuses common to the investment banking business during the 1920s and early 1930s included:

- underwriting and distributing unsound and speculative securities
- conveying untruthful or misleading information in the prospectuses accompanying new issues
- manipulating the market for certain stocks and bonds while they were being issued.

Examples of the first two types of abuses can be found by examining National City Company's involvement in the financial operations of the Republic of Peru. Throughout the 1920s National City Company received reports that Peru was politically unstable, had a bad debt record, suffered from a depleted Treasury and was, in short, an extremely poor credit risk. In 1927 and 1928, National City Company participated, nevertheless, in the underwriting of bond issues by the government of Peru. The prospectuses that were distributed made no mention of Peru's political and economic difficulties. As a result, the public purchased $90 million of the bonds, which went into default in 1931 and sold for less than five percent of their face value in 1933.

While the National City case may be one of the more flagrant examples of these types of abuses, it was generally acknowledged that the extremely competitive banking environment of the 1920s led bankers to encourage overborrowing, particularly by governments and political subdivisions in Europe and South America. Questionable practices were employed to induce the public to purchase the security issues that resulted from the promotional efforts of bank affiliates. In addition to falsifying or withholding pertinent information, National City Company and Chase Securities Corporation attempted, on occasion, to prop up the price of securities while the securities were being sold.

A large portion of the abuses uncovered during the Pecora hearings were common to the entire investment banking industry. Because these problems were not directly related to the relationship between banks and their affiliates, the Glass-Steagall Act was not the proper remedy for these kinds of abuses. There are several reasons why the problems just described are of less concern today. First, the Securities Act of 1933 and the Securities Exchange Act of 1934 hold individuals involved in the issuance of securities responsible for any misstatement of facts or failure to reveal pertinent information concerning the financial condition of governments and corporations issuing securities. Second, it is now the duty of the SEC to prevent any manipulation of the market while a security is being issued. Additionally, these safeguards may help deter banks from underwriting unsound and speculative securities.

Self-Dealing by Bank Officers and Directors

Bank affiliates not only attempted to manipulate the stock and bond prices of other business and governmental entities, they also attempted to manipulate the stock prices of their parent banks. The procedure generally employed was for the affiliate to organize investment pools that traded in the stock of the parent bank. While the pools were financed primarily by the affiliates, they were generally open to selected individuals, including bank officers and directors. Bank officials claimed that the purposes of such trading accounts were to steady the market in order to maintain public confidence in the bank and to encourage increased distribution of the bank's stock. However, there were other motivations for such activity.

First, it is likely that many of the participants expected to benefit from their inside information and gain large profits from their trading activity. In practice, however, these expectations were not always realized. Chase's affiliates earned only $159,000 in profit on trades in Chase National Bank stock totaling $900 million. National City Company sustained $10 million in losses from dealing in the stock of its parent bank.

A second reason may have been that by advancing the stock's price it became more attractive to the stockholders of other banks that were acquired on an exchange-of-stock basis. Chase National and National City Bank each acquired several other banks during the period when their affiliates were trading in their stock.

In addition to the profits obtained by trading in their own bank's stock, bank officers and directors often received compensation from affiliates far in excess of that paid to them by their banks. For example, instead of permitting the stock of affiliates to be owned by bank stockholders, the stock was often wholly owned by officers and directors of the bank. This "ownership" may have been illegal and was clearly improper. Because the profit opportunities of the affiliates were a direct result of their association with their parent banks, any profits they derived rightfully belonged to the bank's stockholders.

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The types of abuses just described sparked public outrage against commercial banks and their investment banking affiliates. However, the Glass-Steagall Act was not the proper remedy for such self-dealing and insider abuse. Trading accounts in the stock of parent banks by affiliates and the participation in such trading by bank officials could have been prevented by making it illegal for affiliates to deal in or own the stock of parent banks. The establishment of management funds is a problem mainly of concern to stockholders. With adequate disclosure of the salaries and bonuses distributed through such funds, stockholders can determine whether they are excessive. Affiliates owned entirely by bank officers and directors instead of by bank stockholders also could have been prohibited.

Abuses Arising From the Mixture of Commercial and Investment Banking

There were a number of abuses that occurred from the mixing of commercial and investment banking functions. Most of these relate to conflict-of-interest concerns, and while they have implications for bank safety and soundness, there is no evidence that a large number of bank failures were due to interactions between banks and their affiliates. The types of abuses revealed during Senate testimony in 1933-34 included:

- Using the affiliate as a dumping ground for bad bank loans. In an example highlighted during the Pecora hearings, National City Bank transferred to National City Company $25 million worth of loans to Cuban sugar producers after the price of sugar collapsed and the borrowers were unable to repay the loans.
- Using the bank or its trust department as a receptacle for securities the affiliate could not sell. While examples where Chase National Bank bailed out its affiliates were revealed during the Senate investigation, it appears that trust departments generally were not used for such a purpose.
- Lending to finance the purchase of securities underwritten by the affiliate. This could have been another means whereby the affiliate's problems were transferred to the bank. That is, if the affiliate found it difficult to sell a particular issue, the bank may have chosen to offer loans to prospective purchasers under conditions disadvantageous to bank stockholders.
- Excessive lending to affiliates to finance underwritings. This practice may have led to an inadequate level of bank asset diversification, the significance of which would have depended upon the quality of the underwritings.
- There was a tendency for banks to invest too much in long-term securities. This practice caused liquidity problems that contributed to a number of bank failures during the late 1920s.
- Lowering the quality of bank assets by purchasing part of a poorly performing security after it had been issued. The reason for such action would have been that the bank was concerned with its image if a security its affiliate had underwritten or distributed began to lose value.
- Lending to a corporation that would otherwise have defaulted on an issue underwritten by the bank's securities affiliate. Again, this would have occurred if a bank was concerned that its image would be severely tarnished in the event a corporation defaulted on an issue the bank's affiliate had underwritten or distributed.

The first five problems outlined above could have been controlled with fairly simple legislative remedies. For example, to prevent the use of a bank or its affiliate as the dumping ground for the other's bad assets, federal authorities could have been given, and now have, authority to conduct simultaneous examinations on a periodic basis. Lending to finance the purchase of securities underwritten by a bank's affiliate could have been prohibited. The concern that banks may lend excessive amounts to their affiliates could be handled by prohibiting such lending, by requiring that it be collateralized, or by simply placing a limit, perhaps as a percentage of bank capital, on the amount a bank may invest in any one and in all of its affiliates. However, the underlying concern in this case is that banks, by investing heavily in their affiliates, would not have a sufficiently diversified asset base. This concern can also be directly addressed by limiting overall investments in related markets or product lines. Similarly, the tendency for banks to invest too much in long-term securities could be controlled by prohibiting or limiting the number or amount of securities a bank could purchase from operating securities affiliates.

The potential for "tie-ins" also should be of concern. While it appears that investment banks can, and on occasion do, threaten to withhold certain services unless an entire "package" is purchased, the power of such a threat takes on a somewhat greater significance when it is a line of credit that might be withdrawn if an issuer does not choose a particular bank or bank affiliate as its underwriter. As with the previous two concerns it does not appear that examples of abuse were uncovered during the Pecora hearings.

The types of potential tie-ins that should be of concern to public policymakers are due either to self-dealing or to inadequate levels of competition. In neither case is a continued separation of commercial and investment banking an appropriate way to address effectively the problem. An example of the former is if a bank official tried to induce potential customers into purchasing a service (presumably, but not necessarily, at a relatively high price), in which the official had a personal interest, by tying-in and underpricing at the expense of the bank's or its affiliate's stockholders a second service in which the official's personal stake was less direct. Self-dealing of this kind can largely be prevented by other means.

In the absence of self-dealing at the expense of the benefactors of the proceeds of one of the tied-in services, the only way the tie-in threat can be effective is if the customer has no viable alternative. In competitive markets, customers would simply purchase the services elsewhere at more reasonable rates. This type of tie-in, to the extent it can occur, represents only one facet of a broader antitrust concern which is most appropriately dealt with through policies designed to foster greater competition. Since most banking markets are reasonably competitive, it is highly unlikely that investment bankers, as a group, will be at an unfair competitive advantage due to such tie-ins. Moreover, since nondepository institutions are becoming more involved in the extension of credit, it is difficult to argue that commercial banks should not be permitted to underwrite corporate securities on the grounds that such tie-ins are possible.

Conclusion

By the 1930s, the general view in Congress was that the mixing of commercial and investment banking posed a threat to the safety and soundness of the banking system, created numerous conflict-of-interest situations and led to economic instability due to the channeling of bank deposits into "speculative" securities activities. To alleviate those concerns, the Glass-Steagall Act was enacted.

From the evidence gathered during the Senate investigation into stock exchange practices it appears that, to the extent the concerns of Congress were valid, they could have been handled through less disruptive legislative means. There is little evidence that the investment banking activities of commercial bank affiliates were a major factor in causing bank failures. Where investments in securities underwritten by affiliates contributed to an institution's failure, it was generally because the bank was illiquid due to an overinvestment in long-term assets. Affiliate losses were generally due to speculative activities unrelated to investment banking.

Most of the abuses that arose during the 1920s in connection with the operation of security affiliates by commercial banks appear to have been conflict of interest concerns rather than factors threatening the safety and soundness of commercial banks. However, it appears that most of these problems could have been remedied without having to resort to a forced separation of commercial and investment banking. Certain abuses which arise from mixing commercial and investment banking cannot entirely be controlled; but, they do not appear to have been so significant as to have warranted legislation separating commercial and investment banking. Finally, the provision of the 1934 Securities Exchange Act that authorized the Federal Reserve Board to regulate the extension of credit for the purchase of securities effectively achieved the third objective of the Glass-Steagall Act, which was to control the speculative uses of bank assets in the securities markets.

In conclusion, bank affiliates were not regulated, examined, or in any way restricted in the activities they could participate in until the 1930s. As a result, abuses occurred. A certain degree of supervision and regulation and some restrictions on bank affiliate powers would have gone a long way towards eliminating the types of abuses that occurred during this period.

ATTACHMENT D

CURRENT SAFEGUARDS

Section 23A of the Federal Reserve Act restricts transactions between member banks and their affiliates, and the Federal Deposit Insurance Act extends the coverage of 23A to nonmember insured banks. Section 23A attempts to prevent the misuse of insured institutions by placing quantitative limitations on "covered transactions" between a bank and its affiliate, establishing collateral requirements for certain transactions, requiring that all transactions be on terms and conditions that are consistent with safe and sound banking, and prohibiting a bank from purchasing low-quality assets of an affiliate. "Covered transactions" include loans to an affiliate, purchases of securities issued by an affiliate, acceptance of securities issued by an

affiliate as collateral, and the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

Section 23B of the Federal Reserve Act places additional limitations on federally insured banks and their affiliates, by providing that a bank may engage in certain transactions with its affiliates only on an "arm's length" basis. In addition to the "covered transactions" of Section 23A, Section 23B applies to the sale of securities or other assets to an affiliate, to service contracts between the bank and its affiliate, and to transactions with a third party where the affiliate has a financial interest in the third party.

The Federal Reserve Board has established prudential limitations on the activities of the "Section 20 companies" of bank holding companies (BHCs) that underwrite and deal in debt and equity securities to a limited extent. Among other things, in determining capital compliance, BHCs must deduct from consolidated primary capital any investment in an underwriting subsidiary, or any extension of credit that does not meet certain collateral requirements. BHCs and their subsidiaries are prohibited from: entering into any financial arrangement that might be viewed as enhancing the marketability of a bank-ineligible security issued by the underwriting subsidiary; extending credit to a customer to purchase a bank-ineligible security issued by the securities affiliate during or shortly after the underwriting period; or purchasing ineligible securities from a securities affiliate during or shortly after the underwriting period. Officer, director or employee interlocks between a BHC's underwriting subsidiary and any bank or thrift subsidiary are prohibited. An underwriting subsidiary must provide adequate disclosures that its products are not federally insured. There are limitations on the ability of affiliated banks or thrifts to provide investment advice regarding the purchase of securities underwritten or dealt in by the securities affiliate. Bank or thrift subsidiaries are prohibited from extending credit to a securities affiliate except in certain limited instances, or from purchasing or selling certain financial assets to or from a securities affiliate.

On December 28, 1984, the FDIC implemented its regulation on securities activities of subsidiaries of insured nonmember banks and bank transactions with affiliated securities companies (12 CFR § 337.4). At that time, the FDIC determined that it is not unlawful under the Glass-Steagall Act for an insured nonmember bank to establish or acquire a bona fide subsidiary that engages in securities activities nor for an insured nonmember bank to become affiliated with a company engaged in securities activities if authorized under state law. At the same time, the FDIC found that some risk may be associated with those activities. In order to address that risk, the FDIC regulation (1) defines bona fide subsidiary, (2) requires notice of intent to acquire or establish a securities subsidiary, (3) limits the permissible securities activities of insured nonmember bank subsidiaries, and (4) places certain other restrictions on loans, extensions of credit and other transactions between insured nonmember banks and their subsidiaries or affiliates that engage in securities activities.

In our regulation, the term "bona fide" subsidiary means a subsidiary of an insured nonmember bank that at a minimum: (1) is adequately capitalized, (2) is physically separate and distinct in its operations from the operations of the bank, (3) maintains separate accounting and other corporate records, (4) observes separate corporate formalities such as separate board of directors meetings, (5) maintains separate employees who are compensated by the subsidiary, (6) shares no common officers with the bank, (7) a majority of the board of directors is composed of persons who are neither directors nor officers of the bank, and (8) conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the subsidiary that the subsidiary is a separate organization from the bank and that investments recommended, offered or sold by the subsidiary are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank.

This definition is imposed to ensure the separateness of the subsidiary and the bank. This separation is necessary as the bank would be prohibited by the Glass-Steagall Act from engaging in many activities the subsidiary might undertake. Also, the separation safeguards the soundness of the parent bank.

The regulation provides that the insured nonmember bank must give the FDIC written notice of intent to establish or acquire a subsidiary that engages in any securities activity at least 60 days prior to consummating the acquisition or commencement of the operation of the subsidiary. These notices serve as a supervisory mechanism to apprise the FDIC of which insured nonmember banks are conducting securities activities through their subsidiaries that pose potential risks to which the bank otherwise would not be exposed.

Activities of the subsidiary are limited in that it may not engage in the underwriting of securities that would otherwise be prohibited to the bank itself under the

Glass-Steagall Act unless the subsidiary meets the bona fide definition and the activities are limited to underwriting of investment quality securities.

A subsidiary may engage in underwriting other than that listed above if it meets the definition of bona fide and the following conditions are met: (a) The subsidiary is a member in good standing of the National Association of Securities Dealers (NASD); (b) The subsidiary has been in continuous operation for a five-year period preceding the notice to the FDIC; (c) No director, officer, general partner, employee or 10 percent shareholder has been convicted within five years of any felony or misdemeanor in connection with the purchase or sale of any security; (d) Neither the subsidiary nor any of its directors, officers, general partners, employees, or 10 percent shareholders is subject to any state or federal administrative order or court order, judgment or decree arising out of the conduct of the securities business; (e) None of the subsidiary's directors, officers, general partners, employees or 10 percent shareholders are subject to an order entered within five years issued by the Securities and Exchange Commission pursuant to certain provisions of the Securities Exchange Act of 1934 or the Investment Advisors Act of 1940; and (f) All officers of the subsidiary who have supervisory responsibility for underwriting activities have at least five years experience in similar activities at NASD member securities firms.

A bona fide subsidiary must be adequately capitalized, and therefore, they must meet the capital standards of the NASD and SEC. As a protection to the insurance fund, a bank's investment in these subsidiaries engaged in securities activities that would be prohibited to the bank under the Glass-Steagall Act is not counted toward the bank's capital, that is, the investment in the subsidiary is deducted before compliance with capital requirements is measured.

An insured nonmember bank which has a subsidiary or affiliate that engages in the sale, distribution, or underwriting of stocks, bonds, debentures or notes, or other securities, or acts as an investment advisor to any investment company may not engage in any of the following transactions: (1) Purchase in its discretion as fiduciary any security currently distributed, underwritten or issued by the subsidiary unless the purchase is authorized by a trust instrument or is permissible under applicable law; (2) Transact business through the trust department with the securities firm unless the transactions are at least comparable to transactions with an unaffiliated company; (3) Extend credit or make any loan directly or indirectly to any company whose obligations are underwritten or distributed by the securities firm unless the securities are of investment quality; (4) Extend credit or make any loan directly or indirectly to any investment company whose shares are underwritten or distributed by the securities company; (5) Extend credit or make any loan where the purpose of the loan is to acquire securities underwritten or distributed by the securities company; (6) Make any loans or extensions of credit to a subsidiary or affiliate of the bank that distributes or underwrites securities or advises an investment company in excess of the limits and restrictions set by section 23A of the Federal Reserve Act; (7) Make any loan or extension of credit to any investment company for which the securities company acts as an investment advisor in excess of the limits and restrictions set by section 23A of the Federal Reserve Act; and, (8) Directly or indirectly condition any loan or extension of credit to any company on the requirement that the company contract with the banks securities company to underwrite or distribute the company's securities or condition a loan to a person on the requirement that the person purchase any security underwritten or distributed by the bank's securities company.

An insured nonmember bank is prohibited by regulation from becoming affiliated with any company that directly engages in the sale, distribution, or underwriting of stocks, bonds, debentures, notes or other securities unless: (1) The securities business of the affiliate is physically separate and distinct from the operation of the bank; (2) the bank and the affiliate share no common officers; (3) a majority of the board of directors of the bank is composed of persons who are neither directors or officers of the affiliate; (4) any employee of the affiliate who is also an employee of the bank does not conduct any securities activities of the affiliate on the premises of the bank that involve customer contact; and (5) the affiliate conducts business pursuant to independent policies and procedures designed to inform customers and prospective customers of the affiliate that the affiliate is a separate organization from the bank and that investments recommended, offered or sold by the affiliate are not bank deposits, are not insured by the FDIC, and are not guaranteed by the bank nor are otherwise obligations of the bank. The FDIC has chosen not to require notices relative to affiliates because we would normally find out about the affiliation in a deposit insurance application or a change of bank control notice.

The FDIC has created an atmosphere in which bank affiliation with entities engaged in securities activities is very controlled. Although we have examination au-

thority over bank subsidiaries and under Section 10(b) of the Federal Deposit Insurance Act we have the authority to conduct examinations of affiliates to determine the effect of that relationship on the insured institution, we have in practice allowed these entities to be functionally regulated, that is FDIC examination of the insured bank and SEC and NASD oversight of the securities subsidiary or affiliate.

The FDIC feels that its established separations for banks and securities firms has created an environment in which the FDIC's responsibility to protect the insurance fund has been met without creating duplicative regulation for the securities firms. However, our experience indicates that these separations may not be perfect. Insider maneuvering may be able to evade the intent of the firewalls, securities firms affiliated with nonbank bank holding companies may fall outside the regulatory coverage of Part 337.4, and if systemic problems were to develop in the securities industry, the difficulties may overwhelm the protection in place.

Therefore, the FDIC believes that functional regulation should not be designed in a fashion that would preclude the FDIC from examining securities subsidiaries and affiliates for matters which are unsafe and unsound. This would include reviewing insider involvement in the securities firms, monitoring financial transactions between the insured institution and the securities firm, reviewing securities firms records to assure that the restrictions contained in Part 337.4 are being adhered to, and regularly reviewing financial statements of the securities firms.

The FDIC is also maintaining an open dialogue with the NASD and the SEC concerning matters of mutual interest. To that end, we have entered into an agreement in principle with the NASD concerning examination of securities companies affiliated with insured institutions and have begun a dialogue with the SEC concerning the exchange of information which may be pertinent to the mission of the FDIC.

The number of banks which have subsidiaries engaged in activities that could not be conducted in the bank itself is very small. The activities these subsidiaries are engaged in are underwriting of debt and equity securities and distribution and management of mutual funds. We have received notices from 444 banks that have subsidiaries which are engaged in activities that do not require the subsidiary to meet the definition of bona fide such as investment advisory activities, sale of securities and management of the bank's securities portfolio.

Since implementation of the FDIC's regulation, the relationships between banks and securities firms have not been a matter of supervisory concern. We believe in great part that this can be attributed to the protections we have in place. However, we are aware that in a time of financial turmoil that these protections may not be adequate and a program of direct examination may be necessary to protect the insurance fund and continuation of our examination authority in that area is important.

ATTACHMENT E

PROHIBITIONS AND RESTRICTIONS ON SECURITIES ACTIVITIES IMPOSED BY SECTION 20 OF THE GLASS-STEAGALL ACT AND BY THE BANK HOLDING COMPANY ACT

Section 20 of the Glass-Steagall Act ("Section 20") (12 U.S.C. §377) prohibits banks that are members of the Federal Reserve System ("member banks") from affiliating with organizations that are "engaged principally" in underwriting, distributing or selling securities. Section 20 states, in relevant part, that: "no member bank shall be affiliated in any manner... with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale... of stocks, bonds, debentures, notes, or other securities..." 12 U.S.C. §377. The statute defines an "affiliate" to include any corporation, business trust, association or other similar organization—

(1) Of which a member bank, directly or indirectly, owns or controls either a majority of the voting shares or more than 50 percent of the number of shares voted for the election of directors, trustees, or other persons exercising similar functions...

(2) Of which control is held, directly or indirectly, through stock ownership... by the shareholders of the member bank who own or control either a majority of the shares of such bank or more than 50 percent of the number of shares voted for the election of directors of such bank...

(3) Of which a majority of directors, trustees, or other persons exercising similar functions are directors of any one member bank; or

(4) Which owns or controls, directly or indirectly, either a majority of the shares of capital stock of a member bank or more that 50 percent of the number of shares voted for the election of directors of a member bank.... 12 U.S.C. §221a.

In contrast to Section 16 of the Glass-Steagall Act, which imposes an absolute ban on bank securities underwriting activities, Section 20 prohibits affiliations between

banks and entities that are "engaged principally" in securities underwriting activities. Therefore, affiliations are permitted as long as the nonbank institution is not engaged "principally" in the securities activities restricted by Section 20. Section 20 itself, however, does not define the term "principally engaged." The legislative history of Section 20 also fails to define or explain the precise meaning of the term.[1] To date, the United States Supreme Court has not ruled on the question and very few lower federal courts have addressed it.[2] Thus, the meaning of the term "engaged principally" is not firmly resolved. Based on court decisions on other related provisions of the Glass-Steagall Act, and absent further clarification by the United States Supreme Court, the term "engaged principally" is not confined to the majority of a firm's business. Instead, any bank affiliate engaged in securities underwriting as a "substantial activity" would be in violation of Section 20.[3] A determination of what level of activity is "substantial," however, is still required.

The Federal Reserve has approved numerous applications allowing so-called "Section 20 subsidiaries" to underwrite and deal in securities (that are not exempt from the Glass-Steagall restrictions (i.e., "ineligible securities")) on the grounds that the subsidiaries are not "engaged principally" in such activities, and thus their affiliation with member banks is not proscribed by Section 20.[4] In a precedential order issued in 1987 ("1987 Order") the Board of Governors of the Federal Reserve System imposed a "five-to-ten-percent" standard to differentiate permissible from impermissible levels of securities underwriting activities. The Board explained its rationale, in part, as follows:

> [T]he Board believes it is bound by the statutory language of section 20 [of the Glass-Steagall Act] to conclude that a member bank affiliate may underwrite and deal in the ineligible securities proposed in the application, provided that this line of business does not constitute a principal or substantial activity for the affiliate. The Board reaffirms its conclusion... that Congress intended that the 'engaged principally' standard permit a level of otherwise impermissible underwriting activity in an affiliate that would not be quantitatively so substantial as to present a danger to affiliated banks...
>
> With respect to the appropriate quantitative level of ineligible activity permitted under section 20, the Board concludes that a member bank affiliate would not be substantially engaged in underwriting or dealing in ineligible securities if its gross revenue from that activity does not exceed a range of between five to ten percent of its total gross revenues..." *Citicorp, J.P. Morgan & Co., Inc., and Bankers Trust New York Corp.*, 73 Fed. Res. Bull. 473, 475 (1987).[5]

With specified exceptions, the Bank Holding Company Act[6] ("BHC Act") prohibits a Bank Holding Company ("BHC") from acquiring direct or indirect ownership or control of any voting shares of any company that is not a bank (12 U.S.C. § 1843(a)). Under Section 4(c)(8) of the BHC Act (Id. at 1843(c)(8)) that prohibition does not apply to a BHC's acquisition of "shares of any company the activities of which the [Federal Reserve] Board... has determined (by order or regulation) to be so closely

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[1] *See* Banking Law, Vol. 5, §96.02[3] (Matthew Bender, 1994).

[2] *In Board of Governors* v. *Agnew*, 329 U.S. 441 (1947), the United States Supreme court defined the term "primarily" to mean "substantial." This was in the context of section 32 of the Glass-Steagall Act, however, and not Section 20. (Section 32 restricts officer, director and employee overlap between member banks and entities "primarily engaged" in securities underwriting.)

[3] *CF. Board of Governors* v. *Agnew*, supra.

[4] The Federal Reserve has approved the establishment of over thirty "Section 20 subsidiaries." 59 *Fed. Reg*. 35,517 (1994).

[5] The Federal Reserve Board's standard was sustained by the Second Circuit Court of Appeals in *Sec. Ind. Ass'n* v. *Board of Governors*, 839 F.2d 47, 68 (2d Cir. 1988), *cert. denied*, 486 U.S. 1059 (1988).

In July 1994, the Federal Reserve requested comments on proposed alternatives to the current "gross revenue" and "indexed gross revenue" tests. 59 *Fed Reg*. 35,516 (1994).

[6] The BHC Act requires approval by the Federal Reserve for the formation of a BHC. 12 U.S.C. § 1841 *et seq*. A BHC is any "company" that has "control" over any "bank" or over any company that is or becomes a BHC. The BHC Act defines a "company," in part, as a corporation, partnership, business trust, association, or similar organization. *Id.* at 1841 (b). A "bank" includes an "insured bank" under the Federal Deposit Insurance Act that: (1) accepts demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties, and (2) is engaged in the business of making commercial loans. *Id.* at 1841(c).

Under the BHC Act a company "controls" a bank if: (1) the company directly or indirectly owns, controls, or has the power to vote at least 25 percent of any class of the bank's voting securities; (2) the company controls the election of a majority of the bank's board of directors or trustees; or (3) the Federal Reserve determines after the opportunity for hearing that the company exercises a controlling influence over the bank's management or policies. *Id.* at 1841(a).

related to banking or managing or controlling banks as to be a proper incident thereto..."[7] In the 1987 Order the Federal Reserve concluded that underwriting and dealing in "ineligible securities" is "closely related" and a "proper incident" to banking under the BHC Act.[8]

Specifically, the Board of Governors stated that "underwriting and dealing in commercial paper, municipal revenue bonds and 1-4 family mortgage-related securities, under the limitations discussed in [the 1987] Order, are closely related to banking, because banks provide services that are so operationally and functionally similar to the proposed services that banking organizations are particularly well equipped to provide such services...[T]he proposed activities are natural extensions of activities currently conducted by banks..."[9] The Board of Governors also concluded that the "proposed underwriting and dealing activities" were a "proper incident to banking [because they] may reasonably be expected to result in substantial public benefits that outweigh possible adverse effects."[10]

In the orders that the Federal Reserve has issued in connection with the permissible securities underwriting activities of member bank affiliates, the Federal Reserve has expressed concerns about the potential for adverse effects that might result from the proposed activities, such as unsound banking practices, conflicts of interest, unfair competition, undue concentration of resources and loss of public confidence. Because of these concerns, the Federal Reserve has included limitations and conditions in its "Section 20" orders. There were separate protections in the Federal Reserve's original order of which the following are the most significant:

- In determining compliance with capital adequacy requirements, the applicant is required to deduct from its consolidated capital any investment in the underwriting subsidiary that is treated as capital in the underwriting subsidiary.
- The underwriting subsidiary shall maintain at all times capital adequate to support its activity and cover reasonably expected expenses and losses in accordance with industry norms.
- No applicant or subsidiary shall extend credit, issue or enter into a stand-by letter of credit, asset purchase agreement, indemnity, insurance or other facility that might be viewed as enhancing the creditworthiness or marketability of an ineligible securities issue underwritten by an affiliated underwriting subsidiary.
- There will be no officer, director or employee interlocks between an underwriting subsidiary and any of the BHC's bank or thrift subsidiaries.
- An underwriting subsidiary will provide each of its customers with a special disclosure statement describing the difference between the underwriting subsidiary and its banking affiliates.
- An affiliated bank may not express an opinion with respect to the advisability of the purchase of the ineligible securities underwritten or dealt in by an underwriting subsidiary unless the bank affiliate notifies the customer that its affiliated underwriting subsidiary is underwriting or making a market in the security.
- No applicant or any of its subsidiaries, other than the underwriting subsidiary, shall purchase, as principal, ineligible securities that are underwritten by the underwriting subsidiary during the period of the underwriting and for 60 days after the close of the underwriting period.
- No lending affiliates of an underwriting subsidiary may disclose to the underwriting subsidiary any non-public customer information consisting of an evaluation of the creditworthiness of an issuer or other customer of the underwriting subsidiary (other than as required by securities laws and with the issuer's consent) and no officers or employees of the underwriting subsidiary may disclose such information to its affiliates.[11]

Mr. FIELDS. Thank you, Ms. Helfer.

The Chair will recognize himself for 5 minutes. Chairman Levitt, you focused in your testimony on what jumped out to me last night when I was reading your testimony on page 4, you talk about a SID as not the same as full functional regulation, and then going down in that paragraph, you say bank SIDs could also present

[7] This exception is implemented by the Federal Reserve in Regulation Y of the Federal Reserve's regulations. 12 C.F.R. §225.

[8] 1987 Order, p. 477.

[9] 1987 Order, p. 487.

[10] 1987 Order, p. 489.

[11] 1987 Order, pp. 503-504.

some practical problems relating to securities examination and enforcement efforts.

If I heard your testimony correctly, you were talking about commingling and the difficulty of perhaps following a paper trail. My question to you, is there a way to correct the practical problems for securities examination and enforcement efforts and then, also, is there a way in your mind in your interpretation to bring SIDs under full functional regulation?

Mr. LEVITT. Well, let me say at the outset that I think that a SID is a better arrangement than having all of these activities strictly in the bank, but it is a less good arrangement in my judgment than having a separate entity of some sort. The problem is because of what I regard to be both redundancy and confusion that is created by the SID concept.

It is almost as if you had two sets of rules with respect to driving down the highway. For some drivers, the speed limit might be 50 m.p.h.; for others, it would be like a different jurisdiction: it would be 30 m.p.h. We would have a problem in gaining access to the kinds of information that might not be in the SID, but might yet be in the bank. We would have to work very closely with other regulators, and I think that bank securities activities would be burdened with redundant and more costly regulatory procedures.

My long-winded answer to your question is that this is a very complex way of creating the sort of functional regulation which I think is essential to protecting investors' interests.

Mr. FIELDS. So that I understand what you are testifying to, are you saying that there is—there is not a way to correct the practical problems that you foresee in examination and enforcement?

Mr. LEVITT. The best way, in my judgment, would be the creation of a separate entity that would enable us to clearly define the activities of that entity, supervise it and regulate it, surveil it completely from beginning to end. The SID does not provide us with that.

Mr. FIELDS. Okay. Chairman Greenspan, let me ask you, because last night when I was reading your testimony, something else jumped out that you really didn't testify to today, and that was the financial globalization of our markets. And my question is a very broad question: What happens in that particular respect if we don't pass legislation this year, if we don't modernize our laws?

Mr. GREENSPAN. Mr. Chairman, that is an extraordinarily important question, and I suspect that if we weren't involved in the varied details of this particular piece of legislation, I would have spent some time on that.

The issue that confronts us is that because of the extraordinary change in information and communications technology, the financial system is changing very rapidly, and it is very crucially important that we modernize our regulatory system to enable us to have financial institutions which can function competitively, both domestically and internationally.

In that regard, and the reason why I am supportive of H.R. 1062, as indeed my colleagues are at the Federal Reserve Board, is we believe that to the extent that one can do that, this bill does it. I should emphasize that we have to remember that we are dealing with a very complex financial system. If we were starting from

scratch and tried to reconstruct a whole set of regulations which would focus on the type of financial system we expected to exist in the 21st century, we would probably do it somewhat differently than H.R. 1062. But there are significant elements in our financial system right now which work.

They may not work exactly the way we might have figured they would best do so if we could start from scratch, but they do work; and what H.R. 1062 does, in my judgment, is that it alters those parts of the system which don't work well, which inhibit our ability to compete in the global system, and which should very quickly be rescinded if we want to maintain the type of viable system which I think we are developing.

Mr. FIELDS. Thank you, Chairman Greenspan. The Chair's time has expired.

The Chair will now recognize the distinguished ranking member of the subcommittee, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman. I might begin by noting that, unlike the 1988 and 1991 hearings, no one is mentioning how we should be more like Japan. No one has mentioned that we don't have one of the top 25 banks in the world in size, and we don't hear it from you, Mr. Chairman of the Fed, and we don't hear it from anyone else here; and there is a good reason why we don't hear it anymore. Because in yesterday's Wall Street Journal, we heard that the top 21 banks in Japan now have $600 billion worth of bad loans on their books and that the government is talking about a $200 billion bailout of the banks in that country.

So bigger isn't necessarily better, I guess we would assume from that—this little lesson. I guess I would actually assume it from the silence in terms of people pointing us towards Japan once again, because unlike the lessons of the 1980's, which I think we should learn, we should be more like ourselves and trust ourselves to our own history and our own lessons and not keep emulating those around the rest of the world because they may not know as much as we know.

My great problem here, if I may, is what happens if we have one of these water cooler situations where the Chinese walls, the firewalls, are all kind of taken down, and on one floor in a bank, in one office actually, you have got one guy who is wearing many hats at the same time, and not only is he a banker, but he also sells you derivatives, exotic derivatives, inverse floaters, floortions, captions, whatever, and it is based upon a very sophisticated algorithm that is based upon a bet on what the Japanese interest rates or German deutschemark might be a year or 2 from now; and we assume, just for the sake of the discussion, that the market drops from 4,500 or 5,000 a thousand points over the next two or three years—just speculation, not predicting, but it is very possible.

What then happens to the depositors, to the taxpayers, if those products are part, not of a separate subsidiary being monitored by the Securities and Exchange Commission and being completely separate from the bank's activities, but intimately, integrally involved in the bank's activities? Is the taxpayer liable? Will the taxpayer have to pick up the tab?

And the only reason I raise this is that we didn't discuss this question in the early 1980's during that phase of banking deregula-

tion, and we wound up with $200 billion worth of taxpayer money having to be ponied up to bail out bankers.

Now, my problem with that is that that is basically the whole medicare debate. We are talking about cutting $200 billion from medicare, from the elderly in our country. If we never had that banking crisis, if we never had the taxpayers having to kick in that money, we wouldn't be in a situation where we had to talk about cutting the elderly right now; we would have that $200 billion back.

I want to discuss this subject in terms of how it impacts on the risks that are being taken by banks that expose taxpayers, depositors, to the risk; not the shareholders of the bank, but taxpayers.

So may I ask you then, Chairman Greenspan, what, in fact, would be the protection against exotic derivatives being traded, not as part of a separate subsidiary, but as a part of this new banking entity which you support being authorized by this legislation?

Mr. GREENSPAN. Congressman, first let me just for the record say that it was the savings and loans, not the banks, which created the huge loss which we estimate at a little over $150 billion. The Bank Insurance Fund was not involved in that. And there are differences here, and we did run into problems in banks, but they were fortunately resolved.

On the issue of derivatives and other types of instruments, that is a problem we have today. This is not an issue which fundamentally relates——

Mr. MARKEY. May I say, if I may interrupt, for the technical debate, I guess you can make a distinction between a savings and loan and a bank, but for the average depositor walking in and putting their life savings in, there is no distinction between a savings and loan and a bank. While semantically you are correct, for the purposes of how depositors and taxpayers view depository institutions, there is no distinction.

Mr. GREENSPAN. I grant you that, and I only made the point because there is a technical distinction which we ought to be aware of.

Derivatives and all such similar products which are involved in the bank are subject to a very significant amount of supervision and regulation, and what it is that maintains the safety and soundness of an institution is the ability of a supervisor, when it perceives that a particular unsafe or unsound policy is involved, that the supervisor acts to change that.

If it perceives that there is riskiness in some activities of a bank, its appropriate response is to ask for increased capital, and that is the fundamental function of supervision and regulation of banks; and that would exist under today's statutes or it would exist under H.R. 1062.

Mr. MARKEY. If you have exotic derivatives in a separate subsidiary or inside the bank, how would you handle it?

Mr. GREENSPAN. First of all, the definition of what constitutes "exotic derivatives" is a fairly vague one, and I would——

Mr. MARKEY. Inverse floater. Where would you put an inverse floater?

Mr. GREENSPAN. It depends on the overall issue of how much risk is being taken and what the capital of the institution is. I don't necessarily argue that it should be one place or another, but——

Mr. MARKEY. A dangerous inverse floater, would you keep it in the bank or over—being dangerous, where would you put a dangerous inverse floater?

Mr. GREENSPAN. If I concluded it was dangerous, it should be nowhere.

Mr. MARKEY. So your basic decision is, it will never go over to the separate affiliate, you will either ban it or it will stay inside of the—is that your basic conclusion?

Mr. GREENSPAN. No. If it is perceived of as dangerous, bank regulators will institute cease and desist orders to eliminate that practice.

Mr. MARKEY. Chairman, again, I admire your ability in perfecting the art of evasiveness. It is raised to an art form.

Mr. FIELDS. The gentleman's time is expired. The chairman of the full committee, Chairman Bliley of Virginia.

Mr. BLILEY. Thank you, Mr. Chairman.

Chairman Greenspan, with the unrestricted entry of banks into the securities business, should the rules be changed so that banks, like brokerage houses, are required to mark to market their entire portfolio of securities holding, to require to mark to market?

Mr. GREENSPAN. Under H.R. 1062, the activity would be taking place in broker-dealer affiliates regulated by the Securities and Exchange Commission, and I would presume, like all such institutions, would be marking their securities portfolios to market.

Mr. BLILEY. Do you agree with that, Chairman Levitt?

Mr. LEVITT. Yes. I think that mark to the market is a principle that we embrace. I think that it may take a transition period to get to that point without creating disruption in the banking industry, but mark to the market is something that I strongly support.

Mr. BLILEY. To either of you gentlemen, or both of you, how can you prevent a situation, if you have the bank operating a securities business within the bank, in a SID, how do you prevent the situation that occurred in—with Continental Illinois when you had the problem of the market dropping and they had a restriction as to how much money they could loan to their subsidiary, but they violated the rule and went ahead and loaned the money anyway.

How do you address that situation or how would you recommend we address that situation?

Mr. GREENSPAN. Mr. Chairman, the particular episode you are referring to is a situation in which, under stress, we have observed some tendencies on the part of institutions of extending credits to subsidiaries when, in fact, it was not authorized under regulation or statute.

That is what I meant, in my prepared remarks, that I thought, under stress, sometimes firewalls do bend, but it is temporary, and it is readdressed by the regulators fairly quickly. I am less concerned about that issue than I would have been in earlier years, before I saw how the adjustment process would take place.

The main issue is that while these firewalls tend sometimes to bend, they do generally work; and it is the rare instance when there are egregious activities in which holding companies will

sometimes move funds from one affiliate to another against regulatory requirements.

Mr. Levitt. I guess I am a little bit more cautious about the effectiveness of any of these devices, of any firewall in times which I regard to be different, greater uncertainty, a greater velocity of impact in terms of products that are out there than we have ever seen before in the Nation's history.

For that reason, I feel that the kind of problem which you have described, Mr. Chairman, would be best addressed by placing securities activities in a separate entity rather than intermingled with other bank activities; and in that way, if a problem did develop, the Commission, in their oversight activity and whatever enforcement activity might follow, would not impair the basic soundness of the bank itself.

It is terribly difficult to anticipate any kind of problem that can develop in this environment, so that I feel that looking at the past and assuming that those protections and those firewalls would necessarily protect us in terms of the uncertainties of the future, I think, represents some risk.

Ms. Williams. Mr. Chairman, if I could add, in that particular situation, when the OCC learned about the transfer of funds, the bank was immediately directed to effect repayment, and this all took place over a matter of hours. So in that situation, there was a very speedy resolution of the problem.

Mr. Bliley. Thank you.

Mr. Chairman, I see my time is expired.

Mr. Fields. Thank you, Mr. Chairman.

The Chair will now recognize the distinguished gentleman from Michigan, the ranking member of the full committee, Mr. Dingell.

Mr. Dingell. Thank you, Mr. Chairman. I note a situation here that, as reported by the Banking Committee, H.R. 1062 would now permit many securities activities to be carried out directly in the bank, and in SIDs, which are separately identifiable departments or divisions within the bank. All the bank's capital would therefore be available to support the activities conducted both directly in the bank and in the SID broker-dealer sections within the bank; is that correct?

Mr. Greenspan. That is correct.

Mr. Dingell. Then, as such, the bank would not be insulated from risk. The Federal safety net, including Federal deposit insurance, would be put at risk if these activities led to significant losses; is that not so, Mr. Greenspan?

Mr. Greenspan. That is the state of affairs today.

Mr. Dingell. And it would be the state of affairs under H.R. 1062.

Mr. Greenspan. With one exception, and that is the issue of municipal revenue bonds, which have been added to the list of securities which could be traded either within the bank or within the SID.

Mr. Dingell. So that creates an interesting ambiguity, but, in point of fact, what would happen then is that if the banks got into securities in a big way, some, for example, of the kinds of risky instruments that were discussed by Mr. Markey, and they got in fi-

nancial trouble over them, the FDIC might then be compelled to bail out the bank; isn't that a fact?

Mr. GREENSPAN. Well, that is precisely the situation we are in today, Congressman. It is not an issue of——

Mr. DINGELL. I am curious, why are we so—

Mr. GREENSPAN. [continuing] H.R. 1062.

Mr. DINGELL. I do not quarrel with that. I just do not see how we come out any better, and I find myself in the curious position of finding that we are continuing a situation which has obvious risk.

Let me ask a different question then. As noted in the testimony, Mr. Levitt, in each of the last three administrations, the SEC has appeared before this committee and has provided us with arguments in support of adopting a functional approach to the regulation of financial services. There is a title in H.R. 1062 entitled, Functional Regulation. My question to you is whether, in this case, the book is to be correctly judged by its cover. Does H.R. 1062 set forth an intelligent and reasonable scheme for financial regulation, or does it fall short of what the Commission has traditionally supported?

Mr. LEVITT. Well, I think, clearly, functional regulation is something that almost everyone who deals with these issues talks about.

Mr. DINGELL. Everybody but the banks wants functional regulation.

Mr. LEVITT. Well, I think even the banks talk about them.

Mr. DINGELL. And the bank regulators.

Mr. LEVITT. Yes, that is probably so.

I think that some steps in the direction of functional regulation have been taken. I think the creation of the SID is kind of a half-step in that direction. I do think that the principles of functional regulation are absolutely essential to the continued flourishing of our securities industry and the development of the entrepreneurial efforts that that industry has brought about. Again, I think that this bill falls short of that again because they have substituted for a separate entity a SID, which I believe is somewhat redundant and confusing. A SID is not the kind of functional regulation that I think is best suited for this.

Mr. DINGELL. Now, Ms. Williams, last year, Comptroller Ludwig gave a speech in which he criticized the concept of functional regulation, and he proposed moving towards entity regulation. Now, is that a fair statement?

Ms. WILLIAMS. Mr. Dingell, I think that there are different meanings——

Mr. DINGELL. Just yes or no.

Ms. WILLIAMS. There are different meanings to what functional regulation is in different contexts and——

Mr. DINGELL. Well, it is fair then to say that your agency does not favor functional regulation, if I understand what Mr. Ludwig has had to say on the matter. In other words, he favors entity regulation and not functional regulation. Is that a fair statement?

Ms. WILLIAMS. I think a fair statement is that, in some circumstances, it may make sense to have an entity regulator apply-

ing uniform rules. The way that the MSRB system works today is an example of that.

Mr. DINGELL. I have been kind of looking forward to seeing Mr. Ludwig before the committee. I am not sure whether you had a consultation with him on this particular matter to know whether or not you were in agreement, or whether Mr. Ludwig agrees with you or whether Mr. Ludwig is for functional regulation or for, as he says, entity regulation.

Ms. WILLIAMS. There are examples of a type of functional regulation where you have uniform rules that apply across the board to different types of entities, but you have different regulators that apply them.

Mr. DINGELL. Yes. So you are saying he doesn't want the same regulation, which means he doesn't want functional regulation; he wants entities regulated differently. For example, a broker-dealer regulated by the SEC, would be regulated one way; your good friends in the banking industry would be regulated quite differently by a quite different entity.

Ms. WILLIAMS. No, I don't think he said that.

Mr. DINGELL. You don't think that is so?

Ms. WILLIAMS. I think he raised a question as to whether there were different approaches to regulation of different types of activities.

Mr. DINGELL. I am not quite sure what you said but my time has expired. I think my interpretation of your comment is correct.

Thank you, Mr. Chairman.

Mr. FIELDS. Thank you, Mr. Dingell.

The Chair will now recognize the chairman of the Subcommittee on Commerce, Trade and Hazardous Material, the gentleman from Ohio, Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

Chairman Greenspan, on page 4 of your testimony, you say, "and this is what we are here today to discuss, the need to remove outdated separations between commercial and investment banking and thereby make the next logical step in rationalizing our system for delivering financial services in a more efficient manner. I might note that in this regard, the United States is, as it was with geographical restrictions, behind the rest of the industrial world. Virtually all of the other G-10 nations now permit banking organizations to affiliate with securities firms and with insurance and other financial entities."

My question to you is, do we have a model out there? My friend from Massachusetts obviously would eschew using Japan as a model, but is there a model out there that could guide us somehow and indicate that somehow there is something out there that actually works?

Mr. GREENSPAN. Mr. Chairman, there are various different models in the rest of the world. There is the universal bank. There is a holding company structure. There are variations of that. They all function in one way or another depending upon the culture of the society in which they have evolved.

My judgment of the way we ought to evolve is essentially the holding company structure, largely because it strikes me as more in line with the type of corporate structure, the type of laws that

we have, and the notions of the relationships amongst various entities in the business system that we have.

I don't think that you can say that, for example, the holding company structure is inherently superior, for example, to any of the other various different forms of structures. They all will work under certain conditions. A universal bank will work under certain conditions.

It is just that we at the Fed believe that the structure that we have viewed over the years works for us and we think that that type of structure would be superior to the other structures in the world for the United States.

Mr. OXLEY. Thank you.

Chairman Levitt.

Mr. LEVITT. Without evaluating a particular structure, I would say that I don't think the United States takes a back seat to any system in the world today in terms of how the market functions or how it is regulated. And I can't help but think that an example, perhaps an extreme example, of a large enterprise that was funded by its parent bank, is Barings. So I don't think that any international model should motivate us toward changing the system.

I am not suggesting that there is only one system. I am suggesting that we can improve upon H.R. 1062 by trying to more clearly define in a separate entity those activities that fall within the bank's entrance into the securities business.

Mr. OXLEY. Thank you.

Ms. Williams, let me ask you an insurance question. As you know, the OCC has consistently taken the position that a State may not require a national bank to obtain a State license to exercise any authorized insurance powers. Doesn't that position essentially repeal McCarran-Ferguson, and if it does not, why doesn't it?

Ms. WILLIAMS. What we have tried to do is to address the question of State laws that affect the basic powers of national banks to engage in activities that they are authorized to engage in under the National Bank Act.

A much more difficult question is how that activity is regulated under State law. And that is actually a question that goes to the heart of the McCarran-Ferguson preservation of State law requirements and touches on an issue that we are currently wrestling with.

We have a proposal that we issued earlier this year that specifically sought comment on the question of the extent to which various types of State licensing requirements and laws of that type would apply to operations of national banks. So I don't think that the positions that we have taken have amounted to something that is inconsistent with McCarran-Ferguson's preservation of the ability of States to engage in regulation of insurance as opposed to prevention of an entity from conducting the activity.

Mr. OXLEY. My time has expired.

Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Tennessee, Mr. Gordon.

Mr. GORDON. Ms. Williams, in your testimony, you mentioned that there might be some banks that would incur additional regulations, even though they chose not to have additional securities pow-

ers. Could you be more specific as to what type of bank that would occur to and under what circumstances?

Ms. WILLIAMS. To the extent that banks are engaged in certain types of securities brokerage activities today or securitization of the loans that they make, whether they are securitizing one-to-four-family residential mortgage loans or getting into securitization of small business loans, there are a variety of types of regulatory requirements that would affect the ability of banks to conduct those activities, to bring nonbanking products to the attention of their customers without going through additional steps and setting up additional internal procedures.

And with respect to the activities of banks today in funding their operations by engaging in certain types of securitizations of loans that they make, they may have to shift those activities into a SID. They may not even be able to continue doing those activities directly in the bank. And the way that the mechanisms in the bill, which I think we would all agree are quite complex, seem to work, there even seem to be limitations on the ability of banks to use securities affiliates to affect securitizations of certain types of loan assets originated by the bank.

Mr. GORDON. What recommendations would you have to cure that problem?

Ms. WILLIAMS. The types of activities in which banks today would be authorized to engage would be where we would start. We don't see where there is any necessary connection between expanded securities activities in a bank holding company affiliate and restrictions on the ability of banks and banks' subsidiaries to engage in certain types of business. We are concerned about limiting and restricting the ability of banks to innovate. We are concerned about potential future restrictions on their ability to fund types of business loans. So I think we would start by saying that there is no need to cut back on what banks would be authorized to do under the law in existence today.

I think the next thing that we would suggest is that in terms of how they are regulated and are going about those activities, we don't by any means quarrel with the concern that there be investor protections, that banks operate in a safe and sound manner. The OCC has been very active and aggressive in trying to provide guidance to the industry. We were the first to put out guidelines on the types of disclosures that we wanted to see banks make in connection with various types of uninsured product sales. There is an interagency statement that all the banking agencies participated in.

So we are not suggesting here that the objective should be any diminution in protection of customers, but there is a question of how do you go about implementing that sort of regime? What is the most efficient way to do it? Are you imposing unnecessary regulatory burdens in connection with trying to achieve those objectives?

Mr. GORDON. Mr. Levitt, do you have——

Mr. LEVITT. Just one point I would make is that it really isn't very expensive to set up a broker-dealer. We have, I guess, about 8,000 broker-dealers in the United States today, and most broker-dealers are very small operations. And I think broker-dealer affili-

ates can work with the banks to get the job done; it is not a cumbersome and expensive process.

Mr. GORDON. Thank you. No more questions, unless anyone else on the panel wants to comment on that subject.

Ms. HELFER. I would simply say that looking at these issues, Congressman Gordon—and thank you very much for your neighborly welcome. Looking at these issues from a safety and soundness perspective and risk to the insurance funds, the FDIC has not seen the ongoing activities that banks have engaged in for a number of years in the bank to present significant risk to the funds. In looking at what structure makes sense going forward, one does have to question whether it is necessary to add layers of regulation onto those activities that banks have quite safely, to date, been able to conduct in the banking organization.

By the same token, brokers have been selling the CDs of banks for a number of years. Nobody is advocating that that activity needs to be placed into separate subsidiaries of securities firms and then separately regulated by the bank regulators. The marketplace has essentially outstripped the measure of regulation, and what we need to do is to try to bring regulation more up to date with the changes that the marketplace has brought. Our view at the FDIC is that this legislation makes a very reasonable attempt to do that.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Iowa, Mr. Ganske.

Mr. GANSKE. One of the concerns I have heard expressed by the insurance industry is that banks conducting the business of insurance would have an unfair advantage related to concerns that the market could perceive a transference of the Federal safety net to affiliates of banks. This is something that you, Mr. Greenspan, have mentioned.

What actions could we take that would minimize that risk, Mr. Greenspan?

Mr. GREENSPAN. The concern that I have with respect to putting noneligible activities in the bank is that it does, in fact, expand the safety net and indeed is working off the implicit subsidy that that safety net accords, and in that sense, creates, in my judgment, a nonlevel playing field, whatever that may be.

I think the solution in that regard is, to the extent that you have such activities, that they are put into a separate affiliate of the holding company and thereby remove to a very substantial extent the issue of the question of a subsidy moving from the safety net to the new activities.

Mr. GANSKE. I can think of some analogous situations to my past medical practice. I would not want a customer or a patient to falsely believe that they would have protections that they wouldn't have and would seek to explain very clearly implications or risks.

Do you think that the legal situation in the banking industry would lead to sufficient explanations that, for instance, insurance products would not be covered by the FDIC?

Mr. GREENSPAN. The banking agencies, the Securities and Exchange Commission, in fact, everyone involved in this issue, has been working very assiduously to make certain that where the safety net begins and where it ends be made as explicit as possible to the consumers of financial products.

Does it always succeed? The answer is obviously not. The question is, should we keep trying? The answer is, most certainly.

Mr. GANSKE. Ms. Helfer, maybe you could comment on this issue also. In your opinion, do you think that the segregation of the banking and the securities activity in a bank or a SID is sufficient to protect the FDIC from excess exposure?

Ms. HELFER. If I understand the proposed legislation, H.R. 1062, the requirements for a SID are essentially for those activities that have already been conducted in the bank, with the possible exception of certain kinds of municipal bond underwriting. Essentially it is an issue of how Congress has already been defining the appropriate powers of banks over the years under the National Bank Act.

I agree completely that we must separate out from the safety net those activities that have not been defined as "banking" by the Congress over the years. Insurance activities, securities underwriting and dealing activities, should be in separate subsidiaries. They should be out from under the safety net. We do need to protect the deposit insurance funds from activities that are not—have not traditionally, over the years, been defined as "banking."

Mr. GANSKE. Ms. Williams, do you care to comment on this?

Ms. WILLIAMS. The experience of banks, not just national banks, but State banks as well, in selling insurance as agent over the years has reflected that that has been done in a way that is responsible and that has not seemed to have created concerns about customers being confused about whether they were buying an insurance product or getting an insured deposit. The risk to the safety net from having a bank sell an insurance product as agent has been one that, based on the experience and the track record, seems to be quite manageable.

Mr. GANSKE. Thank you.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Georgia, Mr. Norwood.

Mr. NORWOOD. Thank you, Mr. Chairman.

Ms. Williams, in looking at Mr. Ludwig's testimony, I am curious to know if you think there are any limits to the amount or type of securities activity that he would permit within a bank.

Ms. WILLIAMS. Yes, sir, definitely. There are parameters that are laid out in the National Bank Act in terms of what banks are allowed to do.

Mr. NORWOOD. You think Mr. Ludwig would agree with those?

Ms. WILLIAMS. That there are parameters in the National Bank Act?

Mr. NORWOOD. No, agree with the parameters.

Ms. WILLIAMS. I am sure he would agree with the parameters that are laid out in the statute.

What has occurred over the years is that there have been certain situations where the OCC has been asked to look at a variation on something that is not expressly specified in the statute and to answer the question of whether that is the same type of product that ought to be viewed as covered by the general description in the statute. So there are limits that derive from the National Bank Act on the types of securities activities in which national banks directly are allowed to engage.

Mr. NORWOOD. I was a little surprised to see in his testimony a call for the securitization of commercial loans to take place in banks. How different is securitization of commercial loans from the underwriting of corporate debt, and should securitization of the commercial loans be subject to SEC regulation?

Ms. WILLIAMS. In fact, they are. The securitizations of the one-to-four-family residential mortgages, consumer loan receivables, and to the extent that there are marketplace developments that allow greater ability to securitize commercial loans, involve pooling. Usually there are many, many loans that are pooled in a grantor-trust arrangement, and there is an SEC-blessed registration statement if there is a public offering of those interests in the trust.

Mr. NORWOOD. In conclusion—the question has sort of been asked, but I would like to hear you maybe say it in a different way—the statement makes reference to different regulatory burdens on page 5. Just very simply tell us what you think those are, and should we eliminate those regulatory burdens in the new bill?

Ms. WILLIAMS. Different regulatory burdens cited in the Comptroller's written statement?

Mr. NORWOOD. Yes, page 5, in his statement, I guess, and he is referring to the regulatory burdens in H.R. 1062.

Ms. WILLIAMS. Are you referring to what is at the bottom of the page, the new——

Mr. NORWOOD. Yes.

Ms. WILLIAMS. [continuing] new regulatory burdens?

If you take a look at the chart that is attached to the written statement and assume that you have a particular product or instrument that the bank is trying to figure out, and if you ask can the bank directly be involved in creating and then offering the product and how it would go about it, I think that the chart lays out the steps—the new steps, for the most part—that the bank would need to go through. That really sort of capsulizes the——

Mr. NORWOOD. I take it you feel they should be eliminated.

Ms. WILLIAMS. I think what we are saying here is that it is a very complex structure and that there are steps here that are not necessary in order to deal with issues of the risk presented by certain types of securities activities. Experience has shown, both here in the United States and abroad, that there are types of securities activities that simply don't present a level of risk to warrant this sort of road map here of trying to figure out how much of them can be done in the bank, not in the bank, in a bank SID, not in a bank SID, do they have to be forced out, what sort of regulatory scheme are they subject to.

Mr. NORWOOD. So I presume that means Mr. Ludwig would like to see them eliminated, or he could do it better.

Ms. WILLIAMS. I think what we would say is that there are unnecessary restrictions being placed on aspects of how banks conduct their business.

Mr. NORWOOD. Thank you, Mr. Chairman. I see the red light.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from California, Mr. Cox.

Mr. COX. Thank you, Mr. Chairman. I am not certain to whom to address my question because my question is, don't we have too

many different layers of regulation right now for things that, from the standpoint of the consumer at least, are essentially the same?

I note in reading the bill that not only are we going to, after the proposed deregulation, if you will, and the proposed revisions to Glass-Steagall, still have the Federal Reserve Board, the FDIC, the SEC, the Comptroller of the Currency and the CFTC, but now, because of an amendment that was added in the Banking Committee, we are going to have the Financial Services Advisory Committee, which is going to comprise all the foregoing, and I wonder whether we are being insufficiently visionary if what we are trying to do is adjust to the new marketplace reality.

Just to give a couple of quick examples, I used to have a savings account in a bank. I now have a mutual fund instead. As a consumer, they are the same to me. If I get a loan, an unsecured loan, probably I am going to get that from a bank as an individual, but if I have a small business, if might be commercial paper. It is essentially the same thing. One is a security; one isn't.

Commercial paper may not be a good example. Bonds, obviously, classified as securities. As a consumer, I might have a credit card, and who are two of the biggest issuers of credit cards today in the lending business? AT&T and Dean Witter. If I have a bank checking account, I may be an anachronism because I might just as well have a money market fund these days, same thing from the consumer standpoint.

I pay my bills on line with the financial services firm called Check Free, but it has to jump through a lot of hoops in order to use a bank somewhere, Bank One, so that eventually we follow all the regulations and we are still behaving as a bank. And as a consumer, I can—on line if I want—this morning, because I have read the newspapers, immediately sell my stock in Time Warner; I can get on line and do that. But that is a different company and because of the regulation, it is a different layer of regulation.

For lack of anywhere else on the panel to start, I am going to ask the Chairman of the Federal Reserve, are we being insufficiently visionary from a regulatory standpoint in this legislative proposal?

Mr. GREENSPAN. Yes, we are. We are being insufficiently visionary; I agree with that.

Let me just say this. As a general rule, if we impose excess regulatory requirements on a system which should not be required, we increase the costs of creating that service and make it less competitive, and as a consequence, would create incentives for other producers of financial products to come on stream.

Indeed, in many respects, the advent of checks coming out of money market mutual funds is precisely that sort of issue, and one of the things that we have not done appropriately, in my judgment, is to look at the full panoply of various different forms of regulatory layers which have been imposed over the years in response to what we perceive to be particular problems of an earlier era. But we tend not to review or sunset these types of regulations, and as a consequence, they tend to build up. They tend to create uncompetitive costs in the institutions on whom they are imposed, and as a consequence, force the product to be produced in another venue and probably a less efficient one.

It is important for us to try to review the regulatory structure periodically and strip it out; and there are other bills within the House of Representatives which, in my judgment, are at least moving in that direction and appropriately so.

Mr. COX. Might I ask any other member of the panel whether or not, since you are all regulators, willing, any one of you, to volunteer his or her regulatory agency to go on the chopping block in this new streamlined regulatory environment?

The SEC Chairman.

Mr. LEVITT. Let me say, I completely associate myself with Chairman Greenspan's view. I think that all too often, our regulations are suited to a different era, and it becomes so difficult to disentangle regulations that were put in place for a time when they may have been appropriate.

The SEC, as we talk, is evaluating all of the regulations that we feel may, in today's environment, provide impediments to capital formation, and we intend to change those regulations or abandon certain regulations. But applying that to this bill, I do think that there is a risk that, in an effort to create regulatory coherence, we could be merely readjusting the proposal in a way where there are new burdens and new problems imposed upon the various industries that are operating here. But I think that can be worked with.

I think, for instance, we have talked so much about the SID, and I have expressed great reservations about it. I had dinner last night with a variety of heads of firms in the brokerage industry that are greatly concerned about this particular device. The open-ended authority of the Federal Reserve Board to put new products into the SID concerns them, and I think that is probably something that we can work with and change if necessary. I think that is the beauty of a hearing such as this, to develop ways to see to it that we are not merely creating regulatory overlap. That is one of my great concerns about creating a SID as opposed to a separate entity which would function as we have functioned in the past in terms of functional regulation.

Mr. COX. Well, my time has expired. I want to thank Mr. Levitt and also Mr. Greenspan.

I wish that the ranking member of the Telecommunications and Finance Subcommittee were here to have heard your answer because there has never been a more forthright and direct answer. Yes, we are insufficiently visionary, you said, and I appreciate your forthrightness.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Oklahoma, Mr. Coburn.

Mr. COBURN. Thank you, Mr. Chairman. Just a short time.

I can't help but ponder the experience of this country and regulators over the savings and loan debacle, and I have to think that somewhere in the mighty wisdom of Congress, hearings such as this were taking place as we deregulated those financial institutions, and I hear such words as "strongly support" and then I hear words "great reservation," and then I heard, especially from Ms. Helfer, that we may be safer. There wasn't the word "is going to be safer"; it was "may." And this tremendous unknown, and the goals of this I agree with.

I just wonder if you might comment to reassure me in terms of what we are doing, especially with—in terms of the FDIC, where you see the FDIC. This is of tremendous concern to people in my district, bankers in my district. They are still wanting to know when the rates are going back down.

Ms. HELFER. Thank you very much for that comment.

From the FDIC's perspective, I think we have tried to assess H.R. 1062 from a safety and soundness perspective, recognizing, as Chairman Fields said at the outset, that we are not writing on a clean slate, that we have a system of regulation in place. How do we then look at the elimination of the Glass-Steagall Act in sequence with the structure that exists now without creating any gaps?

And I think your concern is, could there be gaps created in the way in which the legislation is constructed.

In assessing the legislation, I guess the belief is that this is, in fact, a reasonable, balanced approach which recognizes that in fact the securities activities that banks have to date conducted—and I might add, there is in fact some experience, because outside the United States, U.S. banks have been able to conduct securities activities through both subs of a bank and subsidiaries of a holding company, as well as the more limited experience in the United States—that there is very little evidence that these activities have produced additional risk to the deposit insurance funds when there were bank failures in the late 1980's which did not ultimately require the taxpayer to pay any money with respect to the bank failures.

Mr. COBURN. Let me just disagree with you, because banks are paying more for insurance; therefore, people who are borrowing from banks are paying more because those costs have gone up. So that is not necessarily correct.

Ms. HELFER. I certainly stand corrected on the way in which one may characterize deposit insurance, but with respect to appropriations, there were no appropriations to recapitalize the Bank Insurance Fund.

I think what we found was that institutions found traditional ways to lose money with loans that didn't turn out to be sound loans, and in fact those did cause losses to the insurance funds.

But the kinds of activities that a securities firm engages in and that banks would be permitted to do under this legislation are a range of financial risks that banks are accustomed to dealing with in the normal course of their business. So that, on balance, our judgment is that this legislation presents a reasoned, safe and sound approach, assuming the relevant protections provided for in the legislation which restrict dealings between affiliated organizations and the insured bank are, in fact, effectively implemented.

Mr. COBURN. Okay, thank you very much.

Just one other question. Chairman Levitt, would you specifically describe how you would set up a securities department that could be regulated by the SEC, that would not fall, as the OCC has said, in all this mess of trying to figure out whose obligation this security product is under? How would you set this up within a bank if were you going to allow a securities department within a bank?

Mr. LEVITT. I would create a separate entity which would have distinct capital and distinct management characteristics that would not be an integral part of the bank. I think that gives a much more rational way of surveilling and overseeing the activity of that subsidiary.

It was part of the original bill that preceded this bill, and I think that that kind of formulation would be, from the standpoint of both protection of the bank, the safety and soundness of the bank, and from the standpoint of encouraging and nurturing the sort of entrepreneurship which I feel is jeopardized by intermingling it with the bank because of the different cultures—I think this separation into a different entity would be the way I would go.

Mr. COBURN. Thank you.

Ms. Williams.

Ms. WILLIAMS. I think that illustrates one of the great difficulties that you face in crafting this legislation. Take an example of a small or mid-size business that is used to dealing with a bank, a loan officer; that is the relationship official for that particular business. Now, at a certain point, if that business is successful and grows, maybe it wants to sell some stock, have an offering of commercial paper or something. It would seem that under that scenario described there would be a point at which the people in the bank that know that particular entity's business and that could help it go to market are no longer allowed to be involved in the process.

Mr. LEVITT. Again, if you want to rationalize regulation rather than layer it and make it more expensive, then if you are going to create the SID, all securities should be placed into it rather than some here, some there, and our not knowing where to go and who to go to and how to do it to protect investors.

Mr. COBURN. Thank you.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Florida, Mr. Stearns.

Mr. STEARNS. Thank you, Mr. Chairman.

My first question is to Mr. Greenspan. It concerns the UBS you talked about earlier when Chairman Oxley had questioned you. What does UBS stand for? I assume that is banks in Switzerland.

Mr. GREENSPAN. It is the Union Bank of Switzerland.

Mr. STEARNS. Now, that is a very high-rated bank, as I understand it. Do they sell stocks and securities?

Mr. GREENSPAN. Yes. The answer is yes.

Mr. STEARNS. And isn't it true that Credit Suisse, which is a bank I presume in Switzerland, also owns the First Boston Bank in the United States?

Mr. GREENSPAN. That is correct, through CS First Boston Corp.

Mr. STEARNS. So we have a bank in the United States that is owned by a bank which deals in securities. Do you have any trouble with the arrangement—that arrangement in which a bank is owned by a bank out of Switzerland that sells securities? I mean, is there adequate protection for the First Boston Bank in the United States in the event that the bank in Switzerland sells securities and has problems? Is there adequate protection for the FDIC?

Mr. GREENSPAN. That particular arrangement, to my recollection, was grandfathered under the International Banking Act, and we

have very explicit guidelines for evaluating that particular process, and in my judgment, we have not run into any particular problems associated with that.

Mr. STEARNS. And Chairwoman Helfer, would you comment? Do you feel comfortable that the FDIC is protected at the First Boston Bank?

Ms. HELFER. To my knowledge, that institution does not have an insured office, either a branch or a subsidiary in the United States, but we can certainly provide more information for the record on that.

Mr. STEARNS. Okay.

[The information follows:]

FDIC records show that there is no insured entity named First Boston Bank, nor is that entity an insured branch of a foreign bank.

Mr. STEARNS. Chairman Levitt, do you think you are going to have to hire more employees if this bill passes?

Mr. LEVITT. I think in this environment, it is doubtful that we will hire more employees. But on your point, I think we have to ask ourselves the public policy question, that is: whether the kind of concentrated business systems that we see abroad would serve our country better than the sort of entrepreneurial investment banking efforts that have characterized very small investment banking firms that have assisted developing companies to become among the greatest in American commerce.

So I think we have to give some thought to whether there is anything from that system abroad that we care to emulate and put into our system.

Mr. STEARNS. Mr. Levitt, when you look at the chart it shows the permissible security activities for a bank and it shows that you are not going to be regulating municipal revenue bonds. How do you feel about—you will be regulating the other securities, but the municipal revenue bonds' eligible securities you will not be regulating. What is your opinion on that?

Mr. LEVITT. We have supported having the municipal revenue bonds going into the SID. A lot of thought has to be given toward this because we have seen evidence in recent years of activities in the municiple arena that really require very comprehensive oversight.

Mr. STEARNS. Are you saying you strongly recommend that the SEC regulate it rather than the bank regulators?

Mr. LEVITT. No, I am not saying that. I think that, given the existence already of a municipal securities regulatory scheme, we need to coordinate with the banking regulators to try to derive a more rational scheme of regulation and oversight.

Mr. STEARNS. Okay. Chairwoman Helfer, do you favor changing the amount of limits on the FDIC or do you think they should stay the same?

Ms. HELFER. The $100,000 insured deposit?

Mr. STEARNS. Because the whole crux of this debate is the people that are against the bill feel that the banks are going to have to be bailed out by the Federal Government. Obviously, if that was changed, there would be less of a risk for the Federal Government. So I think—have you done any studies as a result of this bill to

see whether that should be changed or not? Or do you feel that that is not a relevant point?

Ms. HELFER. We have taken a look at the issue of whether we think the bill implicates the insurance funds in a way that we would have some concerns about. As I have indicated earlier, we believe that the legislation is a reasonable balance that does not pose additional risk to the insurance funds with respect to the $100,000 limit. Obviously, that is a judgment that Congress made; and Congress can make a judgment to change that number if it chooses.

I believe the market has essentially discounted for the $100,000 level, and I also believe that there are people across the country who choose to put their savings—I know that Congressman Cox has decided to put his savings outside or not in an insured account. But there are those people in the country who have chosen to put their savings in insured accounts, and it may be that this level is a level they are relying on, but that is not a judgment the FDIC would make. I think that is, in the end, a judgment for Congress.

Mr. STEARNS. Thank you, Mr. Chairman.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Washington State, Mr. White.

Mr. WHITE. Thank you, Mr. Chairman.

Mr. Greenspan, I am troubled that you don't think this bill is sufficiently visionary. I am concerned that it may not be sufficiently visionary myself, and I think it would be a shame to miss the opportunity not to make this bill as visionary as it ought to be.

Even before you answered Mr. Cox's question, I sensed a little reluctance in your testimony. You said this was the next logical step. And I would be very interested to hear from you what we can do to make this bill better. What do you think we could do to—and it will probably never be quite as visionary as we might like. What could we do to move in that direction?

Mr. GREENSPAN. Unfortunately, the whole structure of supervision and regulation as it evolved over the decades has basically been a set of compromises coming out of the Congress; and in our constitutional system it is probably the best that is reasonably expectable.

Now the one thing that I am concerned about is that you can very readily make the best the enemy of the good, and I could probably sit here and give you my personal view as to how I think things ought to be structured to improve upon them. My suspicion is, were I to do that and were anyone to take me seriously and think about it, that we would end up with nothing. And I would suggest to you that we have to deal either incrementally or in modest chunks in order to get not only the full Congress and the administration willing to sign off on a particular piece of legislation but, more fundamentally, the American people; and I think we just keep moving in a certain direction, and I think we keep improving. We probably will never get to where any of us individually would like to be, but we are making progress.

Mr. WHITE. So you are saying that our political system is going to keep us from having the ideal regulatory structure?

Mr. GREENSPAN. It is also keeping us from making disastrous mistakes in the other direction as well.

Mr. WHITE. I understand. Well, let me as you this question: Forgetting the political realities for the time being, would you say that, ideally, we should be moving toward a system where there is a lesser role for the government and more role for private institutions to govern themselves or do you think we have the balance pretty well struck where it should be?

Mr. GREENSPAN. No, as the financial system becomes increasingly more complex and the ability of governmental institutions to keep up with the technology that is employed by various different financial institutions it is becoming ever clearer that, as I indicated in previous testimony and on related issues, that to exercize effective banking supervision—and I suspect this is probably true of securities supervision as well—that we are more apt to be functioning on making certain that the internal processes of financial institutions for risk management are suitable.

And that if we try to prod the individual institutions towards ever more awareness of their internal safety and soundness as well as the private institutions, the self-regulatory organizations who are the intermediary between government and the individual financial institutions, I think it is inevitable that regulation is going to be shifted increasingly towards the private sector if the overall safety and soundness of our total global financial system is our goal.

Mr. WHITE. Yes, Chairman Levitt?

Mr. LEVITT. I agree with so much of what Chairman Greenspan has said, but I do have a vision, really. And I have seen this Congress in recent months develop out of highly contentious issues the kind of dialogue and the kind of resolutions which heretofore would have been thought to be impossible.

And I guess my vision is one of a system where investors have confidence in the fairness and openness of the system, where companies can raise capital whether they are giant companies or tiny companies because there are firms small and large that are willing to take risks and a society that is willing to have them fail as well as succeed and regulators who will—and I say this as a regulator—who will try to step away from the fight for turf because that fight for turf often results in costs and redundancy.

Instead of trying to set up a series of mini-SECs within the banking system, I think one SEC is sufficient to do the job.

Mr. WHITE. Thank you very much.

Mr. Chairman, I see my time has expired.

Mr. FIELDS. The gentleman's time has expired.

The gentleman from Georgia, Mr. Deal.

Mr. DEAL. Thank you, Mr. Chairman.

I have enjoyed the intellectual dialogue that has been going on, but let me reduce it to a more elementary concern that I have. And for purposes of my concern and my inquiry I would make the analogy that in the early stages of development a tadpole bears a remarkable similarity to a whale, differentiated primarily by the size.

My concern is a concern that has been expressed by people in my State as we have seen larger banks come in, buy out, merge with, take over smaller banking institutions. And in the process of that we have seen State-chartered banks come in, answering the con-

cern of the constituency that bankers no longer want to act like bankers.

My concern is, is this bill heading us in a direction where bankers no longer want to be bankers but would prefer to be stockbrokers and insurance agents? And, in particular, Ms. Helfer, with regard to your statement criticizing the current structure of restrictions in their activities, that they have turned to riskier ventures such as construction financing, commercial real estate loans. In parts of this country—mine being one of those—those are considered to be primary functions of bankers.

Now, we have seen as this progress of absorption has taken place in the banking community that bankers no longer want to make those kinds of loans, and people who are engaged in those activities have had to gravitate to small loan companies. You would be surprised how many pawnshops we have in my State now as a result of this no longer wanting to do certain things in the financial picture.

My question is, are we headed further down that road of bankers not wanting to be bankers in the traditional sense by expanding their areas of operation? And, if so, how do we answer the concerns of folks back home that say, you know, tadpoles turn into frogs, they don't turn into whales?

Ms. HELFER. I very much appreciate your question because I think it has been a source of some concern to us at the FDIC that the banks' share of credit provided in this country has declined over the last 10 to 15 years or more. In many communities across the country, as you quite rightly point out, banks are the significant financial intermediaries who provide credit to small businesses and to individuals.

With respect to the testimony and the concerns about construction lending and real estate lending, the FDIC's experience in the late 1980's and early 1990's was that a significant share of the losses to the Bank Insurance Fund were, in fact, from unfortunate loans made in those areas that could not ultimately be justified on a cash-flow basis or, ultimately, on safety and soundness grounds.

I had occasion recently to meet with bankers from Georgia and to discuss bank lending at the FDIC, and I found it quite instructive because I do have the sense that there are bankers who really do want to find ways to meet the needs of communities and who don't want to get away from traditional banking.

I talked at some length with a banker from south Georgia on agricultural lending activities, and I have a sense that there are real business opportunities in these areas for banks, as you point out, and that there are bankers that want to meet those needs.

This legislation provides alternative means for assuring that there is—the banks can serve the broad cross-section of needs of businesses in their communities and that banks essentially won't have to do just one type of activity in the financial area when something really quite similar—which is called by a different name under our regulatory structure—might also be offered by the bank to the institution. In those small communities where banks are the principal financial intermediaries that is very important—that banks can offer the full range of service. This is not intended to force banks into areas where they don't feel comfortable and where

they don't feel they can put in place the necessary controls to monitor risks to the institution or the insurance funds.

Mr. DEAL. My concern is not that they are forced into it but that they would be enticed into it to the detriment and the neglect of the other areas. Do you see that as a danger in the direction we are moving?

Ms. HELFER. Well, I think that is a very legitimate concern. We have certainly seen in the past some areas where new powers, particularly with respect to savings and loans, were offered to them in the early 1980's. They took advantage of those new powers without necessarily having the range of experience and expertise to make certain that those activities could be done without losses. But one thing that I am comforted by is that the risks presented by the activities that would be permitted under this legislation are a range of financial risks that these institutions have experience in dealing with.

Mr. DEAL. Thank you, Mr. Chairman.

Mr. FIELDS. Thank you.

The Chair would like to thank this panel for coming and sharing with us this morning.

The Chair would also like to note that there are members who wish to submit statements for the record. That right will be afforded those members.

[The prepared statements of Hon. Carlos J. Moorhead and Hon. Fred Upton follow:]

PREPARED STATEMENT OF HON. CARLOS J. MOORHEAD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Thank you Mr. Chairman: As we progress through the process of modernizing and reforming our nation's financial services sector, I believe it is extremely important that we not overlook the sector of our economy that is the economic lifeblood of this country—our small business men and women. Small businesses employ over 50% of the private work force and are responsible for 47% of our GNP. Because they lack a unifying voice, the problems that confront small business all too often are neglected by our nation's legislators. With that in mind, I believe it is imperative that as we progress, we seriously consider how what we are about to do will affect America's small businesses.

Access to capital is perhaps the most vital issue affecting entrepreneurship, job creation, and innovation today. It is becoming more and more difficult for new ventures, existing companies, and our self-employed business people to borrow critically needed capital to fund their ventures. A major concern of this Congress must be how will financial services reform affect the availability of capital. Let me be specific. The federal government would not have a major guaranteed small business lending program if there was not an urgent need for one. This is not new news. This issue has been with us for over half a century.

And what about recent history, which has encompassed a great deal of business merger in this nation, especially in the financial sector? Recent Congressional hearings featured small business witnesses who had long-term loans and lines of credit called in by their new lenders. This had nothing to do with their financial track record, it was simply because the new large commercial lenders were simply not interested in some of these smaller financial ventures. If Members are interested, I would be more than happy to place evidence of this in our record. Compounding this problem is a disturbing article which appeared recently in *The Wall Street Journal*. In that article, a Journal reporter recounts his investigation of commercial lending by the nation's 20 largest bank holding companies. Although many of these companies widely tout their small commercial lending, their own figures provided to the government do not support this. In some cases they even lump credit card issuances, mortgage lending, etc. under the heading of small business lending.

I do not intend to go on and on about this issue. Quite frankly, I can summarize it in two questions. Is the reform we are undertaking going to provide more capital to our entrepreneurship sector? In addition, is the reform we are about to consider

going to encourage large merging financial enterprises to aggressively reach out to small businesses as opposed to creating a "we only want the BIG deals mentality?" I would hope any and all witnesses who appear before us would address these two questions and I would respectfully ask my colleagues on both sides of the aisle to seriously consider these questions as well.

PREPARED STATEMENT OF HON. FRED UPTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Thank you, Mr. Chairman. I am looking forward to hearing the testimony of our distinguished guests on HR 1062 today. I was especially interested in the written comments of Chairman Greenspan, as he explains very plainly what concerns me most about any attempt to alter our current banking law: Competition and technology are driving today's financial service marketplace, *not* government regulation.

Though I wished the bill would have gone even further to reduce the barriers to competition in the financial marketplace, I believe that HR 1062 is a good start to bringing these services into the 21st century. I am sure that when the Commerce Committee finally begins consideration of this bill, there will be a number of amendments offered to strengthen the marketplace competition inherent in HR 1062.

Michigan has provided a model for changing government regulation of the financial marketplace to ensure competition. Last year, the banking and insurance industry met and agreed to sweeping legislation which would allow state chartered banks to sell insurance as an agent, but not to assume underwriting responsibilities. The provisions in HR 1062 do allow for Financial Services Holding Companies (FSHC) to get in the business of underwriting, while still assuring adequate safeguards between federally insured deposits and insurance capital. While these provisions may need to be slightly modified, it is important that we make every effort to assure that states like Michigan, which have responded to the realities of the financial marketplace, not see their work preempted and limited.

Over the next two days, the Subcommittees on Commerce, Transportation and Hazardous Materials, and Telecommunications and Finance will hear from a number of witness, not all of them who subscribe to the theory that competition will make a better marketplace for all consumers. It is my hope that we will be able to see through efforts to place artificial restrictions on one industry or another, and that we will make efforts to assure that the playing field is level for *all* providers.

Again, I welcome our witnesses, and look forward to your remarks. I yield back the balance of my time.

Mr. FIELDS. The Chair would now like to call up Panel 2: Mr. Hughes, the Vice President and Chief Counsel——

Mr. DINGELL. Mr. Chairman, this has been a very fine proceeding up until now, but there are a lot of unanswered questions. I would like to have permission to have the record be kept open.

Mr. FIELDS. Without objection.

Mr. DINGELL. And I would like to submit a list of questions which I know our panel members would be delighted to respond to.

Mr. FIELDS. Without objection.

[The questions of Hon. John D. Dingell and responses to same follow:]

QUESTIONS SUBMITTED TO HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, AND RESPONSES TO SAME

Question: 1. In your testimony, you discuss H.R. 1062 in terms of the affiliations it would allow between banks and securities firms. Curiously, you nowhere refer to the bill's provisions which would allow banks' directly (in some cases, through separately identifiable departments or divisions, or "SIDDs") to engage in securities activities.

(a) Your written testimony states that "the further the separation from the bank, the better the insulation. We are concerned that conducting [securities] activities without limit in subsidiaries of U.S. banks does not create sufficient distance from the bank." H.R. 1062, however, would allow banks and bank SIDDs to engage *directly* in a range of securities activities (in other words, nothing would separate or insulate the bank from these activities).

While banks and bank SIDDs would be engaging in activities that are, under current interpretations, generally deemed to be "bank-eligible," it seems to me that the "risk of transference... of the subsidy implicit in the federal safety net" noted in your testimony still exists with respect to these activities. Moreover, some of the activities that would be available for bank SIDDs (*e.g.*, underwriting of asset-backed securities) are growing in volume and importance. Thus, it appears that direct bank securities activities, conducted through SIDDs, could rapidly expand beyond today's range. Please describe your views on whether (and if so, why) the risks that arise from conducting such activities in SIDDs rather than in separately incorporated entities are acceptable and manageable.

(b) As noted in the SEC's testimony (pp. 15-16), SEC net capital requirements work in combination with provisions of the Securities Investor Protection Act of 1970 ("SIPA") to maintain broker-dealer liquidity, limit use of customer funds to finance the broker-dealer's proprietary trading in securities, and protect customer funds and securities if a broker-dealer fails. Under H.R. 1062, however, bank SIDDs that engage in broker-dealer activities would not be subject to SEC net capital requirements; instead, the bank as a whole would be subject to bank capital standards (which currently focus on credit but not market risk), and SIPA provisions would apply to the SIDD. Please explain your understanding of how the SIPA and FDIC bankruptcy provisions, with their potentially inconsistent customer and depositor protection standards, would be applied in the event of the failure of a bank that operates a SIDD.

(c) The SEC in its testimony (p. 18) noted that "[b]ecause SIDDs would not be separate entities, with separate capital, the capital of the bank as a whole would be at risk if the Commission brought an enforcement action against a SIDD that involved significant penalties and/or disgorgement on behalf of investors." Please describe how the Federal Reserve, as the appropriate banking regulator for a state member bank, would respond to a situation in which it appeared that SEC penalties or disgorgement assessed against a SIDD would impact the capital of the bank.

Response: 1(a). As I testified, the Board believes that reform of the Glass-Steagall Act to permit banks to affiliate with firms engaged in broad securities activities is best done using the holding company framework, rather than through subsidiaries of banks. The holding company framework provides the bank and the federal safety net with better insulation from the risks associated with broad securities activities than any other organizational structure. More importantly, the holding company framework also more effectively limits the transference to the securities affiliate of the subsidy implicit in the federal safety net than would occur if a securities affiliate were permitted to be a subsidiary of a bank. These concerns are not significant, in our view, in the case of securities activities that banks currently are permitted to conduct directly. These bank-eligible securities activities have not raised significant safety and soundness concerns, and the market has already adjusted to the safety-net subsidy inherent in banks conducting these limited activities.

Moreover, H.R. 1062 provides additional protections in this area. It does so by requiring a bank with a securities affiliate to conduct its asset-backed securitization, private placement and municipal securities underwriting and dealing activities in a separately identifiable department or division ("SIDD"), hereby enhancing the functional regulation of these activities. In my view, the narrow range of these activities and the limited risks they pose make their conduct in a SIDD consistent with bank safety and soundness and the public interest.

1(b). SIPA applies to broker-dealers and therefore would appear to apply to a bank with a SIDD, which is required to register as broker-dealer. This raises the possibility of two separate, and potentially inconsistent, statutory liquidation procedures being applied to a bank with a SIDD in the event of the bank's failure. One approach to this problem would be to exclude banks with SIDDs from SIPA. As the activities in which SIDDs may engage are largely activities currently performed by banks, this would leave the rights of bank customers unchanged by the establishment of a SIDD.

1(c). The concern you cite—that action against a bank for violation of the federal securities laws could affect the bank's capital—is present today and has not caused any significant safety and soundness issue. Banks that engage in bank-eligible securities activities are subject to the anti-fraud provisions of the federal securities laws and, in the case of municipal securities underwriting activities, to the rules of the SEC and the Municipal Securities Rulemaking Board. I believe that the SEC and the Federal Reserve will work together, as they have in the past, to coordinate their actions to assure that a bank takes steps to maintain its capital while addressing SEC actions. If SEC penalties should be of sufficient size to substantially affect the capitalization of the bank, then the appropriate Federal banking agency would take appropriate action, pursuant to the prompt corrective action provisions of the Fed-

eral Deposit Insurance Act or other authority, to ensure that the bank is recapitalized.

Question: 2. H.R. 1062 (proposed new section 10(d) of the Bank Holding Company Act) would require the Federal Reserve to curb the activities of a securities firm in the event that an affiliated bank becomes undercapitalized or is determined to be poorly managed. This requirement would apply even if the broker-dealer were well-managed and well-capitalized. Please explain how such a requirement would promote the safety and soundness of an affiliated bank or a financial services holding company as a whole.

Response: 2. H.R. 1062 provides that a bank may affiliate with a securities firm only if the bank maintains a high level of capital. In our view, a high level of bank capital is the most important safeguard against the risks to the bank and the federal safety net associated with affiliation by a bank with a securities firm.

The provisions of H.R. 1062 that you outline promote safety and soundness by limiting the ability of a financial services holding company to continue to engage in securities activities in the event that the holding company does not maintain high levels of capital in its banks. These provisions are intended to provide a strong incentive for a financial services holding company that operates a securities affiliate to maintain in its banks the required high levels of capital. A holding company that cannot meet this obligation may divest its banks and continue its securities activities without change.

Question: 3. Please describe any areas in which you believe "umbrella" oversight of holding companies could be further streamlined in order to reduce the regulatory burden on holding company subsidiaries and affiliates.

Response: 3. As drafted, the bill already contains substantial streamlining of holding company oversight. Most notably, investment bank holding companies and securities companies that control only a small bank (both in absolute size and relative to the holding company's overall size) will not be subject to capital regulation or application requirements at the holding company level, and examinations will be circumscribed. The Board believes that this diminution in federal oversight of companies that control banks in these circumstances is appropriate in the context of efforts to provide a two-way street and to ensure that securities firms have an opportunity to affiliate with banks.

As banks controlled by a company grow in size, the potential for systemic risk and impact on the federal safety net increases, and along with it the need for umbrella supervision at the holding company level. We believe that H.R. 1062 strikes the right balance between preventing unnecessary and burdensome federal oversight and protecting the banking and financial system.

Question: 4. One of the alternatives for broker-dealers under Title I, Subtitle B of H.R. 1062 is to become an investment bank holding company and acquire a wholesale bank, which does not accept insured deposits. Why is it necessary for the Federal Reserve Board to be an umbrella supervisor of these investment bank holding companies, if the deposit insurance fund is not at risk?

Response: 4. As you note, wholesale financial institutions described in H.R. 1062 would not be allowed to accept insured deposits, and thus would not pose a direct risk to the deposit insurance fund. However, deposit insurance is only one of the three components of the federal safety net that necessitates some federal supervision to protect the public interest. As a member bank, a wholesale financial institution would have access to the payments system and the Federal Reserve's discount window. In view of these benefits and the potential associated risks, we believe, the limited supervision of companies that control wholesale financial institutions provided for in H.R. 1062 is vital to ensure the safety and soundness of the banking and financial system in the United States.

Question: 5. Section 20, which would be repealed by H.R. 1062, currently prohibits any bank that is a member of the Federal Reserve System from affiliating with any company that is "engaged principally in the issue, flotation, underwriting, public sale or distribution" of securities. Section 20, and more specifically the terms and conditions imposed by the Board on the establishment and operation of so-called section 20 affiliates by bank holding companies, creates incentives for banks to move all their securities activities into affiliates. This bill, however, takes a new approach by creating incentives to conduct certain securities activities directly in the bank. What assurances can you give us that this will not lessen the investor protections (*e.g.*, for state and local governments), in connection with their purchases and sales of government securities.

Response: 5. We do not believe that the bill lessens investor protections in connection with the purchase and sale of government securities. Under current law, municipal securities underwriting activities—whether conducted within a municipal securities dealer or in a bank—are subject to the same rules governing investor protec-

tion established by the SEC and the Municipal Securities Rulemaking Board. These rules would continue to govern the municipal securities underwriting activities of all banks under H.R. 1062.

Federal government securities activities of banks, including sales practices, are overseen by the bank regulatory agencies. Under the Government Securities Act Amendments of 1993, the bank supervisory agencies have the authority, similar to the NASD's authority over non-bank government securities dealers, to promulgate sales practices rules for bank sales of government securities. Staffs at the bank supervisory agencies are currently exploring the need for such rules in consultation with the staff of the SEC.

QUESTIONS SUBMITTED TO HON. EUGENE A. LUDWIG, COMPTROLLER OF THE CURRENCY, AND RESPONSES TO SAME

Question: 1. In your testimony, you refer to the outline for Glass-Steagall reform that was proposed by the Treasury Department last March; you note that "[t]he Comptroller's Office fully subscribes to the principles the Secretary set forth."

The Treasury outline called for, among other things, "limit[ing] banks' current exemption from SEC broker-dealer regulation." It did not, however, specify how the bank exclusions should be "limited." Please describe (specifically, and with supporting reasons) what limitations you believe should be imposed on "banks' current exemption from SEC broker-dealer regulation."

Response: Generally, the consideration of broad-based Glass-Steagall Act reform has been coupled with related consideration of amending the securities law exemptions for banks. The appropriateness of limiting or eliminating bank exemptions in this area depends on the nature and breadth of the Glass-Steagall reform being made. The Treasury approach to functional regulation in the context of the Glass-Steagall reform proposal it outlined in March 1995 recommended three specific changes: 1) limit banks' broker-dealer registration exemption; 2) eliminate banks' investment adviser registration exemption; and 3) facilitate appropriate delegation by the functional regulator to the lead regulator for the entity, in the interest of simplicity and economy. The Glass-Steagall reform approach endorsed by the House Banking Committee differs in several respects from the Treasury approach. Due to the evolving nature of the reform under consideration, the OCC has not developed detailed proposals for specific limitations on the securities law exemptions for banks. Our concern is to ensure that Glass-Steagall reform and the accompanying consideration of securities law amendments are consistent with the policies of regulatory effectiveness, fairness and efficiency.

Question: 2. In the preface to your discussion of the impact of H.R. 1062 (appended to your testimony), you state that "it is assumed" that banks would publicly advertise their brokerage services or would receive incentive compensation for such services. As a result, the bank exceptions from the definitions of "broker" and "dealer," as provided in H.R. 1062, would not apply. Please explain your reasons for adopting this assumption. Specifically, please describe how many banks currently advertise their brokerage services or receive incentive compensation for such services.

Response: The assumptions you have referred to in your question were made as a preface to the series of hypothetical situations we provided for the Committee as illustrations of various applications of H.R. 1062. These assumptions were based on our general experience in supervising national banks that are involved in providing brokerage services. That experience indicates that many banks advertise these brokerage, services and receive some type of incentive compensation for brokerage services. Our systems are not designed to retrieve information on the exact number of banks that meet all of the criteria included in the assumption, however.

The Interagency Statement on Sales of Nondeposit Investment Products, and the OCC's implementing examination procedures, also recognize that banks are involved in advertising brokerage services and in receiving incentive compensation for the service. The Interagency Statement requires specific disclosures in advertising bank related brokerage services to avoid customer confusion with FDIC insured products. In fact, last year the OCC reviewed more than 8500 documents, including many advertising and promotional documents, voluntarily submitted by more than 700 national banks for review of compliance under the Interagency Statement. The Interagency Statement also directly addresses incentive compensation, noting that "incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to customers."

Question: 3. The SEC in its testimony (p. 18) noted that "[b]ecause SIDDs would not be separate entities, with separate capital, the capital of the bank as a whole would be at risk if the Commission brought an enforcement action against a SIDD

that involved significant penalties and/or disgorgement on behalf of investors." Please describe how the OCC, as the appropriate banking regulator for a national bank, would respond to a situation in which it appeared that SEC penalties or disgorgement assessed against a SIDD would impact the capital of the bank.

Response: Although unlikely, it is conceivable that a SEC enforcement order, arising from actions in a SIDD, could impact a national bank's capital. In such a case, investors would clearly benefit from the protection of the bank's capital. Moreover, there are adequate statutory and regulatory mechanisms to ensure that the bank's depositors and the FDIC insurance fund would not be harmed by the penalty or order. First, the bank should be adequately capitalized in light of the risk exposure from the activity. Because there is a considerable record of experience with SEC enforcement actions against banks on non-exempted areas of the securities laws, the possible addition of broker-dealer enforcement would not appear to require any immediate revision to OCC bank capital regulations, but current capital rules permit the OCC to impose higher minimum capital ratios on hanks that face significant exposure to risks arising from non-traditional activities. *See* 12 C.F.R. §3.10, 59 Fed. Reg. 64563. How much capital we might require in any particular case depends on the activities, the profile of the bank, and the bank's ability to monitor and control the risks arising from that activity. Second, if a bank incurred a penalty lowering its capital to an unacceptable level, we would require the bank to take immediate steps to replenish its capital to acceptable levels or else face prompt and rigorous remedial response pursuant to the Prompt Corrective Action system established by Congress as part of the Federal Deposit Insurance Corporation Improvement Act of 1991. In extreme cases, this response could include placing the bank in conservatorship.

Question: 4. In her oral statement, Ms. Williams, OCC chief counsel, described as "functional regulation" a system under which an entity's lead regulator administers all the laws applicable to that entity—*e.g.,* banking laws, securities laws, etc. But what Ms. Williams described is in fact "entity" regulation, similar to the system that currently applies with respect to bank securities reporting requirements under Securities Exchange Act section 12(i).

This type of regulation was rejected over ten years ago by the Bush Task Group on Regulation. The Task Group noted that "entity regulation" involves duplication of effort among the various regulatory agencies and often results in differential regulation "when different types of institutions compete across industry lines." [1] Please explain whether (and if so, why) you disagree with the Bush Task Group's conclusion that functional regulation, and not entity regulation, would best promote governmental efficiency and equality of regulatory treatment.

Response: The concept of functional regulation can encompass several different approaches and the term may be used by different observers to mean different things. One form allocates to one regulatory body responsibility for establishing rules and then delegates to the primary supervisor responsibility for monitoring compliance. This approach has been adopted in regulating municipal and government securities brokers and dealers under the Securities Exchange Act of 1934. Another form of functional regulation would allocate responsibility for establishing rules for a particular activity, as well as supervising compliance by any entities engaged in those activities, to a single regulator. Under this approach, several regulators would supervise different, although potentially related, activities by an institution. In contrast, an "entity" approach to regulation, would allocate to a single regulator responsibility for establishing and administering the rules for all activities engaged in by a single institution. We also note that functional regulation is not simply a question of securities regulation of banks' activities, but must also encompass comparable "banking" regulation for the functionally comparable banking activities conducted by securities firms.

The OCC has strong reservations about any regulatory approach that would preclude bank regulators from overseeing permissible bank activities or that would otherwise interfere with the bank regulators' ability to supervise all activities of banking institutions for compliance with safety and soundness standards. Therefore, to the extent the 1984 Bush Task Group Report ("Report") embraced an approach to functional regulation that would exclude the primary bank regulator from performing these important regulatory functions, we would disagree with the Report's conclusions. We would note, however, that one of the implicit premises of the Report was that banking and securities activities could be separated fairly easily. Over the decade since the issuance of the Report, evolution in the banking and securities industries has blurred the lines that may have once more clearly separated banking

[1] *Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services* 39 (1984).

and securities products and markets. As a result, distinguishing banking and other activities has become increasingly difficult and a different approach to functional regulation may be more appropriate today. We believe that effective supervision of banking institutions requires that the primary bank regulator have the ability to supervise all aspects of a bank's operations. Accordingly, we would support a form of functional regulation that establishes comparable rules for competitors, but grants to the primary regulator of an entity the responsibility for administering those rules.

Question: 5. The Supreme Court's recent *VALIC* decision[2] would seem to confirm that the powers available to national banks under the "incidental to banking" clause do not include those powers expressly prohibited in the statute. Please explain how the *VALIC* decision impacts your analysis of national bank powers to engage in activities such as the underwriting of asset-backed securities (since underwriting is a power expressly denied national banks by 12 U.S.C. 24(7)).

Response: It has been the longstanding position of the OCC that a national bank is engaging in a permissible sale of its loan assets when the bank pools its loans and sells interests in this pool. In this regard, the OCC concluded that the Glass-Steagall Act was not intended to preclude banks from conducting this activity, in other words, that "securitization" of a bank's loans was a banking activity—*not* "underwriting" prohibited by the Glass-Steagall Act. The United States Court of Appeals upheld this OCC conclusion in *Securities Industry Association v. Robert L. Clarke,* 885 F.2d 1034 (2d Cir. 198)), *cert. denied,* 493 U.S. 1070 (1990). The *VALIC* decision does not undermine this conclusion. The decision recognizes that an activity or product may have different labels for purposes of different statutes and reaffirms that courts should give great weight to reasonable constructions of a statute by the agency charged with enforcement of that statute. Thus, if anything, the *VALIC* decision supports the OCC's position that when a bank pools its loans and sells interests in the pool, the bank is not engaged in "underwriting" prohibited by the Glass-Steagall Act.

Mr. DINGELL. And I hope the Chair would keep it open long enough because I have quite a few questions.

Mr. FIELDS. The Chair would be glad to do that for the distinguished member from Michigan.

Again the Chair wants to thank the panel.

Mr. Hughes, Vice President and Chief Counsel, American Council of Life Insurers; and Mr. Joseph Bracewell, Chairman and CEO, Century National Bank.

Mr. OXLEY [presiding]. The committee will come back to order.

We now recognize our two witnesses who have been already introduced by Chairman Fields.

Our first witness is Mr. Gary Hughes, Vice President and Chief Counsel for the American Council of Life Insurers. Mr. Hughes, welcome, and you may begin.

STATEMENTS OF GARY HUGHES, VICE PRESIDENT AND CHIEF COUNSEL, AMERICAN COUNCIL OF LIFE INSURERS; AND JOSEPH S. BRACEWELL, CHAIRMAN AND CEO, CENTURY NATIONAL BANK

Mr. HUGHES. Thank you, Mr. Oxley. The ACLI does appreciate the opportunity to appear today to discuss the perspective of life insurance companies on legislation to restructure the financial services industry.

As has been the case for some time now, the principal concern of the ACLI and its member companies is the disregard, if not the total disdain, that the Comptroller of the Currency has shown for the rights of the States to continue to define and regulate the business of insurance. In this context, we believe that the Comptroller has also usurped the role of Congress by rendering rather tortured

[2] *NationsBank of N. Car., N.A. v. Variable Annuity Life Ins. Co.,* 115 S. Ct. 810 (1995).

interpretations of the National Bank Act with the clear intent of expanding significantly banks' insurance sales and underwriting powers without so much as one word of the statute being changed.

In addition to declaring that fixed annuities, variable annuities, mortgage completion insurance, municipal bond guarantee insurance and other products are not really insurance but rather the business of banking or incidental to the business of banking, the Comptroller most recently issued a notice of proposed rulemaking asserting that State licensing laws, including those governing insurance underwriting and sales, are preempted in their applicability to national banks.

Of course, it is only through licensure that State regulators are able to provide essential insurance, consumer and solvency protections. Inasmuch as these safeguards have no counterpart in Federal banking law, the Comptroller is apparently willing to sacrifice virtually all insurance regulatory oversight in its zeal to broaden the insurance authority of national banks.

We believe this abuse of regulatory discretion by the Comptroller must be addressed, and we believe that H.R. 1317 is the appropriate means for doing so. This legislation, which was introduced by committee Chairman Bliley and ranking minority member Dingell, with broad bipartisan cosponsorship, would help the Comptroller's efforts to redefine the business of insurance by administrative sleight of hand and would reinforce the long-standing ability of the States to regulate anyone engaged in the business of insurance.

Of course, your consideration of H.R. 1317 can't be separated from that of H.R. 1062. Unfortunately, we do find H.R. 1062 decidedly not neutral on the subject of insurance, due in large measure to the fact that it does not address the situation with the Comptroller of the Currency.

By permitting banks to affiliate with securities firms and not constraining the Comptroller's ability to define insurance as banking, the bill would authorize bank/securities combinations and at the same time enable the bank to engage in an ever-broader array of insurance underwriting and sales activities, essentially enjoying all three major types of financial services. Insurers, on the other hand, would remain precluded from affiliating with banks.

It is for this reason that the ACLI feels so strongly that H.R. 1062 must be amended by the addition of the Bliley-Dingell language. If this amendment is not added either to H.R. 1062 or to other legislation moving simultaneously with that bill, the ACLI will be forced to oppose H.R. 1062 aggressively.

There are other aspects of the bill that we believe must be amended in order to make it more insurance neutral, and specific suggestions for corrective language are attached to our written statement.

Over the past few weeks committee staff has hosted a number of discussions between banks, insurers and agents in an effort to see whether there is some common ground for broadening H.R. 1062 to include affiliations between banks and insurers. For a variety of reasons, the ACLI must oppose this effort and the draft compromise language which it has produced.

First, the ACLI membership is deeply divided over the propriety of an insurer-bank affiliation. Consequently, we are simply not in a position to embrace legislation that permits them.

Second, for a number of years the ACLI has had in place fundamental policy considerations that must be present for us to give any serious consideration to legislation dealing with banking and insurance powers. The draft compromise language which we have seen does not comport with these policy mandates. For example, our policy would require that life insurers in mutual form have the same competitive opportunities as their stock counterparts, a circumstance that the draft compromise does not accommodate.

Third, the draft compromise incorporates a definition of insurance that we believe represents a significant retreat from the language in the Bliley-Dingell bill and would leave the door open for additional mischief by the Comptroller. As you might imagine, this definition is crucial, from our perspective.

Fourth, the draft provides for preemption of State insurance statutes and oversight, a notion that is flatly contrary to the idea of States' rights and functional regulation of insurance by the States.

Fifth, the draft affords the Comptroller the right to challenge in Federal court a State's determination of what constitutes insurance. We believe this is a question that is exclusively a State matter and should be resolved through a State's administrative process or State courts.

We find this particularly ironic in light of the fact that it is the Comptroller and not the States that has acted improperly and given rise to the need for this legislation in the first place.

Finally, we find it unacceptable that we have been asked to support legislation that would dramatically alter the competitive environment in which life insurance companies and agents operate but have been prevented from having a draft of this language that we could remove from congressional offices and distribute to our membership.

In sum, there are legitimate differences of opinion within the financial services industry on the merits and methods of restructuring, and we believe there is little benefit in broad solutions imposed on all players when no broad consensus for change has yet been reached. Such a course simply invites a stalemate on the House Floor with Members having to make no-win choices among and between major industries.

We support the Bliley-Dingell bill as an amendment to H.R. 1062 because it reflects sound policy, preserves competitive equity between banks and insurers, prevents further erosion of State insurance authority at the hands of the Comptroller and is fully consistent with the principle of States' rights.

That concludes my remarks, and I would be glad to answer any questions that the subcommittees may have.

[The prepared statement of Gary Hughes follows:]

PREPARED STATEMENT OF GARY HUGHES, VICE PRESIDENT AND CHIEF COUNSEL, SECURITIES AND BANKING, AMERICAN COUNCIL OF LIFE INSURANCE

The American Council of Life Insurance (ACLI) is the principal trade association for life insurance companies. Its 606 member companies account for over 91% of the legal reserve life insurance in force in the United States and approximately 94% of

the insured pension business. The ACLI's member companies also account for over 90% of the reserves attributable to annuities underwritten in the United States.

The ACLI appreciates the opportunity to present its views for the record on the way in which the financial marketplace is evolving and, more specifically, on H.R. 1062 as reported previously by the Committee on Banking and Financial Services.

General Observations

Our message to the Subcommittees is little changed from our statement of May 22, on H.R. 1317. From our perspective, there are three key points to be made: 1) H.R. 1062 in its current form is not insurance neutral and must be strongly opposed by the insurance industry, unless modified by the addition of H.R. 1317, the Bliley/Dingell bill; 2) The purported compromise amendment on bank/insurer affiliations is totally unacceptable to the insurance industry, and its addition would result in the insurance industry's forceful opposition to H.R. 1062 even if modified by the inclusion of H.R. 1317; and 3) The life insurance industry is not in a position at this time to support any other amendment to H.R. 1062 which would permit corporate affiliations between banks and insurers.

In our view, it is necessary to add H.R. 1317 to H.R. 1062 in order to preserve the ability of the States to regulate insurance, to protect consumers of insurance products, and to maintain competitive balance between the banking and insurance businesses. By taking this, course Congress will also address the notorious disregard which the Comptroller of the Currency (OCC) has demonstrated for Congressional intent and the right of the States to regulate the business of insurance.

OCC Has Usurped Congress' Authority

Over the past few years, the OCC has used tortured interpretations of the National Bank Act as a means to unilaterally expand the insurance authority of national banks. These interpretations have largely been rubber-stamped by a judicial system spellbound by the concept of regulatory deference. A few examples of the OCC's activity in this area are instructive:

1. Interpreted existing statutory authority of small town banks to sell insurance in rural areas in a way that permits money center banks with branches in small towns to sell insurance nationally.
2. Concluded that municipal bond guarantee insurance could be issued by national banks as "standby letters of credit."
3. Concluded that mortgage completion insurance could be issued by national banks as "debt cancellation contracts."
4. Pronounced that annuities are not insurance and can therefore be sold by national banks without limitation.
5. Pronounced that certain annuities can be underwritten by national banks as "deposit obligations," thereby forcing the FDIC to extend federal deposit insurance coverage to this form of insurance.
6. Proposed a regulation permitting national bank "operating subsidiaries" to engage in broad non-banking activities, presumably including insurance agency and underwriting activities in which the bank could not lawfully engage directly.
7. Issued a notice of proposed rulemaking that would preempt all state licensing laws, including those governing insurance underwriters and agents, in their applicability to national banks.
8. Actively counseled national banks to ignore state insurance licensing laws, even when the bank was currently complying with those laws.

The common thread in all of these actions by the OCC is that Congressional intent has been ignored, as has the competitive implications of these decisions on insurance companies and agents.

Of greater concern to consumers, perhaps, is that by defining traditional insurance products as "the business of banking," the OCC is also attempting to render state insurance consumer and solvency laws and regulations which apply as a result of licensure inapplicable to the insurance activities of banks. In fact, the agency has stated publicly that "...the OCC has consistently taken the position that a state may not require a national bank to obtain a state license to exercise the powers authorized for national banks..." Consumers buying insurance products from insurance agents are protected by comprehensive laws and regulations governing the following areas:

—Agent training, licensing, discipline
—Cost comparison requirements
—Right to rescind insurance contracts
—Policy form approvals
—Non-forfeiture laws
—Unfair trade practices

—Required matching of assets and liabilities
—Reserve requirements
—Investment limitations appropriate for the long-term liabilities insurers assume
—Requirements on policy readability and disclosure, including illustrations of policyholder and contract holder benefits
—Literally hundreds of additional rules and regulations appropriate to the operations of the insurance business and developed over more than half century by regulators with experience and expertise in the field.

These important consumer safeguards have no counterpart in federal banking law and would not apply to consumers buying similar products from national banks. This strongly suggests that the OCC is willing to sacrifice virtually all insurance regulatory oversight in its zeal to broaden insurance authority for banks.

This assault by the OCC on the ability of the States to define and regulate the business of insurance shows no signs of abating. As noted above, the OCC recently proposed regulations to permit potentially risky insurance activities to be conducted in operating subsidiaries of national banks and separately proposed to issue a regulation expressly preempting state licensing laws, including those governing issuers and sellers of insurance, in their applicability to national banks.

The abuse of regulatory discretion by the OCC must be addressed, and H.R.1317 is the appropriate means for doing so. The "Insurance States' and Consumers' Rights and Fair Competition Clarification Act of 1995," introduced by Commerce Committee Chairman Tom Bliley and Ranking Minority Member John Dingell, would halt the OCC's efforts to redefine insurance by administrative sleight of hand and would reinforce the ability of the States to regulate anyone engaged in the business of insurance.

One point of clarification. The ACLI is not suggesting that previous decisions of the OCC on specific insurance powers for banks should be overturned. We accept that banks are now in the business of selling certain insurance products. We do not accept that banks are entitled to underwrite annuities and life insurance, nor that state insurance laws governing the sale of insurance products should be preempted.

Impact of H.R. 1062

Clearly the Commerce Committee's consideration of H.R. 1317 cannot be separated from the ongoing discussions and eventual consideration of H.R. 1062, the Banking and Financial Services Committee's bill to repeal the Glass-Steagall Act.

H.R. 1062, as reported, exacerbates the insurance industry's problem with the OCC by tilting the competitive landscape still further in favor of banks. This occurs in three principal ways:

1) By permitting banks to affiliate with securities firms and not constraining the OCC's interpretive powers in the insurance field, bank/securities combinations would be able to obtain insurance powers and provide all three of the major types of financial services. Insurers, on the other hand, would remain prohibited from affiliating with banks.

2) The five year (and perhaps ten year) transition period for the divestiture of non-conforming activities by bank/securities enterprises affords these institutions an unreasonably long period to exploit combined banking, securities and insurance operations, to the disadvantage of competitors who are legally precluded from having a similar range of capabilities.

3) The "leeway" provision allowing bank/securities enterprises to invest up to 10% of their total consolidated capital and surplus in activities determined by the Federal Reserve Board to be "of a financial nature" poses a substantial likelihood that such enterprises could also have a sizable insurance underwriting component.

The bill also fails to address the deposit insurance policy issue raised by the so-called CD-Annuity, a product purporting to qualify not only for tax deferred income accumulation but also federal deposit insurance coverage. Surely there is no public policy rationale for extending federal government guarantees to a product and a market which have functioned perfectly well for decades in the absence of such government largess.

There may be a variety of ways to address the competitive equality issues associated with H.R. 1062, but we believe the preferable approach is simply to attach H.R. 1317 to H.R. 1062, reduce the divestiture provision from 5 to 2 years and require that the 10% leeway provision cannot be used to acquire an insurance underwriter unless the depository institutions within the holding company are all "wholesale banks." We have attached statutory language to reflect these suggestions.

Bankers Objections

Bankers have raised a number of specious objections to the Bliley/Dingell bill which need to be addressed:

1) Bankers strongly object to the States being given the authority to define the term "insurance," purportedly because state insurance regulators might try to define current bank products as "insurance."

We believe this objection is groundless for a variety of reasons. First of all, state insurance regulators have *always* had the implicit authority to define the term "insurance" and, since the enactment of the McCarran-Ferguson Act in 1945, have had that authority on an explicit basis. Second, looking back over the two hundred or so years that we have had formal regulation of insurance in this country, bankers cannot point to a single instance in which state insurance regulators have attempted to define a bank product as insurance. To the contrary, as detailed above, it has been the *federal* banking regulators who have raided the insurance industry's turf time and time again by defining insurance products as banking. That is precisely the reason, and in fact the only reason, that a state definition of insurance is necessary in the context of this legislation.

Moreover, state insurance regulators do not operate in a vacuum; they function on the same level as state banking regulators. (In some states the same individual handles both functions). In any event, a dispute resolution mechanism is present in the form of the state attorney general to ensure that neither state regulator unduly infringes on the jurisdiction of the other.

2) Bankers have also complained that if the states are permitted to define insurance, there may be 50 different definitions that may make conducting business difficult for a single institution doing business nationwide. Welcome, banks, to the world of insurance. While disparate treatment is indeed a possibility, as a practical matter, there is generally uniformity on this issue among the states. Moreover, regulatory diversity among state insurance departments is an unavoidable consequence of the state regulatory system with which insurers deal every day. If bankers desire to be in the insurance business, they can scarcely complain about operating under the same system that governs traditional insurers and agents.

3) Bankers have claimed that state regulators may subject them to discriminatory or competitively disadvantageous regulations with which other providers of insurance will not have to comply. As a preliminary observation, we would point out that H.R. 1317 does not change the status quo in that regard. Indeed, one of the bankers' favorite responses to the requirement that state regulation as contained in H.R. 1317 be observed is, "we already comply with state insurance laws." We believe the phrase "discriminatory regulation" when used by the banks in this context is code to describe their distaste for any consumer protection provisions which recognize the unique nature of the banking function and the need to avoid consumer confusion over FDIC-insured institutions selling non-deposit products. Perhaps this is why banks did not take kindly to federal bank regulators issuing the joint interagency guidelines on the retail sale of non-deposit products. These guidelines, of course, "discriminate" between insured deposit products and insurance products such as annuities.

In fact, there are differences between banks and insurance agents as sellers of insurance that need to be reflected in the regulatory process. Clearly, however, we would not countenance regulatory provisions which were determined to be unfairly or arbitrarily discriminatory.

It should also be pointed out that H.R. 1317 does not give state insurance regulators any additional regulatory authority—it just requires that whoever is engaged in insurance activities must abide by state law. We feel confident that banks and their regulators at the state level are up to the task of preventing unfairly discriminatory regulations from being put in place.

The real worry of banks in connection with H.R. 1317 is simply that the bill will do what it is intended to do—put an end to the era of unrestrained expansion of their insurance powers at the whim of the OCC, an unelected federal bureaucracy that has up to now ignored Congressional intent with impunity. We understand why banks are not supportive of this language, but frankly, their arguments lack credibility.

Proposed Compromise Amendment

Committee staff have hosted a number of discussions between banks, insurers and agents on the points of contention associated with broadening H.R. 1062 to encompass insurer/bank affiliations. We particularly want to commend the Chairman and his staff for making a sincere and dedicated effort to find common ground between all the affected parties that could serve as the basis for a compromise amendment on insurance. A lot of energy and thought has been put into this process by everyone who has been involved in these sessions over the last few weeks. Progress has been made, and nearly all of the issues have been placed in much sharper focus. But significant and, perhaps, fundamental differences remain. Despite good faith efforts to

reach a consensus, we could not do so within the time constraints of the committee's sequential referral.

Simply put, the ACLI is not in a position to support any proposal which contemplates affiliations within the same corporate structure between banks and insurers. Undeniably, there are sharp differences of opinion within our membership over the affiliation issue. However, for some years the ACLI has taken the position that there are four critical elements which at a minimum would have to be incorporated in any affiliation proposal in order to receive even initial consideration by life insurance companies: 1) all insurance activities would have to be conducted by an entity or entities separate and distinct from any depository institution. Such insurance affiliates could neither be divisions nor subsidiaries of a depository institution; 2) all such insurance affiliates would have to be subject to all the requirements of the appropriate state insurance regulatory authority, including requirements relating to company licensing and agent qualification and licensing; 3) the potential use by any depository institution of its credit-extending powers to promote the sale of insurance by or through its insurance affiliates would have to be subject to stringent safeguards designed to protect consumers and preclude unfair competitive advantages over insurance entities not affiliated with a depository institution; and 4) any structure permitting such affiliations would have to be supplemented by a grant of reciprocal authority that would permit both stock and mutual insurance companies to engage in the business of banking and other activities in which depository institutions are permitted to engage.

The discussions unfortunately did not result in unanimity on even these fundamental points. It was also a severe handicap not to be able to have free access to the committee staff's legislative language. Obviously, any proposal to fundamentally alter the relationships between the major financial service providers needs to be carefully scrutinized by the affected parties. I am disappointed to say that this has not been allowed by staff. Our brief opportunity to examine a draft of this proposal suggested that it failed to meet our four fundamental objectives noted above and raised a number of additional problems any of which would prevent us from supporting it. Accordingly, we would suggest that the issue of affiliations between banks and insurers be taken up in another context.

In sum, we do not believe there is a crisis facing the financial services industry which compels Congress to impose a particular "broad solution" on the financial services industry when no broad consensus has yet been reached. Such a course simply invites a stalemate on the House floor with members having to make "no-win" political choices between major interest groups.

We support the Bliley/Dingell bill because it prevents further erosion of state insurance authority at the hands of the OCC and is consistent with the notion of functional regulation which lies at the heart of all of the current restructuring proposals. Whether or not affiliations between banks and insurers are ultimately permitted, the Bliley/Dingell language is a necessary addition to H.R. 1062. Without it, we must strongly oppose H.R. 1062.

Mr. OXLEY. Thank you, Mr. Hughes.

Mr. Joseph S. Bracewell, Chairman and CEO of Century National Bank. Welcome.

STATEMENT OF JOSEPH S. BRACEWELL

Mr. BRACEWELL. Mr. Chairman, Mr. Fields, Mr. Dingell and members of the committee, I would like to thank you for this opportunity to testify before you. I filed a formal statement and would be happy to answer questions at the conclusion of my remarks.

My name is Joe Bracewell. I am Chairman of Century National Bank in Washington, DC, and Vice Chairman of West University Bank in Houston, Texas. I serve as a member of the board of directors of the Independent Bankers Association of America, which is the only national trade association exclusively representing the interests of the Nation's community banks.

We appreciate this opportunity to testify on the issues of the Glass-Steagall Act and Bank Holding Company Act reform proposals. Both of these acts have been cornerstones in maintaining the

safety and soundness of our banking system, prohibiting undue financial concentration and protecting the integrity of the deposit insurance fund. These legislative foundations help create our remarkably diverse financial services industry which, in turn, supports the strongest small business structure in the world.

When you legislate changes, you must be convinced that they are for the betterment of America and not just for the betterment of Wall Street and for those few banks that compete globally.

The purpose of the Glass-Steagall Act was to limit the securities activities of banks because of various hazards connected with the mixing of investment and commercial banking. The Bank Holding Company Act prohibits the mixing of banking and commerce. These restrictions were enacted because Congress felt that otherwise there would be consolidation in the industry that would lead to monopolization, and huge banking and industrial complexes would be created if bars were not put into place.

These issues have not changed over the years. There is still the potential for conflicts of interest when banking and nonbanking firms affiliate. Massive industry consolidation will lead to unmanageable systemic risk, and the integrated firms would enjoy an unfair advantage over banks and other commercial firms not associated with a bank.

Breaching the banking and commerce wall also undermines bank supervision, a point which was made clear in Federal Reserve Chairman Alan Greenspan's testimony before the House Banking Committee earlier this year.

H.R. 1062 would allow the affiliation of commercial banking and investment banking under a bank holding company that is regulated by the Federal Reserve Board. The bill would also amend the Bank Holding Company Act to allow bank holding companies to own companies that are financial in nature except for insurance underwriters.

The bill contains firewalls between the investment and commercial banks. However, our view on the question is still open as to whether these protections are sufficient. The IBAA is currently studying this issue to determine the most probable manner that banking and Main Street America will be well served by H.R. 1062.

We recognize that the financial services industry has changed significantly over the last two decades. We also recognize that large banking companies compete in different markets from community banks and therefore may need to exercise powers that they do not now possess in order to compete in those markets. However, granting large banks powers cannot be at the expense of community banks and the communities and small business customers that they serve so well.

With respect to three of the issues this committee may be considering during its 30 day review of H.R. 1062, the IBAA opposes the common ownership of banks and insurance underwriting companies.

IBAA also opposes any rollback of existing bank retail insurance powers.

Third, IBAA opposes the regulatory loopholes which have allowed the walls between banking and commerce to be eroded, specifically

the nonbank bank loophole and the unitary thrift holding company loophole.

We understand that this committee may consider a proposal to allow the affiliation of insurance underwriters and commercial banks. Breaching the banking and commerce wall in this manner will allow for the possibility of systemic risk that could prove fatal.

Insurance underwriting brings with it some very large risks, including the fact that insurance companies are direct investors in and developers of real estate and they invest in many other types of activities, including derivatives, and yet the insurance companies are not federally regulated. This committee should be most careful indeed in allowing affiliations between such entities and federally insured banks.

Two provisions of the National Bank Act permit national banks to engage in retail insurance and annuities activities. We understand that this committee is also considering a proposal to limit these powers. Retail insurance powers do not contain any safety and soundness threat to insured banks. There are also no consumer protection issues involved.

Bank-employed and affiliated salespeople are licensed by the State with the same license that independent agents have. The sole reason for limiting bank sales of insurance products is to restrict competition in the insurance sales area. This is anti-competitive, anti-free market and anti-consumer special interest legislation masquerading under a States' rights banner. IBAA strongly opposes any rollback of existing retail bank insurance powers.

Mr. OXLEY. Would you summarize, Mr. Bracewell?

Mr. BRACEWELL. In conclusion, the Glass-Steagall Act and the Bank Holding Company Act have provided significant protections for our banking system and to competitive equality in this country.

I wish to thank the committee for the opportunity to present these remarks on behalf of the IBAA.

[The prepared statement of Joseph S. Bracewell follows:]

PREPARED STATEMENT OF JOSEPH S. BRACEWELL, CHAIRMAN AND CEO, CENTURY NATIONAL BANK, ON BEHALF OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. Chairman, I am Joseph S. Bracewell, Chairman and CEO of Century National Bank in Washington, D.C. Century is $90 million, locally-owned and operated community bank, and we are members of the Independent Bankers Association of America (IBAA). I am proud to serve on IBAA's Board of Directors, and I also serve on IBAA's Bank Operations Committee. The IBAA is the only national trade association that exclusively represents the interests of the nation's community banks.

We appreciate the opportunity to testify before this joint subcommittee hearing of the House Commerce Committee on H.R. 1062, the Financial Services Competitiveness Act of 1995. This legislation amends the Glass-Steagall Act and the Bank Holding Company Act, both of which have been cornerstones in maintaining the safety and soundness of our banking system, prohibiting undue financial concentration, and protecting the integrity of the deposit insurance fund.

AMERICA'S DIVERSE FINANCIAL SYSTEM

The Glass-Steagall and Bank Holding Company Acts are legislative foundations that helped create our remarkably diverse financial services industry, which in turn supports the strongest small business structure in the world. We hear too much that we should change our existing system to mirror the Japanese, British or German system. I do not understand this type of inferiority complex thinking. We have the strongest, the best, the most resilient financial system in the world. When you legislate changes you must be convinced that they are for the betterment of all of Amer-

ica, and not just for the betterment of Wall Street and for those few banks that compete globally. I also note that Germany currently is critically reviewing its financial structure, particularly the role of universal banks in this structure.

There are several important banking issues that this Congress will face this year, including derivatives activities, the capitalization of the SAIF and the payment of the FICO bonds, and the reform of the Federal Home Loan Bank System.

These items should be receiving a higher priority than the repeal or reform of the Glass-Steagall Act, which is an issue without any popular constituency and which is being driven by a relative handful of large financial players. I would like to think that a benevolent God was passing all of us a message when the venerable Barings Bank failed a few days before Secretary Rubin unveiled the Treasury proposal for repealing Glass-Steagall. If I were one of the large financial players I also would be advocating repeal of Glass-Steagall—repeal would increase my market share and power.

Our main caution with regard to Glass-Steagall Act reform would be—do it right and know what you are doing. Otherwise, future Congresses will have to deal with the mess that you created. And as you know, we are still digging out from the abysmal public policy decisions that led to the S & L debacle and cost the American taxpayer more than $150 billion.

GENERAL BACKGROUND

The Glass-Steagall Act was enacted as part of the Banking Act of 1933. It was part of the protections that were put into place to prevent a recurrence of the systemic collapse of the banking system which led President Roosevelt to declare a bank holiday in 1933. The Supreme Court, in the case of *ICI vs Camp.*, held that the purpose of Glass-Steagall was to limit the securities activities of banks because of the following potential hazards:

1. The association of a bank and securities firm could impair public confidence in the bank if the latter performed poorly.
2. The bank might be tempted to make unsound loans to its securities affiliate or to companies whose securities it was underwriting.
3. Bank customer goodwill could suffer if any customer suffered losses after investing in securities offered by the bank.
4. The bank may make unsound loans in order to facilitate the sale of securities in which the bank or its affiliate dealt.
5. The affiliate could dump poor issues into the bank's trust department.
6. The bank's promotional interest in the securities would be in direct conflict with its obligation to render impartial advice.

With the Glass-Steagall Act protections, safety and soundness issues still come to the forefront. The potential for large and unexpected losses in an investment bank is a fact of life today. The Barings Bank is a good example. Barings was the oldest investment bank in Great Britain, over 200 years old. It was also said to be one of the most conservatively run investment banks in the country. Yet, over the course of only one month a single trader in its Singapore office was able to rack up losses that would appear to exceed Barings' capital by $1 billion. And the potential conflict-of-interest problems noted by the Supreme Court on the *Camp* decision are still valid today.

The Bank Holding Company Act prohibits the mixing of banking and commerce. The restrictions were first established in the Bank Holding Company Act of 1956, and they were amended and expanded in the 1966 and 1970 amendments to the Act. The restrictions were enacted because Congress felt that otherwise there would be consolidation in the industry that would lead to monopolization, and huge banking and industrial complexes would be created if bars were not put into place.

These issues have not changed over the years. There is still the potential for conflicts of interest when banking and non-banking firms affiliate. Maintaining the wall between banking and commerce is critical to the free enterprise system. Our system relies on banks to allocate credit to its most productive uses. Separating banking and commerce insures that credit is allocated impartially and without conflicts of interest. Breaching that wall raises the risk that credit decisions will be based on the business strategies of the bank's corporate parent and not on economic merit.

If banks were allowed to affiliate with commercial and industrial firms, they would enjoy an unfair advantage over other banks and over commercial firms not associated with a bank. Cross selling of services is very important in companies with multiple arms. Banks, subject to the Bank Holding Company Act, can only engage in activities closely related to banking. By contrast, if diversified firms owned banks, they would be free to combine banking with a wide variety of financial or other services.

Breaching the banking and commerce wall also undermines bank supervision by threatening the safety and soundness of our financial system. There is no practical way to separate a bank from its affiliates, either operationally or in the public's perception. Federal Reserve Board Chairman Alan Greenspan testified about his concerns with the efficacy of firewalls when he testified before the House Banking and Financial Services Committee on February 28, 1995. He warned against placing too much faith on firewalls, because "under stress, they tend to melt." This testimony was similar to testimony by then Federal Reserve Board Chairman Paul Volcker throughout the 1980s. For example, he testified before the Senate Banking Committee that "problems in one part of the system *will inevitably* be transmitted to other parts." (S. Rep. 100-19, 100th Cong. 1st Ses., March 19, 1987, pg. 9) (emphasis added).

Firewalls meant to protect the insured bank from the risks associated with securities, commercial and industrial affiliates will not work in an emergency. As history shows, in the case of a conflagration, firewalls will burn very quickly. One only has to look back a few years to Continental Illinois and its First Options affiliate. Although firewalls were in place, when First Options suffered massive losses, Continental Illinois National Bank stepped in and improperly loaned money to First Options to prop it up. Although the loan was quickly upstreamed to the holding company, and the bank suffered no loss that time, what occurred shows how useless firewalls are.

PROVISIONS OF H.R. 1062

On May 9, under the able leadership of Chairman Leach, the House Banking and Financial Services Committee approved H.R. 1062. This moves the financial services industry one step closer to economic and financial concentration. But compared to other proposals that had been advanced by the Administration, Congressman Baker, and others, the bill reported out by the Banking committee is relatively modest.

H.R. 1062 would allow the common ownership of healthy, well capitalized banks and securities firms under a Financial Services Holding Company supervised by the Federal Reserve Board. Banks could engage in investment banking activities only through a holding company affiliate, and substantial firewalls separate banking activities from securities activities. Any securities firm acquired by a bank must divest itself of ownership in any nonfinancial company within five years (ten years under certain conditions).

In addition, the bill creates a new category of bank holding companies called an Investment Bank Holding Company, also supervised by the Federal Reserve Board, that will be allowed to engage in a wider range of activities not covered by deposit insurance. Uninsured wholesale banks that cannot accept deposits in amounts less than $100,000 may be organized under an IBHC.

The bill requires that the lead depository institution and depository institutions controlling at least 80% of the assets in a financial services holding company seeking to acquire a securities company must have received a satisfactory or better CRA rating in its last exam. It also changes the "closely related to banking" test to a "financial in nature or incidental to such financial activities" test for purposes of authorizing non-banking activities for Financial Services Holding Companies.

NON-BANK BANK GROWTH CAP AND UNITARY THRIFT HOLDING COMPANY LOOPHOLE

H.R. 1062 also contains several items that IBAA finds highly objectionable. The bill lifts the 7% annual growth cap on well-capitalized non-bank banks, subject to certain conditions and approval by the Federal Reserve Board. Former FDIC Chairman William Seidman testified before the Senate Banking Committee that the nonbank bank loophole, which breaches the wall between banking and commerce, "is highly inequitable and detrimental. *Allowed to grow*, nonbank banks can weaken the real banks by competing in an unfair contest in the market place." (S. Rep. 100-19, 100th Cong 1st Ses., March 19, 1987, pg. 9) (emphasis added).

The bill, as reported out of the Banking and Financial Services Committee, also retains the unitary thrift holding company loophole that allows commercial firms to own unitary thrifts, and allows them to convert to a Financial Services Holding Company under an expedited procedure. Earlier versions of this legislation would have closed the loophole. This loophole breaches the separation of banking and commerce. Under current law, unitary thrift holding companies are not prohibited from affiliating with commercial firms. This has allowed thrifts to affiliate with industrial and other types of companies in violation of prudent safety and soundness principles. We believe the potential systemic risks permitted by this loophole should be a concern to lawmakers. The risks of merging banking and commerce are just as applicable to the thrift industry as they are to the banking industry. Repealing the

exemption would level the playing field and put all insured financial institutions in parity. IBAA can find no reason for the perpetuation of this loophole, which should be closed entirely rather than made marginally wider.

We strongly support a provision in the bill that allows well-capitalized national banks to underwrite and deal in all types of municipal securities. However, an amendment by Rep. Richard Baker (R-LA) eliminated language in the bill that would have protected local banks by limiting bids to underwrite an issuer's bond to underwriters within 100 miles. Under the Baker amendment, any bank in the country may bid to underwrite a municipal bond issuance anywhere in the country, making it more difficult for small local banks to compete. The IBAA would strongly support an amendment that would restore language restricting bids to give local community bankers a better opportunity to compete in this potentially lucrative market.

COMMON OWNERSHIP OF BANKS AND INSURANCE UNDERWRITING COMPANIES

IBAA is opposed to allowing the common ownership of banks and insurance underwriting companies. Such affiliations breach the wall between banking and commerce. Insurance underwriting brings with it some very large risks. Insurance companies engage in financial services that are the same or similar to those offered by commercial and investment banks, along with the underwriting of insurance. They also are direct investors in and developers of real estate. Yet insurance companies are not Federally regulated. This Committee should be very careful about allowing affiliations between an insured bank and a company that is not only exempt from Federal regulation but can also engage in a wide range of financial services and in real estate activities that have proved fatal to many Federally insured institutions. This Committee should be most careful indeed in putting haphazardly regulated financial entities together in a common structure, particularly in light of the concerns Chairman Greenspan has raised about the efficacy of firewalls.

Allowing the common ownership of banks and insurance companies also raises competitive issues. Our financial system relies on banks to allocate credit in an impartial manner to creditworthy entities. The separation of banking and commerce helps to insure that the credit-making decision is not tainted due to a conflict of interest. To tear down the walls raises the risk that credit decisions will be made on the basis of strategic decisions regarding the business of the holding company and its affiliates, and not on the creditworthiness of the borrower or the economic merit behind the request for the credit. There is also a possibility that credit will be more readily available to affiliates of the bank than to non-affiliates. A business with a guaranteed line of credit has a substantial advantage over one that does not. If this advantage is caused by an affiliation, rather than merit, it is unfair and undermines the basic tenets of the free market system.

One of the reasons given for allowing banks to be affiliated with other financial companies is that cross-marketing and joint-marketing of products and services is more efficient. More efficient it may be, but it raises the likely prospect of customer confusion over whether a product is or is not FDIC insured.

It also gives large integrated companies an unfair competitive advantage over independent banks. In an integrated company, a customer would be able to receive banking, insurance, and securities products all at one time. Although tying of the products is prohibited, the ability to market them as a package will exist. Banks that are not affiliated with insurance and securities companies would have great trouble competing with such companies. And the simple fact is that small banks do not have the resources to purchase such companies, and they are too small to be desirable acquisitions by insurance or securities firms. Thus they are effectively frozen out of the market.

MAINTAINING EXISTING NATIONAL BANK RETAIL INSURANCE POWERS

Two provisions of the National Bank Act permit national banks to engage in insurance and annuities activities. Section 92 authorizes national banks to act as agents for the sale of insurance from any office located in a town with less than 5,000 people. Under this authority, banks can sell life insurance, property-casualty, credit-life, and other forms of insurance products, to any customer, regardless of where the customer is located. Currently unsettled is whether or not State laws that prohibit affiliations between banks and insurance operations apply to national banks. There are conflicting court decisions on this issue that may be decided by the Supreme Court.

The second provision of the National Bank Act dealing with insurance and annuities activities is the incidental powers clause. The Act provides that a national bank may exercise "...all such incidental powers as shall be necessary to carry on the business of banking." OCC has ruled that this clause permits national banks to sell

annuities, underwrite and sell credit life insurance, and enter into other insurance marketing arrangements with insurance agents. Banks cannot sell general life insurance under this authority, however. In the VALIC case, the U.S. Supreme Court upheld the authority of banks to sell annuities under the incidental powers clause.

Bank holding companies, with a few exceptions, are generally prohibited from engaging in insurance activities under the Bank Holding Company Act of 1956.

Retail insurance powers do not contain any safety and soundness threat to insured banks. There also is no consumer protection issue involved. Bank-employed and affiliate sales people are licensed by the state with the same license that independent agents must have. Banks currently are required by law to disclose that annuities products are not insured by the FDIC.

The sole reason for limiting banks sales of insurance products is to restrict competition in the insurance sales area. This is anti-competitive, anti-free market, and anticonsumer special interest legislation.

IBAA opposes any roll-back of existing bank retail insurance powers.

BLILEY-DINGELL BILL

The *Insurance States' and Consumers' Rights Clarification and Fair Competition Act of 1995*—introduced by House Commerce Committee Chairman Tom Bliley (R-VA) and Ranking Minority Member John Dingell (D-MI)—provides that state laws governing insurance will prevail in all aspects of the insurance business. This means that states could prohibit the sale of insurance from banks in towns of under 5,000, they could define what an insurance product is, and they could re-define annuities as insurance products. All these actions would have the effect of rolling-back existing bank insurance powers. Contrary to claims by the insurance industry, banks engaged in insurance sales are licensed and regulated by the states in which they operate. Nonetheless, the Bliley-Dingell bill would give 50 state insurance commissioners unprecedented power over the insurance activities of banks. IBAA opposes attaching the provisions of the Bliley-Dingell bill to H.R. 1062.

CONCLUSION

The Glass-Steagall Act and the Bank Holding Company Act have provided significant protections to our banking system and preserved competitive equality in this country. This has given the United States an economic and financial system which is the envy of the world. Efforts to make major changes in the system should be undertaken only after great deliberation. Additionally, changes should be made on an incremental basis. No one can predict with certainty what the outcome of the proposed changes will be. If we take too great a leap, we could find that we have fallen down the precipice. Change can destroy as well as build. We are still witnesses to the ongoing destruction of the savings and loan industry—a process that was hastened by public policy decisions.

In summary, Mr. Chairman, IBAA opposes any amendment that would allow the common ownership of banks and insurance underwriting companies, or roll-back existing bank retail insurance powers. IBAA also opposes attaching the Bliley-Dingell bill to H.R. 1062 in the Commerce Committee or on the House floor. Common ownership of banks, securities firms and insurance companies could lead to the formation of huge economic and financial cartels. For example, it would allow the formation of a company composed of NationsBank, Goldman-Sachs and Metropolitan Life. It also would bring commercial firm ownership of banks into play, which IBAA strenuously opposes.

I wish to thank this Committee for the opportunity to present the views of community bankers on these important issues.

Mr. OXLEY. Thank you.

The Chair would recognize himself for a line of questioning.

Mr. Hughes, you stated in your written testimony that "the life insurance industry is not in a position at this time to support any amendment to H.R. 1062 which would permit corporate affiliations between banks and insurers other than H.R. 1317." And yet you also argue that H.R. 1062 tilts the competitive landscape in favor of banks because banks right now are gaining insurance powers through court and OCC rulings, while insurers are not allowed to affiliate with banks. Wouldn't such affiliations as per your argu-

ment help even the competitive balance and increase efficiencies and synergies for many insurance companies?

Mr. HUGHES. Mr. Chairman, I think there are two ways of going about, from our perspective, addressing H.R. 1062. One is, you broaden it and encompass insurance in the affiliations. The other is you make it as insurance neutral as you can get it. As we have indicated, our membership cannot agree on the propriety of affiliations. Therefore, our approach has been to make the bill as much insurance neutral as we can get it. The notion to dump the synergies and so on of broad affiliations appeal to us.

I would have to say that for a broad segment of our membership the answer to that question is no. Over the years I don't think you have seen insurance companies clamoring to gain a commercial banking capability, and for a large segment of our membership that does remain the case.

Mr. OXLEY. Well, as you know, the legislation itself is silent. H.R. 1062 is silent on insurance. I don't think the term insurance, the word insurance, is used at all in the legislation. And yet you are telling the committee that somehow this is not neutral on insurance?

Mr. HUGHES. I think what we are suggesting is silence does not necessarily equate with neutrality.

The point we are trying to make is this: The bill would move things further by permitting banks and securities firms, the two legs of the three financial services, to combine. Insurance would not be a part of that.

By the same token, by not addressing the situation with the Comptroller of the Currency, where the Comptroller is affording banks insurance powers, they are just calling it banking, a bank/securities combination would be able to, over time, develop more and more insurance powers, so that the bank/securities organization would also be able to do insurance.

In other words, a bank could do insurance, securities, and banking; and an insurance company could do insurance and securities, but not banking. And, in our view, that is not a neutral approach to legislation; and our view is that silence isn't what does the trick. There has to be some affirmative step taken to stop, to neutralize the activities of the Comptroller of the Currency in this area or the landscape is going to continue to tilt even further.

Mr. OXLEY. You were present for the testimony of the previous panel, I think, and most of them indicated that with the changes that have taken place in technology and changes taking place in global markets that the whole financial services industry is undergoing a tremendous change.

Does the insurance industry fear that they will be left on the side of the road as the rest of the industry and the banks and the securities people provide modern-day services and the insurance industry would remain simply a nonplayer?

Mr. HUGHES. I think there is certainly insurers within our association that would take that view. There are other views that the financial institutions, the insurance companies and the banks that have minded their knitting are the ones that have done quite well over the years. So there also is a perspective of do what you know and do it well and don't try and be all things to all people.

There are some very strongly held views within our business as to why bank insurance affiliations and legislation to permit them don't make any sense, and we have heard I think in this morning's panel some of those views touched upon.

There are a number of life insurance companies that feel that the issue of credit quality—and with an increasingly sophisticated public that is looking for credit quality there is concern within our business that it is impossible through subsidiaries, affiliates, SIDs, whatever you want to use to separate the perception that a bank and its insurance underwriting affiliate somehow enjoys Federal protection and is a safer institution.

Companies, at least insurance companies that have spoken with us, say we don't know how you can legislate that misperception away. You can put all the structures you want in place and you can have firewalls and you can have restrictions on affiliate transactions, but the bottom line is if a AAA credit life insurance company is dealing with a BAA bank that has an insurance underwriting affiliate, the marketplace may perceive them as equal competitors.

Mr. OXLEY. Let me just ask one last question on annuities.

Do you think banks should be allowed to sell but not underwrite annuities?

Mr. HUGHES. I think the courts and the regulators have taken us beyond that point. The ACLI is not advocating rolling the clock back and taking away any insurance powers that the regulators and the courts have already bestowed upon banks. What we are saying is that much and no more. Let's have legislation that, in essence, takes a snapshot of where we are today, gives banks powers that they have, does provide that the States functionally regulate them through the insurance departments but create the opportunity for no more mischief.

Mr. OXLEY. So your testimony is that in a dynamic financial services industry, the insurance industry would essentially like to be frozen in time?

Mr. HUGHES. Again, you have companies that have varying perspectives on that issue, and you have to distinguish within some companies' minds between insurance sales and insurance underwriting.

I don't think there is any question that insurance companies have entered into broader and broader retail sales arrangements with commercial banks. I think that reflects the economic reality of what is going on. Quite another thing, though, to press those companies into saying that the corporate affiliations are the trend of the 1990's.

This has been debated for 20 years and more, and I think there are people that remain convinced that it is basically not a sound idea. They don't necessarily, I think, agree that that doesn't indicate that our business isn't dynamic.

Mr. OXLEY. My time has more than expired.

The gentleman from Michigan, the ranking member of the full committee.

Mr. DINGELL. Mr. Chairman, thank you.

Gentlemen, welcome to the committee. Thank you for being here.

Mr. Bracewell, isn't H.R. 1317 consistent with the prevailing view in Washington these days? That is, that the States are often in a better position to identify and serve the needs of their citizens than is the Federal Government?

Mr. BRACEWELL. The IBAA views itself as a procompetitive organization, if you will; and in the world of bank regulation that has led us, of course, to support strongly the dual banking system, State and Federal regulation.

In the insurance area, our view is that the enabling of the insurance regulators within the States to regulate the securities powers of national banks is really an anticompetitive approach. And while it does shift power to the States, it essentially takes away powers from businesses that are out in the world helping the economy grow.

Mr. DINGELL. Now, the States have been the traditional regulators of rates and services provided by a lot of companies which importantly affect interstate commerce but are really regional in character—regional telephone companies, rates and services for utilities such as electrical services, gas, water. And, traditionally, States have fulfilled this role in the insurance industry. Why should we move away from this traditional role when doing so would be dramatically inconsistent with the purge that Congress has promised the public?

Mr. BRACEWELL. Mr. Chairman, the last panel had some dialogue about whether the bill was visionary enough, and what I didn't hear anybody saying is that moving backwards was something that ought to be considered. And what we have currently is a system where national banks in the retail sales of insurance can compete, and they are—in that activity, they are regulated by the State regulators. So we are really talking about a corporate powers issue and more players in the economic arena.

Mr. DINGELL. Let's talk about that because that leads me to an interesting line.

I am just a poor Polish lawyer, and I walk in and see my friendly banker. I say, I would like to get a mortgage. He says, Mr. Dingell, you are just the kind of fellow we are looking for. He says, you fill out these forms, and we will issue you the mortgage. And while you are here, we will arrange to give you a whole bunch of our special services. We will take over your brokerage, we will take over your insurance, we will take over your other financial activities, and we will serve as your investment advisor. And I am going to say, you know, that is a wonderful idea because I know it is going to get me this mortgage.

Isn't this going to give us just a wee bit of—how should we say—coercion if we allow the banks to have all this broad authority? They get somebody in fat, dumb and happy, wants a loan, and all of a sudden he finds that his best chance of getting that loan is by giving his bank his securities business, his insurance business and a number of other financial activities into which banks will be moving if they get this? How am I, just a poor Polish lawyer, going to be protected against that?

Mr. BRACEWELL. Well, clearly, the——

Mr. DINGELL. My friendly banker puts his arm around me and says, you just go down to the end of the hall and see our experts

on these matters, and we will give you the best of service, and you will get your loan.

Mr. BRACEWELL. Well, clearly, the landscape in the financial services industry has changed a lot in all respects, not just in the banking world, and the situation you describe is certainly more the wave of the future than of the past. The use of the term coercion, I think, brings in——

Mr. DINGELL. A wonderful opportunity for coercion, though, isn't it?

Mr. BRACEWELL. Well, to say it is an opportunity for coercion I think is twisting a situation and making it look bad when, in fact, it is happening all over the world, not only in banks, but you could do the same thing in Merrill Lynch, for example.

Mr. DINGELL. And poor Mr. Hughes, his folks all of a sudden don't have any insurance business. It has all gone to the banks.

Mr. BRACEWELL. Well, the banks are not in the insurance underwriting business, and I believe that is the business that his constituents are in.

Mr. DINGELL. Do you have a comment, Mr. Hughes?

Mr. HUGHES. I think we have seen that the Comptroller would be delighted to get banks into the insurance underwriting business.

I suppose the only thing I would add is that a life insurance company shouldn't be perceived as just an underwriter. The company not only manufactures its products but it has mechanisms to sell them, and there are often employees of the company that are agents. So a life insurance company does both manufacture and distribute its product.

Mr. DINGELL. Just one quick question. I notice my time is over.

Gentlemen, should the Congress consider revisiting any of the interpretations and regulations of the Office of the Comptroller of the Currency that appear to ignore Congress' intent as a part of our consideration of legislation to comprehensively overhaul the regulatory structures governing the financial services industry; and, if so, gentlemen, which ones?

Mr. BRACEWELL. I will go first and say that it is our view that the regulatory environment should move forward and not backward.

Mr. DINGELL. Mr. Hughes?

Mr. HUGHES. Yes. I am not sure where the Comptroller is moving the regulatory environment, and there are probably a fairly long list of Comptroller determinations, rulings, what have you, that we would be delighted to see Congress address, ranging from operating subsidiaries to preempting State law to allowing national banks to issue forms of annuities.

Mr. DINGELL. Would you submit that for the record, if you please, and also you, too, please, Mr. Bracewell?

Mr. Chairman, I thank you.

Mr. OXLEY. The gentleman from California, Mr. Cox.

Mr. COX. Thank you, Mr. Chairman.

I would like to give our witnesses both a chance to respond to one of the statements in Mr. Bracewell's testimony which I think is provocative. He says, "The sole reason for limiting bank sales of insurance products is to restrict competition."

I wonder if I might start with the insurance perspective on that statement.

Mr. HUGHES. I guess I am not sure what Mr. Bracewell was referring to. I think any regulator of any business has the authority, under appropriate circumstances, to constrain activity. We have seen with the joint interagency guidelines that, apparently, the Federal bank regulators in the context of retail sales of investment products have felt it necessary to issue regulations that would constrain activity.

The States happen to be the regulators of insurance, and if there are circumstances that they feel are appropriate to constrain bank activity in the insurance business that would seem just as appropriate as the Comptroller constraining the activities of national banks.

Mr. COX. And would you expressly reject the notion that it is anticompetitive?

Mr. HUGHES. As a blanket matter, yes. I think you would have to go through bit by bit by bit and look at what exactly it is that you are talking about and make some judgment as to the effects of that regulation on competition.

Mr. COX. Mr. Bracewell, I wonder if I can ask, since it is your statement, so I trust you agree with it, I wonder if I can ask you, more generally, is any restriction of this type a restriction on banks from selling something, a restriction on insurance companies from engaging in banking, a restriction on securities firms from doing either innately anticompetitive?

Mr. BRACEWELL. Well, I would draw the distinction between restricting the enterprise from engaging in the activity and regulating the manner in which it is conducted. I think we are talking in that particular issue about restricting the ability of businesses that are already in that business from continuing in that business. They are regulated and licensed.

On the broader issue, I think it is a balance between safety and soundness and concentration of economic power on the one hand and the ability to offer a broad array of products and services on the other. So I would agree that there is some tension there, but where there are no safety and soundness and concentration concerns to arbitrarily limit the ability of a bank to engage in a particular line of business seems anticompetitive, yes.

Mr. COX. Mr. Hughes, insurance products can be very complicated. As a matter of fact, health insurance products can be very complicated. I remember when we were debating the administration's proposal for national health insurance an exchange between the First Lady and an insurance agent in which the insurance agent asked the First Lady if we were going to have a nationalized system of insurance what would become of all the independent insurance agents. And I believe she responded something to the effect: You are a clever person. I am sure you will find another job.

Is there a similar concern among independent agents who sell life insurance that the function that they perform in the system, which is to interact directly with customers and describe a variety of different kinds of very complicated financial instruments in terms that they can understand, that that function will be done away with?

Mr. HUGHES. Frankly, I think that is a question that would best be posed to the independent agents on the panel on Thursday. We represent life insurance companies and life insurance——

Mr. COX. I want to ask you because I think I know how the agents will respond. But I want to ask you because agents play currently a rather significant role in the distribution system.

Mr. HUGHES. Well, from the perspective of our membership, I think there is a very strong view from companies that utilize field force agents that they are instrumental in selling the products and that the role of the agent to those companies is extraordinarily important. And I think the companies that use them, employ them, feel that they do provide value added and that it is an essential part of the system for distributing life insurance products.

Mr. COX. Does the bill reported from the Banking Committee affect that arrangement?

Mr. HUGHES. Well, it does in the sense that, going back to Chairman Oxley's question on silence versus neutrality, if you are leaving an avenue open for the Comptroller of the Currency to increasingly say that insurance products are really the business of banking and that, therefore, banks can conduct them directly and without any oversight at the State level on a regulatory basis very different than the basis that traditional agents are subject to, then I think, yes, it has very dramatic competitive implications.

Mr. OXLEY. The gentleman's time has expired.

Mr. COX. Thank the chairman.

Mr. OXLEY. The gentleman from Iowa, Dr. Ganske.

Mr. GANSKE. This question is for Mr. Hughes. Mr. Hughes, my impression is that the insurance industry is basically unhappy with the current situation because the OCC is loosening up the regulations for the banking industries. Is that correct?

Mr. HUGHES. (Affirmative nod.)

Mr. GANSKE. And, Mr. Bracewell, my understanding is that the banking industry is basically unhappy with the current situation because it has been losing market share of financial services. Is that an overstatement?

Mr. BRACEWELL. I think that is a fair statement for the industry generally, yes.

Mr. GANSKE. Okay. Mr. Hughes, your statement says that you support H.R. 1317, but if we adopted H.R. 1317, am I correct in reading that you still would not support H.R. 1062?

Mr. HUGHES. Correct.

Mr. GANSKE. Mr. Bracewell, if we adopted H.R. 1317, what would the banking industry's position be on H.R. 1062?

Mr. BRACEWELL. We would oppose H.R. 1062.

Mr. GANSKE. So we have a situation where both major players are opposing the bill. Are we in a situation where the status quo is better than what a reasonable compromise might be? Mr. Hughes?

Mr. HUGHES. I think we would generally favor a reasonable compromise.

With the inability of our membership to reach agreement on the broad question of affiliations, it is very difficult for us to ever come out in support of a bill that provides either limited affiliations between banks and securities firms or broadened affiliations between

banks, securities firms and insurance firms. And it is for that reason that if the Bliley-Dingell language is added and if certain other changes are made we would withdraw our objections to the bill, but we still don't feel that we are in a position, given the split within our membership, to support such legislation.

Mr. GANSKE. I understand the split, and I think there is probably some split in the banking industry on this issue, too. If I am correct, that is why this is such a difficult problem. I want to thank you, gentlemen.

Mr. OXLEY. The gentleman's time has expired.

The gentleman from Florida, Mr. Stearns.

Mr. STEARNS. Thank you, Mr. Chairman.

I think my colleague, Mr. Ganske, has sort of touched on the problem. All of us are sort of concerned about the split of two good friends here, and we are trying to come up with some compromise language.

Let me ask Mr. Bracewell, if the banks are already complying on a voluntary basis with all State insurance laws and regulations, why are you concerned about a clarification of State insurance authority?

Mr. BRACEWELL. I think it is the concern that that authority would be used to take away the corporate powers that national banks have to engage in the business itself.

Mr. STEARNS. Do you see any language in the Bliley bill that could be changed that you could accept? In other words, do you think there is a point where you could accept the Bliley bill if certain language was changed; and, if so, what would that language be?

Mr. BRACEWELL. I believe on the specific language I prefer to submit a written response.

Mr. STEARNS. Terrific. Terrific.

Let me ask Mr. Hughes, on the main bill, could you suggest in writing or could you say here at the hearing any language you would recommend that would provide acceptance by the insurance industry with the exception of the Bliley bill language in total?

Mr. HUGHES. We have attached to our statement language that provides amendments in several respects. One would be to so-called basket provisions or leeway provisions that would permit a bank/securities organization to still own an insurance underwriter. The other has to do with some very liberal divestiture provisions. And, again, in both instances we have amendatory language attached to our statement.

Mr. STEARNS. Mr. Hughes, is there any like future product that you can mention today that is coming down that the insurance industry would be selling that is not—that has got you real concerned that perhaps would have to be defined in a bill? Is there any language that you would think we would need to protect this future product? I am trying to think in terms of future language that would allow you flexibility.

Mr. HUGHES. There is nothing that comes to mind.

I think what we have tried to do is we have approached our suggestions for how to handle this is to say whether you are talking about the business of banking or the business of insurance, it is more than just looking at black letter law. You can't just look at

a statute and say, well, now I know everything that the business of banking entails.

Quite obviously, you leave the interpretation of what that business is to the primary regulator of the functions so that the banking regulators can define what the business of banking is. And the States, because they are the primary regulators of our business, should be in a position—for over 200 years have been in a position—of defining what the business of insurance is.

There are mechanisms in place now if the Insurance Commissioner of a State and the Banking Commissioner of a State disagree. Most likely that would be something resolved by the State Attorney General.

We have not seen overreaching on the part of insurance officials in all that period of time. We have seen it by Federal banking officials. So our approach to this has simply been to say let's make it clear that the States, as they have for 260-some years, are the ones making the decision on what is insurance, looking at their statutes, laws and regulations.

Mr. STEARNS. Mr. Hughes, have you looked at the language that Mr. Bracewell has attached to his opening statement?

Mr. HUGHES. I have not.

Mr. STEARNS. Okay. Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman's time has expired.

Let me ask just a couple questions before we complete this panel. I am interested in both of your opinions on the town of 5,000 exemption and what the scope of that exemption should be, both in terms of products and territory, with the understanding that the—I think most of us agree that the original intent that the Congress provided in the statute has been expanded rather substantially. And, Mr. Hughes, let me start with you.

Mr. HUGHES. Well, acknowledging that this is principally an issue for insurance agents rather than insurance companies, I would observe that what we have seen from our perspective seems to be a fairly expansive interpretation of the statute. But, again, I would defer on that to the panelists you will have on Thursday.

Mr. OXLEY. Mr. Bracewell.

Mr. BRACEWELL. I think our position is that where there are no safety and soundness concerns, consumer concerns or concentration of economic powers concerns that the broad interpretation of this provision is in order and that it should not be rolled back.

Mr. OXLEY. Do you have any facilities in towns of fewer than 5,000?

Mr. BRACEWELL. No, sir.

Mr. OXLEY. So you don't really have a dog in that fight?

Mr. BRACEWELL. It is not an issue for either of the banks that I am personally associated with.

Mr. OXLEY. We thank both of you gentlemen for your testimony.

We now introduce the third panel and the final panel for the day: Elizabeth Randall, the Commissioner of Banking for the State of New Jersey, representing the Conference of State Bank Supervisors; and Philip Feigin, President of North American Securities Administrators Association, Washington, DC; and Martin Mayer from the Brookings Institution.

STATEMENTS OF ELIZABETH RANDALL, COMMISSIONER OF BANKING, STATE OF NEW JERSEY, REPRESENTING THE CONFERENCE OF STATE BANK SUPERVISORS; PHILIP FEIGIN, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION; AND MARTIN MAYER, BROOKINGS INSTITUTION

Mr. FIELDS [presiding]. Ms. Randall, we will begin with you, recognize you for 5 minutes. At the end of 5 minutes we will ask you to summarize.

Ms. RANDALL. Thank you very much, Mr. Chairman, and good afternoon.

I am Elizabeth Randall, Commissioner of Banking for the State of New Jersey. I am here today on behalf of the Conference of State Bank Supervisors, also known as CSBS. CSBS is the professional association of State officials who charter, regulate, and supervise the 8,000 State-chartered banks and more than 600 State-licensed foreign banking offices nationwide. We appreciate the opportunity to testify before you today.

Mr. Chairman, CSBS applauds your efforts to modernize our financial system. The Conference of State Bank Supervisors has a long-standing policy in support of expanded bank activities that provide a broader range of choices to the consumer, enhance competition, and do not jeopardize safety and soundness. H.R. 1062 takes some important steps toward that goal.

State bank supervisors oversee the safety and soundness of approximately 6,700 State banks that are not members of the Federal Reserve System. These State nonmember banks are not subject to the Section 20 restrictions of Glass-Steagall. These banks have traditionally been able to conduct a broad range of nonbanking activities, as authorized by their State legislatures and within the bounds of safety and soundness. These activities have primarily been in the fields of agency and brokerage. Currently, 43 States authorize discount or full securities brokerage for their State-chartered banks.

Seventeen states allow banks to underwrite securities through bank subsidiaries; 22 allow bank insurance sales; and 17 allow their state-chartered banks to sell real estate.

State-chartered banks that are not members of the Federal Reserve System generally have the option of conducting their state-authorized expanded activities within the bank or through operating subsidiaries. This structure provides for consolidated supervision of a bank's entire business by the state bank supervisor. States may also require that subsidiaries, such as securities agencies, receive separate licenses from the appropriate state regulator. This combination of functional supervision, with consolidated oversight, has worked well at the state level.

Changes to our current system should preserve safety and soundness. They should also enhance competition in the financial marketplace, offer opportunities for innovation in products and delivery systems, provide flexibility to regulators and bank management, and allow the market to promote efficiency by preserving investor choice. The market should drive changes in the industry. We regulators must supervise these changes to safeguard consumers, depositors, and taxpayers.

H.R. 1062 includes a number of provisions that advance all of these goals.

State initiatives have spurred almost all of the major advances in U.S. bank products and services. Checking accounts, adjustable rate mortgages, electronic funds transfers, and interstate branching are just a few of the bank services that originated at the state level. The dual banking system recognizes that individual markets vary widely from state to state or even from community to community. State banking laws allow local policymakers to determine how best to preserve and protect their citizens.

You have asked us specifically to comment on appropriate structures for bank securities activities. H.R. 1062's new affiliate structure would offer important new opportunities to Fed member banks and bank holding companies.

The key to expanding powers is effective supervision. State and Federal banking agencies must supervise any banking organization that engages in additional activities from the top down, as well as from the bottom up. The structure in H.R. 1062 is appropriate because it does provide for comprehensive supervision. However, we see no need to centralize the supervision of expanded products and services in one particular Federal agency. States have worked very well with both the FDIC and the Federal Reserve in supervising a wide range of financial institutions and their activities.

Effective supervision of the entire organization will reduce the need to enact a host of specific firewalls into statute. Enacting rigid requirements into statutory language almost inevitably creates loopholes, while limiting the regulators' flexibility to address these loopholes. Guidelines, rather than rigid requirements, would also avoid the one-size-fits-all approach that we have seen in previous legislation.

Comprehensive supervision at the top of an organization, whether it be a bank or a bank holding company, is absolutely necessary to protect insured deposits, consumer interests, and, in the case of very large organizations, the very stability of our financial system as a whole.

State bank supervisors are an integral part of our Nation's system of state banking regulation. State banks are well capitalized, profitable, and serving their customers well. H.R. 1062 is a good beginning to modernizing our Federal banking system.

We look forward to working with you, Mr. Chairman, and the members of the committee in adapting our dual banking system for the 21st century and I look forward to any questions you may have.

[The prepared statement of Elizabeth Randall follows:]

Prepared Statement of Elizabeth Randall, Commissioner of Banking, State of New Jersey, on Behalf of the Conference of State Bank Supervisors

Good morning, Mr. Chairman and members of the Committee. I am Elizabeth Randall, Commissioner of Banking for the State of New Jersey. I am here today on behalf of the Conference of State Bank Supervisors (CSBS), on whose Board of Directors I serve. CSBS is the professional association of state officials who charter, regulate and supervise the 8,000 state-chartered banks and more than 600 state-licensed foreign banking offices nationwide. We appreciate the opportunity to testify before you today.

Mr. Chairman, CSBS applauds Congress's efforts to modernize our financial system. The Conference of State Bank Supervisors has a longstanding policy in support of expanded bank activities that provide a broader range of choices to the consumer,

enhance competition, and do not jeopardize safety and soundness. We believe that H.R. 1062 takes some important steps toward that goal.

State Authorizations of Expanded Bank Activities

Under our dual banking system, states and the federal government independently charter and regulate financial institutions for the good of their citizens. The vast majority of banks—71.4% of the industry—are state-chartered. These banks hold 47% of all assets and deposits in the U.S. banking system.

A bank's charter determines its powers, and states have traditionally authorized a wide range of powers for their state-chartered banks. Of the 7,680 state-chartered banks nationwide, 6,697 are not members of the Federal Reserve System. These state nonmember banks are not subject to the restrictions contained in Section 20 of Glass-Steagall. These banks have been able to conduct many non-banking activities, as authorized by their state legislatures, and within the bounds of safety and soundness, as determined by their state bank supervisors. These activities have primarily been in the fields of agency and brokerage: insurance sales, real estate agencies, sales of uninsured investment products, and travel agency. Currently, 43 states authorize discount or full securities brokerage for their state-chartered banks. Seventeen states allow banks to underwrite securities through subsidiaries; 22 allow bank insurance sales; and 17 allow their state-chartered banks to sell real estate.

Until 1991, states were also able to authorize their banks to engage as principals in a wide range of expanded activities. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) restricted such state bank activities to only those permitted to national banks, unless the FDIC determines on a case by case basis that the activity poses no significant risk to the deposit insurance fund. Under this standard, the FDIC has approved a number of additional activities for state-chartered banks.

Expanded Powers through Bank Subsidiaries

State-chartered banks that are not members of the Federal Reserve System generally have the option of conducting their state-authorized expanded activities within the bank or through operating subsidiaries. In fact, many states that allow their banks to engage in expanded activities require that they do so through subsidiaries. This subsidiary structure provides for consolidated supervision of a banks entire business by the state bank supervisor. States may also require that subsidiaries such as insurance agencies receive separate licenses from the appropriate state regulator. This combination of functional supervision with consolidated oversight has worked well at the state level.

CSBS believes that changes to our current system should preserve safety and soundness while first, enhancing competition in the financial marketplace; second, offering opportunities for innovation in products and delivery systems; third, providing flexibility to regulators and bank management; and finally, allowing the market to promote efficiency by preserving investor choice. It is not appropriate for regulation to drive new products and services or new delivery systems; rather, the market should drive changes in the industry. As regulators, we must supervise these changes to safeguard consumers, depositors and taxpayers. Regulation in a market-driven environment can promote safe and sound behavior by making additional avenues for innovation available to well-managed institutions and by limiting the activities of unhealthy banks.

H.R. 1062 includes a number of provisions that advance these goals. Allowing banks to underwrite revenue bonds directly, for example, is a valuable innovation for both the industry and state and local governments.

We do have some concerns, however, about other aspects of the bill. As we begin to modernize the federal structure for new products and services, our main concern is that we not create a system in which federal law becomes the only avenue for innovation in the banking system.

Benefits of State Innovations

One of the keys to our dual banking system is that it provides for initiatives at the state level as well as at the federal level. In fact, state initiatives have spurred almost all of the major advances in U.S. bank products and services. Everything from checking accounts to adjustable-rate mortgages, from electronic funds transfers to interstate branching, originated at the state level. A state bank was the first to offer a NOW account, and state banks developed the automatic teller machine. Because states can act individually to authorize new products and services, banks in other states and the federal banking agencies have an opportunity to learn from these state-chartered banks' experience. When new activities emerge one state at a time, systemic risk is minimized. If an activity proves too risky, unprofitable, or

harmful to consumers, it is much easier for a single state to change its law than for the federal government to reverse itself.

When changing federal law, we must preserve the states' ability to experiment independently with new products and services, new structures and new delivery methods. State-authorized powers are the bridge that brought us to this point. Now that we are here, we must not burn that bridge behind us.

Appropriate Structures for Bank Securities Activities

You have asked us specifically to comment on how banks and bank holding companies should structure their securities activities. We feel strongly that banking organizations should have the option of conducting securities activities through either separately identifiable divisions, as state law currently allows, or through holding company affiliates. We continue to be concerned that H.R. 1062, as reported by the House Banking Committee, may jeopardize the balance of our dual banking system by reducing state banks' current ability to offer their customers expanded products and services in the most cost-effective ways.

The bill prohibits new state authorizations of securities underwriting activities for bank subsidiaries. While grandfathering existing activity, the bill shifts new activities to affiliates of financial services holding companies, subject to Federal Reserve regulation. This would preempt state authority over future activities. Under our current structure, we are not aware that the activities of any state bank's securities subsidiary have threatened the deposit insurance fund. Given this experience, we should not dismantle this structure. Instead, we should build on it, as we broaden the products and services available to banking consumers.

The new affiliate structure proposed by the bill would offer important new opportunities to Fed-member banks and bank holding companies. However, we feel strongly that this should not be the only option available to state-chartered banks that want to engage in these activities. As currently drafted, H.R. 1062 would require that state banks form holding companies to engage in certain state-authorized activities. In our view, this requirement strikes at the heart of the dual banking system. Requiring this additional structure is unnecessary. It centralizes power in the federal government, and moves regulatory authority away from the states which developed these innovative activities. It would be a great loss if, in modernizing our banking system, we limited the structures available to bank management or the traditional authority of the states over the delivery of financial services to their citizens.

The dual banking system recognizes that, although in many ways the market for financial services is now nationwide, individual markets vary widely from state to state or even from community to community. State banking laws provide an opportunity for local policy makers to determine how best to meet their citizens' needs and protect their citizens' well-being.

For this reason, we are also concerned about provisions that would preempt states' ability to decide that certain powers are not appropriate for their banks, or that certain structures are not appropriate means for their citizens to obtain certain types of financial services. The principles of Federalism and states' rights, as recognized in Section 7 of the Bank Holding Company Act, require that states retain their ability to restrict activities as well as to expand them.

Supervision of Nonbanking Activities

As we learned all too well during the savings and loan crisis of the 1980s, the key to expanding powers is effective supervision. For this reason, we believe that the state and federal banking agencies must supervise any banking organization that engages in additional activities from the top down, as well as from the bottom up.

We believe that this type of comprehensive supervision can be equally effective in a subsidiary structure, as the parent bank's primary regulators can examine the subsidiaries as part of a comprehensive examination of the bank. The structure in H.R. 1062 is appropriate because it does provide for comprehensive supervision at the top. However, we see no need to centralize in one particular federal agency the supervision of expanded products and services. States have worked very well with both the FDIC and the Federal Reserve in supervising a wide range of financial institutions engaged in a broad range of activities.

Effective supervision of the entire organization will reduce the need to enact specific firewalls into statute. Past experience has shown us that enacting rigid requirements into statutory language almost inevitably creates loopholes, while limiting the regulators' flexibility to address these loopholes. Regulatory guidelines, which regulators could then adapt for institutions on a case-by-case basis, are a better approach than rigid statutory requirements. Guidelines, rather than rigid require-

ments, avoid the "one size fits all" approach that we have seen as a result of previous legislation. The types of restrictions appropriate for large institutions may not be suitable for small ones, and vice versa.

We are not comfortable with a "functional regulation" model that disregards the banking regulators' responsibility for the overall safety and soundness of the entire organization. As we have seen throughout this debate, interested parties do not agree on exactly what "functional regulation" is or on how it would work in practice. We would like to reiterate our conviction that comprehensive supervision at the top of an organization, whether it be a bank or a holding company, is absolutely necessary to protect insured deposits, consumer interests, and—in the case of very large organizations—the stability of our financial system as a whole.

Activities of Foreign Banking Offices

A significant portion of the assets that state bank supervisors oversee are held by foreign banks. These international banks operating in the United States have different structures; the majority are wholesale, uninsured operations that are prohibited from taking insured deposits.

We believe that "national treatment" means parity of treatment, not identical treatment. H.R. 1062 attempts to provide national treatment to foreign banking organizations in the United States. The structure of the bill allows for this parity of treatment.

Conclusion

State bank supervisors are an integral part of this nation's overall system of bank regulation. State regulation and supervision is professional and effective. State banks are well-capitalized, profitable, and serving their customers well. Preemption and restriction of state powers, state bank structures, and state regulation weakens the system as a whole. Preserving the authority of each state to determine the bank structure, products and services that best suit their citizens' needs, strengthens the system.

We believe that H.R. 1062 is a good beginning to modernizing our federal banking system. It recognizes that the lines between traditional banking and other financial services are disappearing. It provides for a system of comprehensive oversight, although we would like to see the options for supervision expanded to recognize our current structure of bank subsidiaries under state and federal supervision. We look forward to working with you, Mr. Chairman, and with the other members of the Committee, in adapting our dual banking system for the 21st century. I would be happy to answer any questions the Committee may have.

Mr. FIELDS. Thank you, Ms. Randall.

Mr. Phillip Feigin, President of the North American Security Administrators Association.

STATEMENT OF PHILIP FEIGIN

Mr. FEIGIN. I am Phil Feigin, the President of NASAA this year and also the Colorado securities commissioner. In the U.S., NASAA is the national organization of the 50 state securities agencies. I appreciate the opportunity to appear before you to comment on H.R. 1062 and the need for and benefits of functional regulation of the retail security sales activities of banks.

There can be no question that the world of consumer finance and investing has changed dramatically in recent years. One of the unfortunate consequences of these changes has been consumer confusion, and in no instance is this more apparent than that of the retail marketing of uninsured investment products by banks and on bank premises.

In our most recent previous appearances before Congress, NASAA has reported on the problem state securities regulators have encountered directly through inspections of bank broker-dealer securities activity and from the complaints we receive from consumers in our states. You may be interested to learn a few of the trends that we see emerging of late.

First, most of the complaints we are receiving involve elderly bank customers who are directed to securities sales staff by bank employees. Based on the experience of these older consumers, we know that lobby posters and written disclosure forms are insufficient warnings in the face of slick, oral presentations and assurances made by the security sales people. Regrettably, many of these cases are brought to our attention by younger relatives of these unsuspecting investors. This compounds the enforcement problem because the actual investor often has little recollection of what actually occurred.

Second, a large majority of the complaints being lodged with states' securities agencies involve oral statements made during a sales presentation. In one case, an investor came away from a sales session believing that the investment principal was guaranteed; it was just the interest that wasn't.

Third, our experience has been that many of the bank broker-dealer sales people have been poorly trained or inadequately supervised. The security sales activity in many banks is insufficient to warrant establishing a branch office for a brokerage firm. Instead, you get inexperienced and, essentially, unsupervised people.

Finally, most of these elderly consumers are first-time investors. They don't know when they are misled or otherwise dealt with inappropriately because they don't have any other investment experience to compare it with.

The simple fact is that we have not kept pace with the dramatic changes in the marketplace. While there have been serious efforts over the years, most notably perhaps by this subcommittee, to rationalize the oversight of new banking activities, we nonetheless are left today with a regulatory system that defies common sense, is totally inadequate, and potentially could result in serious and devastating losses of both consumer confidence and assets.

Banking regulation in the country is designed to ensure safety and soundness, as we have heard, for the financial institutions while state and Federal security regulation is about investor protection and, in large part, focuses on imposing standards on people who sell securities.

The Congress, the states and the Federal securities regulators have crafted a highly integrated and sophisticated system of screening, testing, licensing, business and sales practice regulation and discipline. There are extensive regulatory injunctive, criminal, and private civil remedies available in the case of violations. There are striking differences between securities regulation and the scheme set up under the interagency statement issued last year by the Federal banking regulators.

To point out just a few, there is no system of licensing in banking, while on the securities side, we know we have entry requirements, there are grounds for denial, background checks, law product knowledge testing, and supervision. These things are all securities facets, but under the banking agreement, they are left to the banks on an ad hoc basis.

Under the banking agreement, there are no books and records requirements. Under securities law, a broker-dealer is required to keep standardized and extensive recordkeeping. Under the interagency statements, banks can adopt their own systems or no sys-

tem at all as long as they have general policies and procedures in place. Uniformity is not required, so that when an examiner goes in, he has to learn a new system every time they enter a bank.

Third, there is no banking regulatory infrastructure to deal with consumer complaints. Securities regulators have numerous offices all across the country with significant resources dedicated to taking and responding to consumer complaints. Our Federal banking regulators prepare to field consumer securities sales complaints.

Fourth, enforcement actions by banking regulators are generally confidential. Will consumers be able to call banking regulators to ask if a security salesperson has been a subject of any disciplinary action? Will enforcement actions be made public, because the public has the right to know with whom they are dealing, or will banking regulators keep enforcement actions secret to preserve the safety and soundness of the financial institution?

Finally, as we know, there are no private rights of action under banking law and there is no right to arbitrate. We are fully aware of these private remedies available to wronged investors under the various securities laws and regulations, but are there any private rights of action for violation of interagency statement or Federal banking laws? We are not saying banks should not sell securities. We simply say that when an investor buys a security, they ought to have the same rights no matter where they buy it.

One last point. I see my time is ending. I wanted to bring up one of the points about an exemption in the bill. It is an example of unintended consequences. There is an exemption that would essentially allow a de minimis exemption that would allow a thousand transactions in a 1-year period for a bank that does not have a broker-dealer affiliate or a subsidiary. Under the law of exemptions, when that bank writes the 1,001st transaction, the law of exemptions will say that that bank has been in violation for all thousand transactions. So I think we have laid more of a trap than provided an exemption.

It is that kind of thing that I think we need to look at. We hope the Congress would—or we would urge the Congress, it might be better to establish some broad guidelines and allow the regulators to work it out in the rulemaking context, than to try this very detailed regulation that may end up providing unintended consequences in the end.

Thank you.

[The prepared statement of Phillip Feigin follows:]

PREPARED STATEMENT OF PHILIP A. FEIGIN ON BEHALF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. Chairmen and Members of the Subcommittees: The North American Securities Administrators Association (NASAA) appreciates the opportunity to submit to the Subcommittee on Telecommunications and Finance and to the Subcommittee on Commerce, Trade and Hazardous Materials comments on the issue of Glass-Steagall reform and financial services modernization. In the U.S., NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

As you know Mr. Chairmen, the primary function of state securities regulation is the protection of small investors from fraud and abuse in the capital markets. As a result, NASAA's comments today will focus primarily on the issue of how best to design a regulatory system that reflects the realities of today's "seamless" financial marketplace, and at the same time minimizes the potential for gaps in the protections available to investors—no matter where they purchase investment products.

While others may come before this panel with a broad agenda for action, NASAA's message is a rather simple one: As banks[1] continue to move beyond their traditional functions and into the securities business, it no longer is enough just to be concerned with preserving bank safety and soundness; there must also be a commensurate understanding of, and commitment to, investor protection principles.

I. EXECUTIVE SUMMARY

Evolution in the financial marketplace and years of tinkering with banking regulations have eroded the barriers that once separated commercial banking from the securities brokerage business. It is clear that the banking and securities industries are becoming more and more integrated every day. NASAA agrees with those who have suggested that these developments have the potential to enhance competition, improve the efficiency of our markets, and, as a result, serve the interests of investors, depositors and taxpayers. However, much of this activity has taken place in an ad hoc fashion, with few rules to ensure that our commitments to investors and to fair and orderly markets are not compromised.

It is NASAA's view that the time is long overdue for federal legislation to address comprehensively the interrelated issues of securities activities conducted on bank premises and the need to protect investors. The simple fact is that the laws and regulations governing the activities of financial institutions have not kept pace with the dramatic changes in the marketplace. While there have been serious efforts over the past several years to rationalize the oversight of new bank activities, we nonetheless are left today with a regulatory system that defies common sense, is wholly inadequate, and potentially could result in a serious and devastating loss of consumer confidence.

H.R. 1062, the "Financial Services Competitiveness Act of 1995," appropriately recognizes the profound changes that have taken place in the financial markets in recent years and seeks to impose on this transformed marketplace a rational and consistent scheme of oversight. NASAA generally supports the objective of the proposed legislation, which, as we understand it, is to permit banks to participate more fully in the securities business while at the same time updating the regulatory system to reflect the new realities of the financial marketplace.

However, the Association has very serious concerns that the bill, as approved by the House Banking Committee, falls far short of accomplishing what it sets out to do. NASAA's primary concern is that although the measure articulates a preference for a functional regulation approach, a host of exceptions contained in the bill would have the practical effect of permitting financial institutions to engage in significant securities activities outside the securities regulatory scheme. In fact, it may be argued that the bill will have the practical effect of encouraging banks to move certain securities activities out of registered broker-dealers and into other entities that may enjoy less stringent oversight. In addition the regulatory scheme contained in H.R. 1062 appears to be unnecessarily complex, rather than streamlined and efficient.

Mr. Chairmen, NASAA appreciates the longstanding and bipartisan commitment of the Commerce Committee and its subcommittees to enacting comprehensive financial services reform legislation that both encourages innovation in the financial services sector and establishes a rational and efficient system for overseeing this ever-changing marketplace. NASAA respectfully encourages you to give serious consideration to the need for an effective functional regulation scheme. NASAA urges you to close the gaping loopholes now contained in H.R. 1062 before it moves to the House floor.

II. THE EROSION OF THE GLASS-STEAGALL BARRIER

The issue of whether commercial banks should be allowed to tap into new sources of business, including the sale of uninsured products on bank premises either directly or indirectly, is no longer an academic question.[2] The fact is that many of

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[1] For purposes of simplification, the term "bank" is used throughout this testimony to refer to financial institutions generally, including thrifts, savings and loan associations and credit unions.

[2] The Securities and Exchange Commission, in testimony on this subject, reported that: In 1994, 119 banks provided investment advice or other services to over $312 billion in mutual fund assets (representing approximately 15 percent of total mutual fund assets); In 1994, over 1800 banking firms sold mutual funds to their customers; As of January 1995, the Federal Reserve had authorized 36 bank holding companies to operate so-called "Section 20" underwriting affiliates; and In the third quarter of 1994, the assets of Section 20 affiliates accounted for 16.6% of the assets of all broker-dealers doing a public business.

Continued

the restrictions on the securities activities of banks erected by Congress in the Glass-Steagall Act[3] have been eroded or removed entirely through judicial and administrative decisions,[4] thereby allowing banks and their non-bank affiliates to participate in a broad range of uninsured investment-related activities.

The regulatory and court decisions creating loopholes in the Depression-era law banning banks from the securities business have been in place for several years now. However, it was only recently that low interest rates sparked an explosive growth in the sale through banks of uninsured investment products. As these low interest rates propelled consumers to search beyond traditional bank savings products for better returns, more and more banks moved to offer their clientele a wider range of financial products. Mutual funds, popular with consumers for a number of reasons, are one of the investment alternatives that many banks now are providing in their bid to retain customer assets and generate new sources of revenue.

Today, banks engage directly in a wide range of broker-dealer and investment advisory activities that are comparable to, and competitive with, the services of registered securities firms and investment advisers. They generally do so, however, outside of the regulatory framework established under the federal securities laws.

III. INVESTOR PROTECTION CONCERNS

Last year, NASAA told Congress that state securities regulators across the country were reporting mounting evidence of consumer confusion about the insurance coverage, the risks, and the fees associated with the sale of uninsured products sold on bank premises.[5]

An informal look by several states at what actually was going on in bank lobbies made it very clear why consumers were so confused: the marketplace was sending them a bewildering variety of mixed, garbled and misleading messages. Among the problems uncovered by state securities agencies at the banks were: a blurring of the distinction between traditional bank activities and the sale of uninsured products; inadequate or misleading disclosure; and a serious gap in the consumer protection available to consumers who purchased securities on bank premises.

Though there have been modest improvements in the general public's awareness that investment products sold at banks are not FDIC-insured or otherwise guaranteed, a substantial share of financial consumers still mistakenly believe that they are "working with a net" when they buy such uninsured products at a bank.[6] It is increasingly evident that older Americans are particularly susceptible to the sales pitch for bank-sold mutual funds, in part because they are the most likely to believe that all products sold within the four walls of such an institution are FDIC-insured.

Though NASAA is concerned that *all* investors be treated fairly in the marketplace, there is emerging anecdotal evidence that in the case of investment products sold on bank premises, the bulk of complaints now being lodged with state securities

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See, Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning the "Financial Services Competitiveness Act of 1995" and Related Issues, Before the Committee on Banking and Financial Services, U.S. House of Representatives, March 15, 1995, p. 6.

[3] Banking Act of 1933, 48 Stat. 162-95 (codified as amended in various sections of 12 U.S.C.).

[4] For example, the Office of the Comptroller of the Currency has used the "incidental powers" clause of the National Bank Act to allow national bankers to engage in certain activities once considered the exclusive territory of investment and insurance firms. The Federal Reserve has used the "closely related" language of the Bank Holding Company Act to expand the permissible product and service lines for bank holding companies.

[5] *See*, for example, the statements of Denise Voigt Crawford before the Subcommittee on Oversight and Investigations, Committee on Commerce, U.S. House of Representatives (March 2, 1994) and before the Special Committee on Aging, U.S. Senate (September 29, 1994); and the statements of Philip Feigin before the Subcommittee on Financial Institutions, Committee on Banking, U.S. House of Representatives (March 8, 1994) and before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U.S. House of Representatives (April 14, 1994).

[6] NASAA's Banks Policy issues Committee recently conducted an informal phone survey of all memberjurisdictions to determine the volume of complaints being received by state agencies on this topic. The phone survey revealed that 30 state securities agencies reported receiving 158 complaints within the last 12 months about the sale of uninsured products on bank premises. Among the states reporting the highest number of complaints were: Texas, 32 complaints; Washington state, 20 complaints; Arizona, 17 complaints; and Connecticut, 11 complaints. NASAA believes that these complaints represent only a tiny fraction of the true number of problem cases. These complaints are unique in that they actually made it to the securities agency, which we do not believe is the first place consumers turn when they perceive they have a problem with their bank.

agencies are made by, or on behalf of, older Americans.[7] perhaps this reflects the fact that the massive entry of banks into mutual fund sales has helped to coax older investors across the tight rope from insured to uninsured investment products. Today, one tenth of all mutual funds are available through banks, which now account for up to 20 percent of first-time mutual fund buyers. For older investors who might be intimidated at the prospect of dealing with a brokerage firm, the familiar presence of a bank plays on the bond of trust resulting from 60 years of reliance on the safety net of FDIC protection.

What concerns state securities regulators is that more and more we will see financially unsophisticated consumers—those who are the least able to recognize the sometimes subtle distinctions between bank products—targeted by bank promotional campaigns. What is significant in this context is that banks are continuing to find ways to benefit from what may be the most important thing they have going for them—public trust. Surveys show that people continue to have more confidence in banks than in other financial institutions.[8] That trust, of course, is rooted in one basic fact: money placed with a bank comes with the federal government's guarantee that it will always be there, even if the bank fails. Although the government insurance does not extend to investment-related products sold on bank premises, that fact has so often been downplayed or completely omitted that it is not surprising that consumers are confused.

While misleading or inadequate disclosure is a problem in this connection, so too are identical or similar names of the insured institution and its investment-related products/affiliated institution. The reasoning behind common or similar names appears to be simple: a bank's name can be a powerful draw in a local market. A good example of how it is that banks trade on the trust they have built up may be found in the case of the Minnesota bank that was planning to put financial planners in several of its branches. The bank decided to identify the planners as employees of the bank's brokerage affiliate (which had a name similar to that of the bank) because a pilot program revealed that bank customers were more comfortable when they believed that the planners were affiliated with the bank.[9]

IV. CLOSING THE CONSUMER PROTECTION GAP: CURRENT AND NEEDED REMEDIES

Mr. Chairmen and Members of the Subcommittees, there can be no doubt that the existing statutory framework is woefully outdated and not up to the demands of a rapidly changing financial marketplace. As you may know, NASAA, along with others, last year developed the following *minimum* standards for evaluating Congressional reform in this area:

- *No "gap" in the consumer protection available to bank customers buying investment products.* Consumers who invest in mutual funds and stocks through brokerage firms or investment companies are provided a comprehensive framework of protections, including suitability requirements, fair dealing and disclosure of risks and costs. Though much of the activity in investments sold through banks is conducted by subsidiaries registered as broker-dealers, there is the potential for banks to deal directly with individuals and firms who would not be subject to broker-dealer regulation. This disturbing possibility has already become reality in some instances.[10]

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[7] The data gathered from NASAA's informal phone survey of member jurisdictions on this subject indicated that older Americans are the source for the overwhelming number of complaints received about the sale of uninsured investment products on bank premises.

[8] Jerry Knight, "Banks Becoming Financial Supermarkets," *Washington Post*, August 23, 1993, p. A1. Barry Barbash, Director of the Securities and Exchange Commission's Division of Investment Management, commented on the results of the focus group sessions being conducted by the SEC and the Office of the Comptroller of the Currency to gauge how well consumers understand the differences between mutual funds and insured deposits: "One thing that comes clearly out of the focus groups is that bank depositors really do think of banks as bastions of safety." (Debra Cope, "Regulators Probe Public's Knowledge of Fund Risk," *American Banker*, January 27, 1994, p. 16.)

[9] Karen Talley, "First Bank System to Place Financial Planners in More Branches," *American Banker*, October 27, 1993, p. 17.

[10] For example, *Financial Planning* magazine in its March 1995 issue reported that SunTrust Corp., an Atlanta bank holding company, dropped the NASD license of 150 of its broker-dealer subsidiary's representatives in what was described as a "dramatic move that other banks may emulate" if the National Association of Securities Dealers (NASD) doesn't revise its proposed rules that tighten its oversight of licensed bank broker-dealers. None of the SunTrust reps whose NASD licenses were dropped were terminated; they now are working as bank employees selling securities full-time within the branches. (*See*, Anthony Kimery, "SunTrust Snubs NASD in Power Play Over Bank Securities Regulation," *Financial Planning*, March 1995, p. 11.)

Continued

At the same time, a serious effort must be undertaken to review the extent and effectiveness of current state and federal regulatory oversight. *All* investors in mutual funds, stocks and annuities should be accorded the same level of consumer protection.

- *Use of disclosure that is proven to work.* It is clear that what is being done now in terms of disclosure is not working. Disclosure about the risks of uninsured bank products should be in the form of a concise and "simple English" document and related lobby posters. No sale of an uninsured product should be permitted to take place before the disclosure document is provided and the customer indicates (perhaps in the form of a signed document) that he or she understands that mutual funds, stocks and annuities sold at banks are not FDIC-insured or otherwise guaranteed against loss of principal by the bank. In view of the apparent ineffectiveness of current disclosures, NASAA and others are actively pursuing the development and testing of model disclosure documents and other materials that can be proven to be effective in eliminating the current consumer confusion about the extent of FDIC and SIPC insurance coverage.
- *A ban on naming or advertising uninsured bank products in any way that creates confusion with insured bank products or the institution itself.* Many consumers mistakenly believe that uninsured bank products are FDIC insured in the same manner as traditional bank products. As a result, every precaution must be taken to avoid undue confusion in the consumer's mind about the "dividing line" between uninsured products on the one hand and the safety and soundness of the bank and its traditional insured products on the other. The use of the same or similar names and logos of banks and their affiliates or subsidiaries should be prohibited. In addition, some mutual funds and other uninsured investment products sold at banks may need to be renamed in order to bring an end to existing instances of the blurring of the line between uninsured and insured bank products.
- Physical separation, to the extent possible, of the sale of insured and uninsured products within banks. The commingling of insured and uninsured activities in bank lobbies greatly increases the potential for consumer confusion. Because of this, no bank should be able to sell insured and uninsured products from the same desk, window or lobby area. A clear, physical separation should exist (along with appropriate lobby posters) in order to distinguish the areas within banks where the two types of products are sold.

  NASAA is mindful that many small banks may be unable to satisfy a requirement that sets out rigid standards for accomplishing this physical separation. As a result, NASAA would support regulatory flexibility in carrying out such a mandate, so long as the bank takes every precaution in ensuring that consumers fully appreciate the distinctions in the functions carried out by the bank in its traditional functions and in its expanded, investment-related activities.

The Benefits of Functional Regulation

Mr. Chairmen and Members of the Subcommittees, the absence of a clear road map for how banks should engage in securities activities is self-evident to anyone who looks at our current regulatory structure. Banking regulations and examinations are generally aimed at ensuring bank safety and soundness and deposit protection. As a result, banking regulators view maintaining the stability and profitability of the institution as their primary mission. In contrast, protecting individual investors is the overarching mission of the securities laws and the enforcement efforts taken by securities regulators reflect as much. There simply is no way to attempt to overlay on to the banking laws and regulatory system the mission and purpose of securities laws. It does not work.

NASAA has long supported the concept of functional regulation. By that, we mean that anyone engaged in the securities business—regardless of whether the business is incidental to another regulated commercial activity such as banking—should be subject on the federal level to one set of laws that are interpreted, administered and enforced by an expert regulatory body as to that aspect of its business. The federal regulator in this case would be the Securities and Exchange Commission (SEC).

Further evidence that banks may take this route was found in a February 14, 1995 letter from Robert D. Flowers, president of BA Investment Services, to the NASD, commenting on the organization's proposed rules for bank-affiliated brokerages. In his letter, Mr. Flowers concluded that: "The activities engaged in by our firm can be engaged in directly by our affiliate, Bank of America National Trust and Savings Association. To maintain competitive parity with our competitors not targeted by the proposed rule, we may need to conduct our business through Bank of America and give up our broker-dealer charter." (As reported in *American Banker*, "Rule Plan Seen Devaluing Link of Bank Brokerages to NASD," April 21, 1995, p. 11.

Why not let the banking regulators incorporate into their oversight functions the sale of investment products, as some have suggested?

The answer is simple. Banking regulators are not equipped to create a regulatory scheme comparable to that which exists under the federal securities laws. On the securities side, there are laws, rules and regulations that have grown up over a 70-year period to protect investors. In addition to the federal Securities and Exchange Commission, there are 51 state securities agencies and multiple self-regulatory organizations, including the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE).

All of these entities work together to ensure the integrity of the marketplace. Rather than relying on this experienced and extensive network of securities regulators, opponents of functional regulation essentially would ask federal banking regulators—who have had *no* prior experience in investor protection, in writing rules, or in enforcing compliance in the securities arena—to take on the job of protecting investors who purchase uninsured investment products on bank premises.

NASAA supports the functional regulation approach because it is grounded in the fundamental principle that all participants in the securities business should play by the same rules and be subject to the same standards. The continued exclusion of banks from the definitions of "broker" and "dealer" serves no public interest and is as antiquated and outdated a concept as is the Glass-Steagall limitation H.R. 1062 seeks to repeal. These exclusions mean that banks need not comply with the customer protection, net capital, and books and records rules specifically designed to protect investors. Unfortunately, the many exceptions to the functional regulation mandate of H.R. 1062 would prolong this system of ambiguous regulation. In addition, if the SunTrust experience becomes more commonplace and securities activities migrate directly into the operations of banks, there will be even further erosion in investor protection.

What purpose is served in allowing for expansive securities powers for depository institutions and yet not subjecting those activities to legally-enforceable and appropriate oversight? It certainly is not the interests of investors that are served by such a gaping hole in the regulatory structure. Banks that act as broker-dealers are, of course, subject to federal banking laws. However, those laws are designed to protect the banks and their depositors, not investors. Consider the following:

- *There is a comprehensive scheme under the securities laws for licensing brokers, including training, testing and tracking.* Although federal banking regulators have claimed that they will require salespersons in banks to meet qualification and training requirements that are determined to be equivalent to those applicable to SEC registrants under the securities laws, NASAA questions how this will be accomplished. Will federal banking regulators put in place a similar licensing scheme for bank personnel selling investment products? Will the federal banking regulators be in a position to develop and administer examinations to test the knowledge and competence of applicants seeking to become securities salespersons? Will banking regulators be in a position to monitor the activities of such individuals and take action when appropriate? An extensive and rigorous program for the training and testing of applicants is well established in the securities regulatory system.

  Securities regulators also track the disciplinary history of brokers in an effort to screen out bad actors. In addition, the brokerage firms and self-regulatory organizations now are moving to put in place continuing education programs to, ensure that individuals in the securities business keep current with new products and trading strategies, as well as new laws and regulatory requirements.
- *Securities salespersons are subject to rules of fair practice.* The rules of the securities industry's self-regulatory organizations and state securities laws and regulations require brokers to comply with rules of fair practice. These rules are designed to ensure that brokers observe high standards of commercial honor and just and equitable principles of fair trade in the conduct of their business. Violation of the rules may result in a fine, suspension or revocation of a securities license. Among the issues covered by the rules of fair practice are: making unsuitable recommendations not in accordance with a client's financial condition, sophistication or risk tolerance; "churning" accounts over and over for commissions; unauthorized trading; misrepresentations as to the possible risks or true nature of the investment product; fraudulently inducing a client to purchase an investment product; and providing advice unfounded in fact. We are not aware of any similar provisions in banking law and regulations.
- *Securities regulators routinely make available to the public information about the background and disciplinary history of stockbrokers.* The licensing of stockbrokers is accomplished through a sophisticated computer network—the Central Registration Depository (CRD)—jointly operated by NASAA and the NASD.

Today, the system contains registration and disciplinary files on approximately 5,200 brokerage firms and more than 440,000 individual stockbrokers. The system captures substantial disciplinary history about registrants and draws from several sources for its data. Individual registrants and their employing brokerage firms also are required to disclose fully all disciplinary history; a failure to do so may serve as a separate ground for state administrative enforcement actions. The CRD database now serves as a primary source of information for investors to learn about the disciplinary and employment history of stockbrokers.

Today, investors may call either their state securities agency or the NASD to access background data on a particular stock-broker or firm. NASAA and the individual states use every opportunity available to them, including the news media, speaking engagements, public statements, and more, to alert consumers to this service. There are no comparable licensing requirements for bank personnel, nor are we aware of any efforts contemplated by federal banking regulators to design, build or maintain such a computer system for those bank personnel who may now sell securities or render investment advice.

- *Securities regulators employ a high-profile program for exposing securities law violators, thereby warning the public about a troublesome scheme, firm or individual.* Federal and state securities regulators, as well as the industry's self-regulatory organizations, deliberately seek to publicize as widely as possible any disciplinary action taken against individual brokers or brokerage firms. The goal is to provide as much information as is possible to the investing public so that they may avoid dealing with unscrupulous or dishonest operators.
- *Securities laws provide for a private right of action and arbitration of customer/broker disputes.* Securities laws provide for—and rely upon—private enforcement actions to supplement government actions. No such system of redress exists in banking laws. The fundamental purpose of federal securities laws is to ensure full disclosure to investors and to punish those who violate the law. Private actions—whether they are brought in court or in an arbitration forum—have become increasingly important as an enforcement tool in light of the dramatic growth of fraud and corruption in the nation's business community and financial institutions and the limitations on state and federal prosecutorial and regulatory resources. In short, private actions under the federal and state securities laws are essential to deter prospective criminals, compensate the victims of fraud, and maintain public confidence in the marketplace. An absence of private actions may well have the effect of eroding confidence in the capital markets, thereby reducing investment and increasing the cost of raising capital for U.S. businesses.

Currently, banks also may serve as investment advisers to certain mutual funds without registering under the Investment Advisers Act of 1940. As a result of this loophole, shareholders in mutual funds advised by banks, unlike their counterparts in other mutual funds, do not receive the protections of that Act's provisions, including those related to the recordkeeping and inspections conducted by the SEC and those restricting performance-based fees and other potential conflicts of interest.

Mr. Chairmen and Members of the Subcommittees, it is obvious that such an elaborate and highly specialized oversight function as currently exists for securities brokers and firms simply cannot be duplicated by federal banking agencies, unless there are thousands of employees now sifting in these agencies with nothing to do and millions of dollars of taxpayer money available to be spent on putting in place the duplicative infrastructure that would be necessary to carry out such a program.

As you are well aware, the federal banking agencies have issued guidelines and a subsequent interagency statement[11] which is intended to supplement their securities regulatory programs. While this effort is a step forward, it is no substitute for a comprehensive regulatory scheme. As "guidelines" rather than regulations, they are advisory in nature rather than legally binding and they may not be legally enforceable by bank regulators or bank customers. Furthermore, rather than establishing precise standards of conduct, the guidelines instead give banks broad latitude in developing procedures and policies to implement them.

NASAA suggests that a more reasonable and appropriate approach is for Congress to adopt a true functional regulation system, which will result in strengthened investor protection, without duplicative and costly overlap in the functions of federal securities and banking regulators.

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[11] *See* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and Office of Thrift Supervision, "Interagency Statement on Retail Sales of Nondeposit Investment Products," issued February 15, 1994.

V. H.R. 1062, THE "FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995"

Mr. Chairmen and Members of the Subcommittees, H.R. 1062 makes a very real contribution to the debate over Glass-Steagall reform and efforts to modernize our financial services regulatory structure. H.R. 1062 would further the principle of functional regulation by repealing the blanket exclusion of banks from the definitions of broker, dealer, and investment adviser under the federal securities laws. In addition, the bill would amend various provisions of the Investment Company Act of 1940 to take account of the increasing bank involvement in the mutual fund business.

For these reasons, NASAA generally supports the objectives of H.R. 1062. However, we are deeply concerned that the bill's numerous exemptions from broker-dealer regulation granted to the banks would serve to undermine the principle of functional regulation that H.R. 1062 seeks to promote. In testimony before the House Committee on Banking and Financial Services, the Securities and Exchange Commission enumerated 13 exemptions that the bill would create for bank brokerage activities. These exemptions would permit banks to engage in a wide range of securities-related activities without being subject to securities regulation.

As approved by the Banking Committee, exemptions from the definition of "broker" are provided for: banks that engage in brokerage activities in connection with networking arrangements; certain trust activities; transactions in exempted securities, including government securities; transactions in municipal securities; transactions in connection with employee or shareholder benefit plans; money market sweep transactions; affiliate transactions; private placements; banks that limit their brokerage activities to fewer than 800 transactions per year in securities for which a ready market exists plus 200 other transactions per year in any other types of securities (the so-called "*de minimis*" exemption) transactions; safekeeping and custody services; clearance and settlement activities; securities lending; and agency transactions involving repurchase agreements.

Exemptions from the definition of "dealer" are provided for banks that engage in transactions involving: (i) exempted and similar securities; (ii) municipal securities; (iii) bank and trust department transactions for investment purposes; and (iv) certain categories of asset-backed securities.

NASAA shares the concern about these exemptions articulated by SEC Chairman Levitt in his March 15, 1995, testimony before the House Committee on Banking and Financial Services. As Chairman Levitt pointed out, some of the exemptions contained in the bill are consistent with Commission policy. However, NASAA believes that it would be preferable to write a strong functional regulation provision and then provide the Commission with the exemptive authority it needs to respond to an ever-changing marketplace. As such, NASAA echoes the SEC's suggestion that the Commission be granted authority to impose additional safeguards or to create specifically tailored exemptions in consultation with the appropriate banking regulators to account for the continually evolving marketplace.

In addition, during the Banking Committee's consideration of H.R. 1062 a new provision was inserted which would allow a bank to conduct certain securities activities directly, through a "separately identifiable department or division" (SID) of the bank, even if the bank has a securities affiliate. The SID would be required to register as a broker-dealer and would be subject to oversight by a securities self-regulatory organization. While the SID would be subject to SEC rulemaking, it would be exempt from broker-dealer net capital rules. NASAA's concerns about this type of arrangement center around the inherent oversight and examination difficulties raised by such a construct, as well as the net capital rules exemption.

Furthermore, H.R. 1062 would authorize the Federal Reserve to permit banks, through SIDs, to effect transactions in any security the Federal Reserve determines is "more appropriately treated as a bank product." NASAA agrees with those who have suggested that such an exemption potentially could allow a range of securities to be. traded and brokered by bank SIDs.

NASAA has been an outspoken advocate of requiring that the securities activities of banks be conducted through separate affiliates that are licensed as broker-dealers and subject to the full range of securities laws, rules and regulations. The Association is unaware of any evidence that would persuade us that the SID approach is preferable to or requiring a separate affiliate. As a result, NASAA respectfully encourages the Commerce Committee to reject the SID approach and instead to require that all securities activities of banks be conducted through separate affiliates fully subject to SEC oversight.

NASAA's final comment with respect to the specific elements of H.R. 1062 is in support of the bill's prohibition on banks sharing confidential customer information with any affiliated securities operation. NASAA believes that most bank customers

would be extremely disturbed to learn that financial institutions routinely share with securities salespersons what commonly is considered to be confidential information about the customer's finances, including the maturity dates of certificates of deposit. A strict prohibition on such information sharing should be adopted.

State and SRO Efforts to Update Regulatory Oversight

It also is recognized that a serious effort must be undertaken to review the extent and effectiveness of current state securities regulatory oversight. The first order of business for state securities regulators has been to gather information about what is going on in the marketplace and to get a better sense of how it is that banks are entering the securities business. Currently, NASAA has two committees charged with working on this emerging issue. These committees are reviewing state securities laws and regulations to determine what changes may be necessary in view of the expanding role that banks are playing in the securities marketplace. In addition, NASAA is taking a hard look at the current statutory authority of state securities regulators to determine what changes may be necessary in the oversight of registered broker-dealers who operate on bank premises.

NASAA also would like to take this opportunity to commend the National Association of Securities Dealers (NASD) for their efforts to respond to this issue by proposing new rules governing securities firms operating on bank premises.[12] The proposed rules would apply exclusively to the activities of NASD members that are providing broker-dealer services on the premises of a financial institution where retail deposits are taken. The rule would, among other things: (1) specify where on a bank's premises a broker-dealer may provide securities services; (2) limit the activities and compensation of unregistered personnel; (3) require broker-dealers to implement supervisory procedures; and (4) mandate specific disclosures to customers. On February 15,1994, NASAA submitted comments to the NASD in support of the proposed rules.[13]

V. CONCLUSION

Mr. Chairmen and Members of the Subcommittees, there can be no doubt that the time has come for Congress to act to address comprehensively the interrelated issues of securities activities conducted on bank premises and appropriate safeguards to protect investors. Absent clear guidance from Congress, federal banking regulators have embarked on a course of action that appears to be designed to completely upend any remaining separation between banking and brokerage activities. For example, after years of more modest administrative actions that chipped away at the Glass-Steagall barriers, the Office of the Comptroller of the Currency more recently suggested sweeping revisions to its rules to permit an operating subsidiary of a national bank to engage in securities activities in which the bank itself would be ineligible to engage. Rather than continuing to allow federal banking regulators to circumvent the Glass-Steagall Act by regulatory fiat, NASAA encourages Congress to act to make clear its intentions in this extremely important area.

H.R. 1062 makes a tremendous contribution to the debate over financial services modernization. For that, its authors and the Members of the Banking Committee are to be commended. However, as approved by the Banking Committee, the bill suffers from serious flaws—flaws that should be corrected before the bill is considered on the House floor. The consequences of not acting prudently here will be felt not only by consumers who purchase investment products on bank premises, but potentially by taxpayers and the economy itself

NASAA would be pleased to assist the Subcommittees and the full Committee as you consider these important issues. Thank you.

Mr. FIELDS. Thank you, Mr. Feigin.

Mr. Martin Mayer of the Brookings Institution.

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[12] *See* NASD Notice to Members 94-94, December 1994.

[13] The NASAA letter reads in part: "Several of the specific elements contained in the NASD's proposed rule are designed to reduce the confusion of consumers who purchase investment products on bank premises. As such, the proposed rule represents an important step forward in the furtherance of investor protection . . . it is NASAA's view that the following elements of the rule proposal should be implemented: (1) physical separation of broker-dealer services on the premises of a financial institution; (2) new procedures governing communications with the public; and (3) a requirement that customers acknowledge in writing that they understand the risks, fees and lack of insurance associated with investment products purchased on bank premises." NASAA also expressed support for the provisions regarding compensation of financial institution employees for referrals, previsions related to solicitation, and those related to the supervision and responsibility for employees.

STATEMENT OF MARTIN MAYER

Mr. MAYER. Thank you. I speak for myself, not for Brookings, of course.

Mr. FIELDS. Yes. You may want to make that statement again.

Mr. MAYER. Yes. I speak for myself and not for Brookings, obviously.

I would like to take a minute to reinforce what Mr. Feigin just said about the infrastructure in being. The securities acts are enforced to a very large extent through self-regulatory organizations, like the New York Stock Exchange, the National Association of Securities Dealers. To the extent that the banks do these things within the bank on an SID basis, it may be very difficult to make the actual operative securities regulation of the country work in that context.

On my own statement, what has concerned me about most of this is that people tend to lose sight of doughnuts and talk about holes. What the Nation needs is a secure, efficient payment system generating a money supply that responds to the needs of trade, while stabilizing the price level; a bank lending apparatus that chooses conservatively and intelligently among applicants for credit in a time when, as Dennis Weatherstone put it, the capital markets dominate the credit markets; and a market system that effectively allocates investment to the industries and companies that will use the money most profitably in the production of goods and services.

What the Nation should worry about is not that we have a peculiar regulatory system, though we do, and not that the profits from participating in the financial services industry are unfairly divided between this sector and that, which is like the sex of a hippopotamus, a matter of significant interest only to another hippopotamus. Instead, we should be troubled by a payments system that wastes more than $40 billion a year on outmoded paper-handling technology, probably $60 billion, including postage, thanks to regulation of the Fed, inviting competition from what may be a very irresponsible entrepreneurship that is out there working now, a bloated banking system that we do not know how to reduce without risking a debt deflation, and that is increasingly reluctant to make the small- to medium-size business loans which are its social and economic function; an insurance industry that pays out too much of its policyholders' resources to brokers and lawyers, and in many areas, operates always on other people's money without effective regulation or supervision, and a securities industry that increasingly lives by trading against its customers.

Remedies to these ills, any one of which could turn serious at any time, are what we need from legislation. Proposals should be judged by their contribution to these goals, not to the comfort or profit of the participants in the industry.

Still, questions of regulatory organization, government-sponsored competitive advantage may well dictate the capacity of a private sector system to respond to challenges and the ability of government to exercise policy.

Glass-Steagall was not a bad idea in its time. It has been, as they say in the State Department, overtaken by events. The end result of all the changes in technology, procedure, and theoretical un-

derpinning has been to confuse the relationship of the government and the private sector and this essential sector of the economy.

My view of government regulation of financial markets is that there are horses for courses. All markets, as Russia daily demonstrates, rest on a legal order, which must be created and enforced. Some of the work of financial institutions is heavily charged with the public interest and some is not. A bank that keeps transaction balances and makes loans creates money, because the depositor still has his money on demand and the borrower gets his loan in the form of a deposit. Creating money is a sovereign function and the government had better not lose control over it.

There is a cover piece in this week's Business Week in which I am quoted as saying that the Fed could lose control of the money supply, and that is true. Ever since cash management accounts and home equity loans gave people the chance to monetize their securities holdings in their houses, it has been dicey, and soon cybercash will present further complications.

Meanwhile, regulatory enthusiasm for bilateral netting and permission for securities firms to cross or fill orders in their offices take more and more transactions out of the public arena, diminishing the information available, first to the investing and trading public, and eventually an inevitable progression to the regulators themselves. This is a more important question than Glass-Steagall.

To the extent that repeal of Glass-Steagall means simply permitting banks to do security business and security houses to accept deposits, it is obviously no big deal, quite apart from the question of whether the Fed let the horses out before setting fire to the barn. Cash management accounts put brokers in the consumer banking business more than a decade ago and Joseph Grundfest observed when he was an SEC commissioner in the 1980's that a term loan is nothing but an illiquid junk bond.

In these days when banks decide whether or not to make a loan according to how strong the market seems for pieces of that loan, loan participations may well be more liquid than junk bonds. The same dealers trade both at the same time.

It is, of course, important that people understand that whatever they buy from a bank's securities affiliate or securities subsidiary is not FDIC insured, and not every bank I visited does a good job at telling that to people. The optimum way to handle this problem is to diminish the fraction of what the bank does that is FDIC insured so that the people do not automatically expect their government to stand behind what they find at a bank.

The insurance industry, I think, is wrong on almost everything else, but it is right on its insistence that banks ought not to be allowed to offer FDIC-insured annuities. Banks should be permitted to offer individuals or the market whatever investment contracts they wish to write. But the government should insure only plain vanilla.

Mr. FIELDS. Mr. Mayer, could we ask you to summarize, please? Your statement will be included in the record in its entirety.

Mr. MAYER. Sure. Thank you.

I do want to stress that there is a deposit insurance question in this. The extent of the separation between the bank and its securities sub or affiliate must reflect the extent to which the taxpayer

is on the hook for the bank's losses. If you can get a narrow bank where the bank can invest only in government securities and commercial paper, then you don't have to worry about where the security sub is. Where the bank and the securities affiliate are dealing in the same sort of instrument, then I think you have to be very, very careful about it. The firewalls delay, but they won't stop fires.

The other—I would like to deal with two of the questions that were sent to me. One is credit enhancement, and I would like to say that, in general, both securities subs and affiliates should be required to purchase any necessary credit enhancement in the market when they act as underwriters to assure an independent analysis of the risk.

On the capitalization question, in practice, the market will permit securities companies to operate with very little capital. There seems to be a sugar daddy in the background, and that has to be avoided. And it could also be noted that capital requirements are not a safety and soundness question; they are a regulatory instrument. It is very unusual that a regulator will demand a capital infusion into a bank or a securities firm before the market has decided it won't put another penny in.

Accounting questions have immense day-to-day impact. The Argentine debt paper that was placed with financial institutions went down in the market to 94 and had to be carried by the securities houses at 94. The banks are still carrying it at 100. We must have uniform accounting for both sides.

There must also be a recommendation of a Shadow Regulatory Committee, some compulsion on the Fed to price daylight overdrafts. Otherwise, if a securities firm within a bank can get virtually a free daylight overdraft and the securities firm outside has too much to spend, then we to have very careful about competitive imbalances.

In the end, all regulation should be functional, and my own feeling is that we have to place derivatives in a securities subregulated by the SEC, which can require full disclosure of the instrument the salesmen are peddling. To the extent that banks or the banking regulators find it awkward to have the SEC controlling some part of the bank, the affiliate structure is a natural solution.

[The prepared statement of Martin Mayer follows:]

PREPARED STATEMENT OF MARTIN MAYER, THE BROOKINGS INSTITUTION

What concerns me most in discussions about Glass-Steagall reform—nobody is really talking about outright repeal, which might wipe out deposit insurance—is that we lose sight of the doughnut and talk only about the hole. What the nation needs is a secure, efficient payments system generating a money supply that responds to the needs of trade while stabilizing the price level; a bank lending apparatus that chooses conservatively and intelligently among applicants for credit in a time when, as Dennis Weatherstone put it, the capital markets dominate the credit markets; and a market system that effectively allocates investment to the industries and companies that will use the money most profitably in the production of goods and services.

What the nation should worry about is not that we have a peculiar regulatory system, though we do, and not that the profits from participating in the financial services industry are unfairly divided between this sector and that, which is like the sex of a hippopotamus, a matter of significant interest only to another hippopotamus. Instead, we should be troubled by a payments system that wastes more than $40 billion a year on outmoded paper-handling technology (probably $60 billion including postage), inviting competition from what may well be a very irresponsible entrepreneurship; a bloated banking system that we do not know how to reduce

without risking a debt deflation, and that is increasingly reluctant to make the small- to medium-sized business loans which are its social and economic function; an insurance industry that pays out too much of its policyholders' resources to brokers and lawyers, and in many areas operates, always on other people's money, without effective regulation or supervision; and a securities industry that increasingly lives by trading against its customers. Remedies to these ills, any one of which could turn serious at any time, are what we need from legislation. Proposals should be judged by their contribution to these goals, not to the comfort or profit of the participants in the industry.

Still, questions of regulatory organization and government-sponsored competitive advantage may well dictate the capacity of a private sector system to respond to challenges, and the ability of government to execute policy. As Professor Hyman Minsky observed in a recent talk to the Levy Institute, the Banking Act of 1935 knocked the theoretical props out from under both the Federal Reserve Act of 1913 and the Glass-Steagall Act. The latter were based on a real-bills theory of money, the notion that each level of economic activity calls forth the proper money supply, and the Federal Reserve's window and open market operations should therefore be restricted to the discount, purchase and sale of privately generated commercial paper. The Banking Act of 1935 was based on the theory that a national currency, as part of the national debt—the part of the national debt on which no interest is paid—should rest on a backing of Treasury notes and bills. The other shoe dropped in 1968, when the drain of gold from our vaults compelled the Congress to repeal the section of the Banking Act that required 25% gold cover for the Federal Reserve Notes that are our currency, and to eliminate the Treasury Silver Certificate that was until then our one-dollar bill.

Let me note in passing that while the real-bills theory is now either outmoded or disproven, depending on your prejudice, it remains the real basis of monetarism, which simply presents the reverse of the same coin. Instead of commercial borrowing creating the right money supply, the monetarists assume that the right money supply will create the right amount of commercial borrowing. Glass-Steagall was not a bad idea in its time; it has been, as they say in the State Department, overtaken by events. The end result of all the changes in technology, procedure and theoretical underpinning has been to confuse the relationship of the government and the private sector in this essential sector of the economy.

My view of government regulation of financial markets is that there are horses for courses. All markets, as Russia daily demonstrates, rest on a legal order, which must be created and enforced. Some of the work of financial institutions is heavily charged with the public interest, and some is not. A bank that keeps transaction balances and makes loans creates money, because the depositor, still has his money on demand, and the borrower gets his loan in the form of a deposit. Creating money is a sovereign function, and the government had better not lose control over it. There's a cover piece in this week's *Business Week* in which I am quoted as saying the Fed *could* lose control of the money supply, and that's true. Ever since cash management accounts and home equity loans gave people the chance to monetize their securities holdings and their houses, it's been dicey, and soon cybercash will present further complications. Meanwhile, regulatory enthusiasm for bilateral netting and permission for securities firms to cross or fill orders in their offices take more and more transactions out of the public arena, diminishing the information available first to the investing and trading public and eventually in inevitable progression to the regulators themselves. This is a more important question than Glass-Steagall, and is getting a lot less attention from either the regulators or the Congress.

To the extent that "repeal of Glass-Steagall" means simply permitting banks to do securities business and securities houses to accept deposits, it is obviously no big deal, quite apart from the question of whether Fed let the horses out before setting fire to the barns. Cash management accounts put brokers in the consumer banking business more than a decade ago, and Joseph Grundfest observed when he was an SEC Commissioner in the 1980s that a term loan is nothing but an illiquid junk bond. In these days when banks decide whether or not to make a loan according to how strong the market seems for pieces of that loan, loan participations may well be more liquid than junk bonds. The same dealers trade both at the same desks.

It is of course important that people understand that whatever they buy from a bank's securities affiliate or securities subsidiary is not FDIC-insured, and not every bank I've visited does a good job at telling that to people. The optimum way to handle this problem is to diminish the fraction of what the bank does that is FDIC-insured so that people do not automatically expect their government to stand behind what they find at a bank. The insurance industry, while wrong on almost everything else, is right in its insistence that banks ought not to be allowed to offer FDIC-in-

sured annuities. Banks should be permitted to offer individuals or the market whatever investment contracts they wish to write, but the government should insure only plain vanilla.

Even with the aura of safety that permeates the bank building, people do not seen to wish to do their securities business there. A very high fraction of what the banks sell in their securities operations seems to be money-market mutual funds, which are not that different from bank accounts. Bank of America's experience with Schwab, Citicorp's experience with Quick & Reilly and now NationsBank's experience with Dean Witter all argue that we may be worrying more than necessary about the banks taking over securities brokerage. Meanwhile, I agree that banks should be allowed to offer the public their own as well as others' mutual funds: if the funds of the trust customer can be commingled in a bank mutual fund, I can't see why the banking customer must be offered only a third-party fund.

Deposit insurance cannot be eliminated from these discussions, however: it remains, in Ross Perot's splendid phrase, the crazy aunt in the attic. The extent of separation between the bank and its securities sub or affiliate should reflect the extent to which the taxpayer is on the hook for the bank's losses. I have come around to something like the Robert Litan narrow bank, otherwise the Henry Simons/Irving Fischer/John H. Williams solution of a 100% reserve system. The bank which has your checking account will be permitted to invest only in government paper and maybe a little short-term commercial paper, like a money market fund. That bank can be insured, though it won't need insurance, and the existing funds in the FDIC will take care of the risk forever.

Such a bank can be owned by a holding company that has other affiliates, or can be a free-standing bank with subsidiaries that do other things: doesn't matter. All the other assets the bank has will be funded with bought money of one kind or another, and the suppliers of that money will be at risk like the purchasers of any security. The narrow bank can't lend money to its securities sub and the sub can't bail the bank out of its bad loans (which was fairly common in the 1920s—the authors of Glass-Steagall were at least as disturbed by the losses loaded on the public through the activities of the securities affiliates of the banks as they were by any belief that the securities subs have killed the banks, and it is deceptive to leave out that part of the 1920s story). Thus, neither the integrity of the payments system nor the deposit insurance fund can be endangered by the existence of a securities subsidiary.

To the extent that the bank invests in a variety of assets and the work of the bank and the work of the securities firm are intermingled, it would be wise to maintain a separate corporate status for the securities firm, linking the two at a holding company level and restricting upstream and downstream lending. Firewalls may delay but will not stop fires. A regulator's ability to sever a corporation from a parent and the parent's other subs, however, can isolate the problem entity. Whether the regulators would *wish* to do so is not clear—they tend to be susceptible to the argument that confidence is so important in banking that the bankruptcy or even criticism of any part of the holding company cannot be tolerated. But if it's a sub, they don't even get the opportunity to exercise good judgement.

It is in this context, too, that you should seek the answer to your questions about credit enhancement. In general, both securities subs and affiliates should be required to purchase any necessary credit enhancement in the market when they act as underwriters, to assure an independent analysis of the risks. I would add that it seems me sound policy to require that credit enhancement for securities backed by bank loans should be in the form of recourse to the bank, not in the form of insurance. What makes banks special and different in their economic role is that they are supposed to nourish relationships with their borrowers.

The brief answer to your capitalization questions is that in practice the market will permit securities companies to operate with astonishingly little capital if there seems to be a sugar daddy in the background. Kidder Peabody had about one-half of one percent capital in summer 1993, but it did have GE Capital behind it. My instinct tells me that capital should be segregated for securities affiliates or subs. One notes in passing that the Comptroller did not permit banks to set up derivatives affiliates that would have to be separately capitalized, because he didn't want the capital taken out of the banks.

It should also be noted that capital requirements are not really a safety-and-soundness question. They are a regulatory instrument. It is very unusual that a regulator will demand a capital infusion into a bank or a securities firm before the market has decided it won't put another penny into that place. Especially in these days when your capital consists of the asserted value of your inventory less your cost of acquiring it (known as "the reconciliation account"), apparently well-capitalized financial services companies can go under just about as fast as apparently poor-

ly-capitalized companies. Uniform accounting is the real need—and the bank regulators have just signed away their right to impose respectable accounting standards in the new Basel agreements on derivatives.

These accounting questions, by the way, have immense day-to-day impact. Recently it became necessary to place a large issue of Argentine debt paper with American financial institutions. They bought it to yield a little less than the market thought Argentine paper should yield, and it traded down about 6% the first day. The investment banks that had bought the paper had to write it down to 94 immediately; the bank regulators allowed the banks to continue to carry—forever, if they wished—at 100. Tell me about level playing fields.

On the matter of the Wholesale Financial Institution, I agree with the Shadow Regulatory Committee that it's a wholesale red herring. The federal subsidy represented by access to the discount window and FedWire obliges the continuance of regulation—not to mention the systemic dangers if a WFI should blindside the market with a piece of bad news that equally astonishes the regulators. I also agree with the Shadow Regulatory Committee, by the way—and the subject is important to your deliberations on Glass-Steagall reform and the status of securities subsidiaries—that the Fed must be ordered to move immediately to realistic pricing for daylight overdrafts. If a securities firm can take advantage of the Fed's virtually cost-free daylight overdrafts under the umbrella of a bank, while an outside securities firm must pay for such services, the competitive imbalance will be severe.

Finally, I think functional regulation is the only way to go. The SEC has a long tradition of believing that even though those fellows on Wall Street make more money than we do, they're no smarter than we are. Banking regulators have a dangerous tendency to believe, even when the explanations are ridiculous, that bankers really know what they're doing.

The SEC has backslid in recent years—I have just finished writing a book about Lloyd's of London, which hopes to take about $3 billion out of the pockets of Americans who received no protection from the Securities Act because the SEC bureaucracy informally agreed with Lloyd's lawyers that the three thousand Americans who agreed to become Names, most of them small businessmen and professionals of little experience in securities or insurance, qualified for status as "sophisticated investors." But it's nothing like the abdication of the banking regulators who insisted that Bankers Trust in its dealings with Gibson Greeting Cards and Procter & Gamble was under no duty to determine the suitability for these customers of the intricately structured derivative instruments the bank sold them—even though the valuation of the instruments could be done only through a computer program the bank decided was proprietary to its traders and could not be revealed to the customers. No matter how close the other relations between a bank and a customer are, the banking regulators have insisted that when the bank acts as a trader it acts at arm's length and may properly take an attitude of *caveat emptor*.

The correct rebuke to these attitudes is to place derivatives activities in a securities sub or affiliate regulated by the SEC, which can require full disclosure of the instruments the salesmen are peddling. To the extent that banks or the banking regulators find it awkward to have the SEC controlling some part of the bank, the affiliate structure would be the natural solution.

Mr. FIELDS. Mr. Mayer, thank you for your summary or detailed conclusion. No; thank you very much for your testimony. Your statement will be included in its entirety for the record.

Mr. Feigin, Ms. Randall, let me ask you. Ms. Randall, in your testimony, you note that 17 states allow banks to underwrite securities through subsidiaries. Are those subsidiaries subject to registration with the state securities commissions? Are they subject only to state banking commission regulation?

Ms. RANDALL. Mr. Chairman, we should probably get you a more detailed survey of those 17 states. Certainly in New Jersey, if there were to be any underwriting activity by a state-chartered bank, that underwriting activity would have to be first approved as an expanded bank power by the FDIC. There would be registration, I believe, with the SEC and our State Bureau of Securities as well.

Mr. FIELDS. Mr. Feigin.

Mr. FEIGIN. I think the answer here is that the only thing excluded from either state or Federal regulation is a bank, not an af-

filiate, not an affiliate of a bank, not a subsidiary of a bank. So as soon as you form a sub or an affiliate, all of the bank exclusions go away and you have a corporation engaging in activity that requires licensing or registration. So if underwriting is engaged in by a bank sub, it is done so as a fully registered broker-dealer.

Mr. FIELDS. So do the state securities commissions become involved with securities fraud investigation of those subsidiaries or is that done exclusively by the banking commissions? Or does that also vary state by state?

Mr. FEIGIN. It may vary, but I think it is far more likely that if fraud occurred in an underwriting conducted by a bank-affiliated broker-dealer, the state securities agency would be far more likely to investigate it than the banking regulator. I think the banking regulator starts to get involved when the assets of the bank may come—may become exposed in some kind of a liability setting.

Mr. FIELDS. What about private placement?

Mr. FEIGIN. Again, if it is an affiliate and it is a fully registered brokerage firm, who owns it is of not much importance to us, so that it would make no difference if it is a private placement or a public underwriting. They still engaged in the business and if they committed fraud, we would investigate.

Mr. FIELDS. In the 17 states that allow securities underwriting of subsidiaries, do any of them require the subsidiaries to be separately capitalized?

Mr. FEIGIN. My guess would be that if they are subs or affiliates in separate corporations, they are likely required to be broker-dealers by the Federal Government as well, so the Federal capital requirements and also those imposed by the NASD take hold, and they, I think, almost universally fulfill any capital requirements under state law.

Ms. RANDALL. Again, if I may, Mr. Chairman, in those 17 states, we probably have a variation state to state in terms of the exact description, but I would certainly submit that it is appropriate to have independent capitalization requirements for those operating subsidiaries of banks where those limited underwriting activities do take place.

The state bank experience, generally speaking, in the underwriting of securities area, is somewhat limited and I believe Chairman Helfer has also previously testified to that effect.

To the extent that we have a track record, it has been a sound one, and the securities endeavors of those banks have proven to not be a problem in terms of the safety and soundness of the insured institution.

Mr. FIELDS. My time is about to expire. I have got some other questions in this area. I would like to submit those to you for your response for the record.

The Chair will now recognize the gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Mr. Mayer, on page 10 of your testimony, you say that functional regulation is the way to go and you prefer a healthy skepticism from the SEC looking at these activities rather than a bank regulator's boosterism.

Can you critique for us the SID's structure as proposed in this legislation?

Mr. MAYER. I would be quite concerned about the ability of banking regulators to enforce the securities act. We go abroad for the best recent example, which is Barings, where the Bank of England was very clearly blindsided by what was going on at Barings Bank and Barings Securities, and the Fed, incidentally, was also blindsided. Citibank put up 57 million bucks for Mr. Leason in Singapore and the Fed didn't even know about it and the Fed doesn't believe it to this day, but they did.

There is a naivete about banking regulators on the whole, particularly in dealing with securities matters, and I cannot see what we gain in asking people and not trying to enforce a body of law to go do it when there is an existing, particularly self-regulatory organization, which goes about that business every day.

Mr. MARKEY. And what about the history of the 1980's? A couple of thousand S&Ls and banks went under in the 1980's.

Mr. MAYER. That is the accounting procedure question really, and this Congress after all, in the Garn-St Germain Act, validated what Richard Pratt had done at the bank board in terms of changing the accounting rules for federally insured depository, S&Ls and banks both.

The experience of the S&Ls is that—there were two. Let me take 1 minute. One is that the S&Ls were losing their social function because Fannie and Freddie were taking over the financing of housing. They were in deep trouble. They had $700 billion of assets. We encouraged them to grow out of their troubles. They got to $1.4 trillion of assets. Not surprisingly, a lot of those assets were no good. We got out cheap at $150 or $200 billion.

But the other part of it is that the Congress looked at a set of institutions that were in deep trouble, and said, gee, we have got to find some way to get them out of trouble and, really, there was no way to get them out of trouble and we made the trouble worse.

To some extent, when you look at the banks today, you look at the same sort of overcapacity that you had in the S&Ls. You have got $3.5 trillion of liabilities. You don't have $3.5 trillion of good bankable assets, so you seek for ways—they look healthy today, but they are not underneath.

You seek for ways in which they can continue to make a living because they are very important organizations. A good deal of this effort is that. And you do have to be terribly careful that in doing that, you are not duplicating this set of problems in which guys get into businesses they don't understand because they can't make money in their own business.

Mr. MARKEY. So how do we view this as we introduce more securities and insurance into the picture and the risks that are entailed if the system can't adequately deal with the risks that are being introduced?

Mr. MAYER. It is functional regulation, I do believe, and you have to avoid doing things like permitting, for example, the creation of exotic derivatives which would otherwise be forbidden by the gaming laws, to go ahead without fairly, fairly close regulation of them, very—I mean, what is done in the Chicago markets is mostly a great contribution to the country. What is done in bank back rooms

in terms of constructing special things may or may not be a contribution. The people who are more likely to have an intelligent view of that are the securities people, not the banking people.

Mr. MARKEY. Now, you heard my question to Chairman Greenspan about whether or not exotic derivatives should be placed inside of the bank and not in a separate subsidiary, and he demurred as to whether or not, in fact, it would or would not be there.

What is the recommendation that you would have with regard to that?

Mr. MAYER. He said it is in the bank now. The securities houses form separate subsidiaries to trade derivatives, Salomon, Merrill Lynch, Morgan Stanley, all of these guys have their own subsidiary that trades derivatives. The banks wanted to do that, in fairness to them. The Fed and the comptroller wouldn't let them because they wouldn't let the capital be taken out of the bank.

I think that they should be done in separate subsidiaries, which are to some extent severable and they should have to earn their own AAA ratings.

Mr. MARKEY. What happens if they are not?

Mr. MAYER. I wouldn't be surprised if we will have some news stories within the next year that tells us what happens when they are not. The comptroller and the Fed are still permitting banks to carry inverse floaters and structured notes at their historic cost, even though they are worth a great deal less and there are some very misleading bank balance sheets as a result.

Mr. MARKEY. Thank you, sir.

Mr. FIELDS. The Chair will now recognize the gentleman from Iowa, Mr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman. I just have a brief question for Mr. Mayer.

In light of what is already going on with the courts and the OCC how important is it that we do something about Glass-Steagall?

Mr. MAYER. It is such a mess now. There are so many aspects of banking regulation in this country that are such a mess. It is certainly worth working at it, and I also think that it is much better to have a legal framework within which people operate, rather than having a legal framework which can be chipped away at here and there by the Fed, sometimes in response to special pleadings, sometimes in response to the fact that the technology of the world has changed a great deal.

I think this is something that should be done, but I think it should be done very carefully. You know, reference was made to the Swiss banks and others earlier. The deregulation of banking has been a worldwide disaster. The Scandinavian banks nearly all went under. The British banks have been in terrible trouble. The Swiss banks are not happy campers. The German banks are not happy campers, and the Japanese banks we know about. It is not something you can do on a wholesale basis and expect to be happy with the results. Guys tend to do better in businesses they understand.

Mr. GANSKE. I appreciate it.

That is all, Mr. Chairman.

Mr. FIELDS. Thank you.

The gentleman from California, Mr. Cox.

Mr. COX. Thank you. I would like to address this question to any one of the three of you that cares to respond, but I will start with Mr. Feigin because it was your testimony that caused me to think about it.

You emphasized your view that we should try to achieve physical separation of the sale of bank product and the sale of securities within the bank lobby. They shouldn't be offered from the same desk, physically. They shouldn't be offered from the same teller window or what have you, and the first thing that occurred to me is that that is an antiquated notion because we are doing so much of this now in other ways than people walking into lobbies, sitting down and talking to someone, ATM, for example, for a lot of routine commercial transactions, computers that people have at home, or at their offices, even for personal transactions, and bigger computers for companies and so on.

So that that might not buy us much, but I ask myself, why is it that we are interested in this kind of physical separation? Of course your concern is that we want to cordon off anything that is government insured from anything that is privately insured.

Now, I have a money market fund that behaves, as far as I am concerned as a consumer, exactly like my savings account would behave at a bank, and through devices that you are well aware of, I am able actually to write checks and it looks to me exactly the same way as it would look if I had a regular bank account.

But earlier, one of the bank regulators suggested that I was making an election to have a noninsured account. In fact, my moneys are all insured, but they are not government insured; they are privately insured. Isn't what we are talking about here indulging the notion that somehow government insurance is safer than private insurance?

Mr. FEIGIN. I think there are a couple questions in there, but first let me comment on physical separation. I think that is one component of a suggestion or an urging, to try to figure out a way to convince the public away from the 60-year notion that when they deal with a bank, they are dealing with an insured or safe environment. When they go to a brokerage firm, that is a different—that is an election. So the physical separation, so-called potted palm idea of keeping it separate, was just one way of attempting to cause the public to recognize that they are not dealing with an insured entity anymore.

I speculated that perhaps having it off in a separate room might raise the image of the dealing with that to make it more special. And also, in my jurisdiction, in Colorado we have a lot of rural banks that are simply one roomed, so that physical—or demanding physical separation might cost $10,000 and be of no real value.

So I think it is just one component or one suggestion of ways to achieve the end of finding ways to convince the public that when they deal with an insured institution or uninsured products, they are aware of it.

Mr. MAYER. May I comment on that? You had Charlie Keating in your district selling his unsecured debentures.

Mr. COX. Let me talk about the question, which is private insurance versus—I was hoping you would address that, too. I don't

have but 5 minutes here so I want to make sure we stick to the question.

Should we encourage people to think negatively about SIPC and favorably about FDIC?

Mr. MAYER. Sure. FDIC is much better insurance than SIPC, and he is from Colorado where you had a bunch of industrial banks that went under and you can talk to people from Ohio about the state-insured S&Ls that went under. The Federal Government prints the money. Its insurance policy is always good. A lot of these money markets——

Mr. COX. Isn't that what led us to the S&L crisis? The fact that everybody knew you were playing with the government's money and so we didn't have the normal marketplace discipline. We know how that all worked. You get all the upside, if you invest in risky things because you are an S&L. The downside goes to the taxpayer and there is nobody in the marketplace looking after that risk.

Mr. MAYER. Do something about deposit insurance.

Mr. COX. We are dealing with the notion that what we really should be doing is capping off the government insurance because it is the source of so many of our problems.

Mr. FEIGIN. I would say that you talked about dreaming or being forward enough. Part of the problem here is that we talk about banks getting into all these other areas, but we forget the one essential thing that banks mean to the American public, and that is deposit insurance.

If the banks only get involved in those other activities, let's do it in a way so that everybody knows it is not insured activity. That is the competitive disadvantage that a bank brings to the marketplace. They have that 60 years of this warm quilt that you can pull over yourself. That is part of the problem.

If banks are engaged in that activity, maybe we need to drop away from insurance and just let them have insurance for—in a very segregated place.

Mr. COX. My red light is on. I don't know if the chairman would like to let Commissioner Randall respond or not. If you have a response on that question, I am sure——

Ms. RANDALL. Thank you. Briefly, whether the product is FDIC insured or is privately insured or totally uninsured, the key, I feel, is disclosure to the consumer, and of course, we as regulators want to protect the consumer and have an informed consumer, and I think that is really the key.

And if there is one thing I think regulators can do, based on legislative and statutory authority, I think we can craft those regulations and make sure the institutions, the banks follow them and make those disclosure requirements very clear and strictly enforce them.

Mr. COX. I thank you and I thank the chairman.

Mr. FIELDS. The Chair wants to thank all of the witnesses that have appeared today. Your statements will be included in their entirety in the record. The Chair will also announce that our second hearing on Glass-Steagall reform will be this Thursday, June 8, at 11 a.m. in this room.

[Whereupon, at 1:36 p.m., the subcommittee was adjourned, to reconvene at 11 a.m., Thursday, June 8, 1995.]

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THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995

THURSDAY, JUNE 8, 1995

HOUSE OF REPRESENTATIVES, COMMITTEE ON COMMERCE, SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE, AND THE SUBCOMMITTEE ON COMMERCE, TRADE, AND HAZARDOUS MATERIALS,

Washington, DC.

The subcommittees met, pursuant to notice, at 11 a.m., in Room 2123, Rayburn House Office Building, Hon. Michael G. Oxley [chairman of the Subcommittee on Commerce, Trade, and Hazardous Materials] and Hon. Jack Fields [chairman of the Subcommittee on Telecommunications and Finance] cochairing.

Members present, Subcommittee on Telecommunications and Finance: Representatives Fields, Oxley, Stearns, Paxon, Gillmor, Cox, Deal, Frisa, White, Coburn, Bliley (ex officio), Markey, Rush, Eshoo, Klink, and Dingell (ex officio).

Members present, Subcommittee on Commerce, Trade, and Hazardous Materials: Representatives Oxley, Fields, Gillmor, Crapo, Ganske, Frisa, Norwood, White, Bliley (ex officio), Markey, Brown, Lincoln, Deutsch, Stupak, and Dingell (ex officio).

Staff present: Steve Blumenthal, majority counsel; Robert Gordon, majority counsel; David Cavicke, majority counsel; Rob Cimo, staff assistant; Tim Ford, minority counsel; and Consuela Washington, minority counsel.

Mr. OXLEY. The committee will come to order.

And before we welcome our first panel, the Chair would recognize the chairman of the full committee, the gentleman from Virginia, Mr. Bliley.

Mr. BLILEY. Thank you, Mr. Chairman. I have a very brief statement that I would like to make. First of all, I want to commend you and Chairman Fields for the fine work each of you and your staffs on attempting to develop a workable resolution that addresses the insurance issue surrounding Glass-Steagall.

I also want to thank my good friend, Chairman Jim Leach of the House Banking Committee, and his fine staff for their cooperation over these past few weeks in attempting to draft an agreement acceptable to all of the parties and good for the Nation as a whole.

Following hours of intense discussion with Members of the House Leadership and weeks of meetings with each of the interested parties, it has become apparent to me that an affiliation approach is unworkable at this time. The parties are too far apart in their commitment to their respective positions, too firmly held, for such an approach to succeed at present.

To pursue the insurance affiliation issues forever, it is now clear it would only jeopardize this window of opportunity to enact historic legislation modernizing our financial services industries. Nevertheless, we are committed to the pursuit of a resolution of the issues, which we have endeavored to address over these past few weeks. Ultimately, these issues must be successfully addressed; if not today, then soon, and I pledge to continue this committee's work toward that resolution.

I thank you, Mr. Chairman.

Mr. OXLEY. I thank the gentleman. I now recognize the ranking member of the Telecommunications and Finance Subcommittee, the gentleman from Massachusetts.

Mr. MARKEY. I thank the Chair very much, and the full committee chairman's statement reminds me of the admonition that we got from my civil procedure professor in my first year in law school. And he said that it is always interesting near the end of the exam when students start going through, after the 3 hours are about to be over, to answer the question and they start crossing out key words, words like "not," you know. And as we get nearer the end of this exam, we are moving towards the goal of trying our best to narrow it down to those issues which we can make some progress on, and I congratulate the full committee chairman and the subcommittee chairman for their decision on that issue. I think it is going to help considerably in our efforts towards reconciling.

At the subcommittee's Tuesday hearing, we received testimony from the Nation's top financial regulators on the need to repeal the 60-year-old Glass-Steagall separation between banking and securities. I have long been on record in support of such legislation, provided it is linked to an effective system of functional regulation and strong firewalls that protect investors, depositors and taxpayers from potential abuses and conflicts of interest.

We heard testimony at the last hearing about the need to modernize financial services regulation in order to provide a level playing field. I agree that this should be one of our principal objectives. When we talk of level playing fields, however, we should keep in mind that in the game of baseball, the American League allows its teams to have designated hitters, while National League rules require teams to put the pitcher in the batting rotation. We wouldn't allow an American League team to move over to the National League while retaining their designated hitters, while at the same time forcing all the National League teams to continue playing with pitchers in the battle lineup.

Likewise, we should not allow banks to engage in the full range of securities activities unless they agree to abide by the rules that govern all other firms operating in the securities markets. In baseball, as in life, competitors should play by the same set of rules enforced by the same set of umpires.

Unfortunately, as these charts indicate, under H.R. 1062, banks will be free to retain their regulatory designated hitters. Under the bill, banks would have to conduct some securities activities in a separate affiliate outside the bank subject to full SEC regulation. Other securities activities, however, could be done inside the bank in a separately identifiable department, or SID, regulated by the

SEC but not subject to the SEC's net capital rule or to the regulatory firewalls.

Still other securities activities could be carried out either inside the bank itself or in a SID regulated not by the SEC, but by the bank regulators. Moreover, the Fed is given a wild card regulatory authority to allow anything the SEC has determined to be a security to nevertheless be regulated as a traditional banking product that can be traded inside the bank.

Banks are free to decide whether or not to establish a separate affiliate and if they choose not to do so, they potentially will be able to conduct a range of risky activities inside the bank, including dealing in such exotic derivative securities as inverse floaters, real estate mortgage investment conduits, and collateralized mortgage obligations, a product so risky it is known on Wall Street as toxic waste.

If the bank decides to conduct such activities inside the bank, it will not be subject to SEC capital rules or the credit enhancement or other regulatory firewalls in the bill. The bank also will not be subject to oversight by the SEC or securities self-regulatory organizations, such as the NASD, or the New York Stock Exchange.

This may be a field of dreams for the banks, but it will perpetuate a system which provides inconsistent protections for investors and markets and uneven and duplicative examinations and enforcement within the securities industry.

I understand that existing law allows banks to conduct government securities, municipal securities, mortgage-backed securities and asset-backed securities inside the bank. However, when these rules were devised, there was no Fannie Mae or Freddie Mac and the term government securities meant plain vanilla Treasury offerings.

Today, we have a far different marketplace containing securities derived from government mortgage-backed or municipal securities which are far more complex and risky. If we are going to restructure financial service regulation, we must take account of this fact. It is ironic that some of the same people that argue we must be visionary in eliminating old regulatory structures in light of rapidly changing market dynamics argue that risky securities activities should be moved outside the bank because that is just where we do it now.

I, therefore, will be interested in hearing from our second panel whether we can replace the Byzantine SID structure of H.R. 1062 with a simpler construct which generally requires banks to place securities activities in a separate affiliate and which subjects all such activities to functional regulation by the SEC and appropriate firewall protections.

Mr. Chairman, I want to commend you for holding this hearing and I thank you for the indulgence and the extra time for the opening statement.

Mr. OXLEY. I thank the gentleman for his baseball analogy and for his visual aides, and if no other member feels burdened by an undelivered opening statement, we can go right into the first panel.

Noting none, I will introduce our first panel. First is Mr. James Klagholz, Chairman of the Government Affairs Committee for the Independent Insurance Agents. Our second witness is Andrew

Cassidy, Chairman of the Council of Insurance Agents and Brokers. Next is Michael Grace, President Elect of the Wright and Percy Insurance Company; and lastly, Peter Browne, Chairman of the National Association of Life Underwriters, representing the Committee on Federal Law and Legislation.

Gentlemen, welcome to the panel and, Mr. Klagholz, you may begin.

STATEMENTS OF JAMES KLAGHOLZ, CHAIRMAN, GOVERNMENT AFFAIRS COMMITTEE FOR THE INDEPENDENT INSURANCE AGENTS OF AMERICA; ANDREW CASSIDY, CHAIRMAN, TASK FORCE ON FINANCIAL SERVICES, COUNCIL OF INSURANCE BROKERS AND AGENTS; MICHAEL GRACE, PRESIDENT ELECT, WRIGHT AND PERCY INSURANCE COMPANY, REPRESENTING THE NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS; AND PETER C. BROWNE, CHAIRMAN, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, REPRESENTING THE COMMITTEE ON FEDERAL LAW AND LEGISLATION

Mr. KLAGHOLZ. Chairman Oxley and Chairman Fields, my name is James Klagholz and I am Secretary/Treasurer of the Quiqman Sterling Associates of Seaside Park, New Jersey, as well as Government Affairs Committee Chairman for the Independent Insurance Agents of America. Thank you for inviting us to appear and comment on H.R. 1062.

I appear today on behalf of the insurance agents of America, more than 300,000 men and women who work in every part of the United States. As far as Glass-Steagall reform is concerned, our position is well-known by now. We understand the desire to modernize the banking industry in this country and we are not opposed to such modernization.

In fact, if I could leave these committees with one thought today on behalf of the agents I represent, it would be this: We are not here to ask you to keep banks out of the insurance business. Agents simply want to preserve the rights of the States to make that decision and for the States to determine just how and if any bank may offer an insurance product.

Insurance is a State-regulated business. The States protect the insurance-buying public and insure a level playing field for all of those in the business. States must be allowed to continue to perform this function for everyone, including national banks.

I want to thank Chairman Bliley for introducing H.R. 1317 and for his wisdom and continuing commitment to preserve State law in this area, not preempt it. His efforts will have the full throttle support of the Nation's insurance agents and companies.

H.R. 1062 is not neutral on the insurance issue. It allows some affiliation between banks and insurance entities contrary to State law, and more importantly, it gives banks expanded power without doing anything to curb the Comptroller of the Currency's appetite for even further expansions, contrary to congressional intent. As it currently stands, we must oppose H.R. 1062.

We have two solutions. First, stop the Comptroller from creating additional insurance powers for national banks without Congress' involvement in that policy judgment. The OCC has been extremely

active in this area, most recently proposing a regulation that would permit national bank operating subs to engage in broad nonbanking activities, presumably including insurance sales and underwriting, that the bank itself cannot engage in.

Second, add H.R. 1317 to the Bliley-Dingell—H.R. 1317, the Bliley-Dingell bill, to H.R. 1062. The reason is simple. Insurance is and should remain regulated by the States. This is the only approach consistent with the functional regulation concept embedded in H.R. 1062.

As I mentioned at the outset, the authority to determine who may or may not sell insurance is critical. Some might say the critical aspect of functional regulation. A State may decide it is in the best interest of its citizens not to permit banks to sell insurance or affiliate with those who do. Perhaps it is the concern about consumer confusion regarding what kind of product they are purchasing, perhaps the concern about the potential that customers will feel they must purchase the insurance from the bank in order to preserve a credit relationship, or perhaps it is the concern that confidential customer information will be exchanged to the detriment of the customer and competitors.

Whatever the reason, more than a handful of States have decided that a separation between banking and insurance is the best public policy decision. You cannot give lip service to functional regulation at the same time you are trampling over that State decision.

We understand that banks are deathly afraid State insurance regulators will all of a sudden start calling banking products insurance. It has not happened yet and States have been regulating insurance for over 200 years. The encroachment has been the other way; Federal banking regulators with no knowledge or experience in insurance declaring insurance products free game for banks in total disregard of established State insurance law. It is time to take such judgments out of the hands of unelected Federal banking regulators. The States have traditionally regulated the insurance industry and should continue to do so.

If banks want to engage in that area of commerce, they must abide by State-made rules. That is what H.R. 1317 provides and that is why we urge you to add it to H.R. 1062.

Unlike many in the banking community, IIAA wants this process to be successful and for Congress to pass a financial modernization bill this year. All we ask is that Congress prevent further erosion of State insurance authority by the Comptroller's office and that Congress declare the Comptroller may not create any new insurance powers for national banks. We look forward to working with you to reach this end.

Thank you, Mr. Chairman.

[The prepared statement of James Klagholz follows:]

PREPARED STATEMENT OF JAMES KLAGHOLZ ON BEHALF OF THE AMERICAN LAND TITLE ASSOCIATION; COUNCIL OF INSURANCE AGENTS AND BROKERS; INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.; AND THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

This testimony is submitted on behalf of the insurance agents of America, and their employees, more than 500,000 men and women who work in every part of the United States. These people are represented by the following organizations: American Land Title Association; Council of Insurance Agents and Brokers; Independent Insurance Agents of America, Inc., and National Association of Life Underwriters.

INTRODUCTION

Mr. Chairman, we thank you for holding this hearing today and for asking us to testify.

Congress has heard much from us in the last few years on the question of banks and commerce, and, in particular, banks and insurance. In the 1980's, we were warned—repeatedly—that a brave new world was ahead of us, that banks must be able to sell, and perhaps even underwrite, insurance, that financial department stores were the coming vogue.

Congress has not succumbed to these entreaties. Indeed, the major banking legislation enacted by Congress in the 1980's spoke directly to our concerns. You amended the Bank Holding Company Act to state that, except in very limited circumstances, bank holding companies and their subsidiaries should not sell insurance. And, in the Federal Deposit Insurance Corporation Improvement Act of 1991, you prohibited FDIC-insured banks from underwriting insurance.

Unfortunately, banking regulators have not held true to Congress' intent. The OCC and other federal regulators have sought to push the envelope at every opportunity to permit banks to engage in insurance-related activities. Much of the Bank Holding Company Act's force has been eviscerated by rulings that it does not apply to the bank itself and the OCC's willingness to interpret the National Bank Act to permit ever expanding insurance powers to national banks. For its part, the FDIC, contrary to apparent legislative intent, has interpreted FDICIA's underwriting prohibitions not to include annuities—a traditional insurance product of growing importance to consumers.

The principle embedded in existing law—that banking and commerce, and particularly insurance, should be separated—is not a form of domestic protectionism. It is necessary to ensure fair competition and to protect the insurance consumer as well as the banking consumer and the taxpayer.

We understand that there is a need for financial modernization—particularly in light of pressures from foreign commerce and economic pressures within this country. It may indeed be the case that banks deserve some regulatory relief in the conduct of their banking business. And there may well be room for careful and reasoned restructuring of the Glass-Steagall Act to modernize the relationship between banking and securities.

However, we stand opposed to any breach in the wall between banking and general lines of commerce. And, in particular, we oppose any lessening of the separation between banking and insurance. We oppose all proposals to integrate or expand insurance activities for banks. In particular, we could not accept any proposal that would override State regulation of insurance. Any modernization must be done with a clear eye toward maintaining stability, competition and consumer access to community-based financial services—and preserving state insurance regulation.

REASONS TO SEPARATE THE BANKING AND INSURANCE INDUSTRIES

Put simply, our position is this: The sale of insurance by banks is inherently unfair both to consumers and to insurance agents not affiliated with banking institutions. The reason is simple: When a bank simultaneously loans money and sells insurance, a borrower faces an inherently unfair circumstance. Especially in hard economic times, when credit is tight, what borrower will fail to buy insurance if there is any possibility that the purchase might improve the chance for a loan? What business that is dependent upon its bank for a line of credit will risk that relationship by going to an outside insurance agent when it is suggested that the business deal with the bank? Especially in small towns and limited markets for credit, what insurance agency will feel comfortable when it needs money and has to borrow it from a bank that is also its largest customer? The risks of harm clearly outweigh the putative benefits of full-fledged bank entry into the insurance business.

To begin, the notion that consumers will necessarily benefit from bank sales of insurance must be dispelled. It is important to keep in mind that insurance customers shop on the basis of coverage, price and customer service. No seller of insurance—including banks—can dictate the scope of coverage. The availability of insurance is controlled exclusively by the insurance companies, which decide what type of insurance they want to write, what limitations that want to impose, and what exposure they want to insure. Thus, the sale of insurance by banks would not create a greater supply of liability insurance for small businesses, nor would it increase the number of available homeowners, policies, for example.

Nor is there any evidence that banks, entry into the market will lower the cost of insurance to the consumer. In the first instance, the price of insurance is set by the insurance company—not the agent. In addition, state insurance laws and regulators tightly regulate the fees and charges insurance agents can charge customers

on insurance-related business. To the extent there is some play in cost, however, there is substantial evidence that banks would charge *more*, not less, for insurance products. Credit insurance—the type of insurance in which banks have been engaged most prevalently—is the most dramatic case in point. Banks have consistently been shown to sell credit insurance at the highest possible rate. In fact, in 1990, the Consumer Federation of America conducted a study in which it found that credit life insurance, sold almost exclusively by lenders, to be "the nation's worst insurance ripoff." To the extent banks have realized any cost savings, those savings certainly are not passed on to the consumer.

The third aspect of insurance sales—service—similarly offers no evidence of bank advantage. Banks and their supporters routinely tout the purported benefits of "one-stop-shopping." It is not clear what precisely they mean. If they mean that customers should be able to do their banking, buy insurance, and get their teeth cleaned within the same four walls, we question whether customers indeed want such so-called "convenience." Indeed, the most recent major experiment in the department-store approach has failed: Sears has either spun off or is the process of divesting itself of Allstate, Caldwell Banker, and Dean Witter. But even if one were to give credence to the supposed benefit of "one-stop-shopping," the purchase of insurance is only the beginning of the services provided by an insurance seller. Of equal or greater importance is claims service: the ability of insurance agents to respond when disaster strikes, to meet the customer's needs when the customer's needs call for attention. An insurance agent does not work bankers' hours; an insurance agent cannot be replaced by an ATM.

By contrast to the paucity of evidence of potential benefits, bank entry into the insurance business poses very real risks to fair competition and to consumers.

Banks, especially banks outside large cities, exercise significant market power. Particularly in times of economic downturn, access to credit is not easily available. A study by the Federal Reserve Board not too long ago demonstrated that "[o]verwhelmingly, the single most important financial institution for nearly every financial product and service used by small and medium-sized businesses is a local commercial bank.[1]

But the ability of banks to tie insurance products to their financial products does not depend on market power. In the banking industry, the power to affect a customer's decision is inherent in the banking relationship itself. That is, no small business dependent on a loan or line of credit, is going to challenge a bank that, as part of its loan approval or review process, "suggests" that the borrower purchase insurance from the bank, even if the customer understands he or she has a theoretical right to shop around for credit or insurance.

The coercion need not be express; the tie-in need not be compelled. Indeed, the greatest danger is of voluntary tie-ins—customers themselves choosing not to shop for insurance products. Voluntary tie-ins are inherent in the combination of the sale of any product and the extension of credit. People think that they will enhance the likelihood that they are going to get the credit by buying this product from the bank.

The pervasive existence of "voluntary" tie-ins explains why simple legal restrictions, like the anti-tying statute found in the Bank Holding Company Act, 12 U.S.C. § 1972, fail to achieve the abolition of tying arrangements.

The result of tie-ins and steering is inevitably the concentration of markets. Figures from a 1987 report to the Wisconsin Commissioner of Insurance showed that, in Montana, one title insurance company's market share increased from 11% to 52% in the first four years after it was acquired by a lender. In Minnesota, the State's largest S&L acquired a major interest in a title insurance company in 1979; from April 1979 to August 1980, the amount of business referred to the company from the S&L increased from 12% to 83%. Also in Minnesota, in the first five months of 1988, two savings banks had 94% and 96% of all their respective recorded mortgage transactions insured by captive title insurance agencies.

The concern goes beyond potential coercion, tie-ins and resulting concentration of markets. As one court recently observed in connection with Florida's law prohibiting bank sale of insurance:

> the concern, then is that insurance not be sold through institutions which require such coverage in order to conduct other business, and that such institutions would be lax or indifferent to enforcing actuarial standards... [S]uch institutions, particularly banks, might require their cus-

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[1] G. Elliehausen & J. Wolken, Banking Markets and the Use of Financial Services by Small and Medium-Sized Businesses at 32 (Staff Studies, Bd. of Governors of the Federal Reserve System, September 1990).

tomers seeking loans for certain properties (e.g., home or automobile) to purchase "needed" insurance through the institution's insurance agent....

For example, in order to make a profit on automobile loans or home mortgages, the insurance agents may incur business they might otherwise reflect because they would be pressured by the bank to do so in order to consummate the bank's loan transactions. This might lead to the overinsurance of risky business, which could result in the insolvency of the insurer.

Additionally, and notwithstanding the existence of specific prohibitions on coercive credit extensions, the Court finds that loan officers could steer customers to the bank's insurance agent for the purpose of suggesting the sale of insurance that is not needed, in order for the bank to make a profit on the insurance policy. The concern herein expressed is that an arms-length relationship be maintained among the bank, the loan officer and the insurance agents. The maintenance of this relationship is for the protection of the solvency of the insurance industry, and the prevention of coercion, which in turn protects all potential, present and future policyholders.[2]

Maintaining the separation between banking and insurance is particularly important in the case of title insurance. Consumers purchase title insurance only once or twice in their lifetimes and generally do not shop for such insurance. Rather, they rely on recommendations from real estate professionals, such as their mortgage lenders. Accordingly, if banks are allowed to be affiliated with title companies there is a significant risk that consumers will be steered by bank loan officers to the bank's affiliated title company even when other title companies can provide better quality, services or prices. Moreover, because banks are insured under title insurance policies issued in connection with their mortgage loans, there is an inherent conflict of interest when an affiliate of the bank acts as an agent for the issuance of a title insurance policy to the bank.[3]

The U.S. Court of Appeals for the Second Circuit has ruled that national banks may not engage in the title insurance agency business or own such businesses as part of their "incidental" banking powers.[4] And the Federal Reserve Board has determined that the insurance prohibitions of the Bank Holding Company Act apply with full force to title insurance.

As one court simply put it: "[T]here is a potential for abuse inherent in financial institutions being involved in the sale of insurance."[5] The current separation between banking and insurance is essential for the protection of consumers and to avoid conflicts of interest, and should be maintained.

Moreover, allowing banks to sell insurance would increase concentration in the financial services sector. Large banks would acquire or affiliate themselves with large insurance agencies and brokerages. Agencies and brokerages that are unaffiliated with banks would be effectively shut out of the insurance market. Competition in insurance would decline and customer service would decline as well.

The consumer is not the only one at risk when banks are involved in the sale of insurance. Banks are not on the same level playing field as agents not affiliated with financial institutions. Banks have preferential access to cheap funds by which to enter the insurance business. Federally chartered commercial banks, for example, can obtain below-market funds from the Federal Reserve discount window. This access to below-market credit is a substantial advantage over others in the market.

Furthermore, banks alone have the benefit of the federal safety net—FDIC insurance—funded by the taxpayer. This unique benefit enables them to get customers in the door in ways no other business could hope to duplicate. Recent studies have shown that the vast majority of customers who purchase non-banking investment products and annuities from banks wrongly believe them to be FDIC-insured. The fact is that even those customers who understand the non-insured nature of the non-banking products they are purchasing somehow feel "safer" once they see the "FDIC-insured" seal on the door. Non-affiliated insurance agents cannot replicate that sense of security—however false it really is.

Insurance agents are not afraid of competition. We face it every day. The insurance agency business is highly competitive and the hurdles to entry are low. What

[2] *Barnett Banks of Marion County, N.A. v. Gallagher*, 839 F. Supp. 835, 841-42 (M.D. Fla. 1993), *aff'd* 43 F.3d 631 (11th Cir. 1995) (petn. for cert. pending).

[3] For an excellent discussion of the problems posed in this regard by bank entry into the title insurance business, see Prof. Joyce Palomar's article entitled "Bank Control of Title Insurance Companies: Perils to the Public That Bank Regulators Have Ignored," 44 Southwestern Law Journal 905 (Fall 1990).

[4] *American Land Title Ass'n v. Clarke*, 968 F.2d 150 (2d Cir. 1992), *cert. denied*, 113 S.Ct. 2959 (1993).

[5] *Barnett Bank of Marion County, N.A. v. Gallagher*, 43 F.3d at 635.

we do require is a level playing field. And that cannot be achieved through expanded bank insurance sales.

H.R. 1062

We recognize that H.R. 1062 takes a more reasoned approach to financial institutions modernization than other broader proposals that have been made. But, as reported out of the Committee on Banking and Financial Services, H.R. 1062 is not insurance neutral.

For example, the bill would permit securities firms to retain their investments in companies that engage in activities that are not "financial in nature" for five years or more. That provision would effectively permit the affiliation of a bank and an insurance company or agency, even if state law prohibits such affiliations.

In its current form, we will oppose H.R. 1062.

A. H.R. 1317 Should Be Added to H.R. 1062

Given that H.R. 1062 already implicates insurance, and given that it broadly addresses bank powers, we believe it is an appropriate vehicle for adding an insurance-specific provision that affirmatively reinforces state regulation of this area of commerce. As we have previously testified, in our view, H.R. 1317—the "Insurance States' and Consumers' Rights Clarification and Fair Competition Act of 1995"—should be added to H.R. 1062.

Put simply, H.R. 1317 would clarify—once and for all—that no one is free from state regulation of insurance. *Every entity* that engages in the underwriting and sale of insurance must comply with applicable state insurance regulation. This applies to foreign entities, entities that operate across state lines, and banks.

It is needed now, and it is particularly appropriate for inclusion in H.R. 1062, because the Office of the Comptroller of the Currency has boldly advised national banks that they need not abide by state law when they engage in the insurance business. It does not matter that a state legislature has made the reasoned decision that banks should not engage in insurance sales activities within the State—the Comptroller tells the national banks they may simply ignore state law. More generally, the Comptroller has told national banks they need not even be licensed, despite the fact that every State requires insurance agents and brokers to qualify for and obtain a license before selling insurance. The licensing authority is effectively the only mechanism for policing agents' and brokers' activities.

B. No Abrogation of State Sovereignty Through Pre-Emption of State Anti-Affiliation Laws.

We understand that there have been, and continue to be, considerable efforts by members of Committee staff to craft some kind of a "compromise" that will permit banks to affiliate with insurance companies and agencies despite prohibitive state law. It is difficult, if not impossible, to testify about the specific provisions under consideration, since it seems to be a moving target and we have not seen the latest proposal. But we can comment about what kinds of things we have heard proposed, and representations that have been made about what it would mean for the insurance and banking industries.

Let us make one thing clear. We strongly oppose any proposal that would preempt state anti-affiliation laws—laws the States have crafted that prohibit banking institutions from affiliating with insurance companies and/or agencies. All of these "affiliation" proposals are premised on such preemption. This is exactly the opposite direction from the one in which Congress should be going. Instead of overriding States' judgment regarding whether a bank should be permitted to engage in the insurance business or affiliate with an entity that is, Congress should be reenforcing that judgment.

For over 200 years, the States have had virtually exclusive regulatory control over the insurance industry. Up until 1944, it was universally understood by everyone (including Congress) that Congress had no constitutional authority to regulate the business of insurance. This changed with a single Supreme Court decision that year. Congress responded immediately by enacting the McCarran-Ferguson Act, which "restore[d] the supremacy of the States in the realm of insurance regulation."[6]

McCarran's statement of policy could not be more clear: "The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business."[7] Particularly given that States have had exclusive control over the insurance business for this na-

[6] *United States Dep't of Treasury v. Fabe*, 113 S.Ct. 2202, 2207 (1993).
[7] 15 U.S.C. § 1012 (a)

tion's history, States are in a better position to judge whether banks should be permitted to engaged in insurance-related activities and/or affiliate with insurance entities within their boundaries. That policy approach should not be abandoned.

This is, moreover, the only approach consistent with the states-rights mandate given this Congress by the electorate. Indeed, it is difficult to imagine anything more inconsistent with the current congressional agenda than abrogating States' rights with regard to a few entities engaged in the insurance business. At time when Congress is seriously considering empowering States in myriad areas where the federal government has taken over people's lives, Congress should not strip the States of their authority to regulate in a business arena they have run throughout this country's fruitful history.

Even if States' rights were not the current political and philosophical agenda, the States are the only logical choice for the regulation of insurance. While there are uniform national concerns in this industry, like many others—in uncountable ways, insurance involves concerns of a local nature. The concerns in Iowa, for example, with hundreds (if not thousands) of farmers, few large urban areas and serious hail storms, are very different than the insurance issues raised in Florida, with its coastal hurricanes and large elder population. Thus, the measures the State legislatures may deem necessary to protect the insurance consumer in their respective states are bound to be different. These differences must be respected and preserved.

Not every State has the same view regarding bank sales of insurance or bank affiliation with insurance entities. We are not asking Congress to choose among those policies, but merely to respect the decisions the States have made.

However, it is perfectly legitimate for a state legislature to decide that this separation should be maintained. As recently as January 30, the U.S. Court of Appeals for the Eleventh Circuit acknowledged the legitimacy of that decision in the context of Florida's prohibition. The court noted the underlying concern with "overreaching by financial institutions if permitted to sell insurance." [8] The Court recognized the state legislature's desire to prevent coercion of insurance purchasers, unfair trade practices by the banks, and undue concentration of resources: "The Legislature has determined that there is potential for abuse inherent in financial institutions being involved in the sale of insurance, and that the licensing of employees of financial institutions as insurance agents is not in the public interest." The Court determined, "[t]he danger in these situations . . . is the loss of arms-length transactions and objectivity when the bank becomes involved with insurer and insured."

As Senator Dole recently stated in endorsing continued state regulation of insurance: "governors and state legislatures can make decisions that are just as good or probably better than some nameless, faceless bureaucrat in Washington."

Not only is the federal government not the appropriate vehicle for insurance regulation, but—particularly in a time of fiscal constraint—there is no possible justification for establishing a duplicate system or replacing the state system.

Put simply, preemption of state anti-affiliation laws is a hurdle we cannot jump.

C. Comments on Specific Provisions of Insurance Affiliation Model.

1. *Pre-Emption of Anti-Affiliation Laws and Shoring Up of Section 92 Powers.*— We understand that the basic affiliation model being proposed would broadly preempt state laws that prohibit any depository institution from affiliating with an insurance agency or company. Within the new holding company structure, the power of a national bank to engage in insurance agency power directly would be determined by state law: if state law prohibits state-chartered banks from selling insurance, national banks would be bound by that law; if state law permits national banks to sell insurance, national banks would have that full power. In restrictive states, all insurance agency activities would have to be done through an affiliate of the bank, not the bank itself.

Let there be no mistake. This is a win-win situation for the banks. And a lose-lose situation for insurance agents and the States. National banks get expanded insurance powers. In restrictive states, for the first time they get to affiliate with insurance agencies in contravention of state law. In permissive states, they no longer are bound by federal law limitations on their insurance agency activities; they no longer must act through a small town office, for example; for the first time, they get full agency powers.

Staff has suggested that what the agents get in exchange for this is a shutdown of the OCC's power to expand national bank insurance agency powers coupled with a closing of the Section 92 small town national bank loophole. This all sounds good, but in the context of the affiliation structure it has little practical meaning.

[8] *Barnett Banks of Marion County, N.A. v. Gallagher*, 43 F.3d 631 (11th Cir. 1995).

The Comptroller needs to be reigned in. An unelected regulator should not be permitted to expand national bank insurance powers through the expedient of calling the product something other than insurance or simply declaring it incidental to banking. But with the parity and affiliation approach outlined by the proposal, the national banks will no longer need the OCC to champion their desire for more fee income. In permissive States, they will be able to sell any kind of insurance directly; they will not need OCC approval. In restrictive States, they can affiliate with an agency that sells all kinds of products.

Similarly, we agree that the Section 92 loophole should be closed. Here, again, the Comptroller has aggressively turned a limited exception into an expansive national bank power. When Congress enacted Section 92 in 1916 it wanted to give limited insurance agency authority to banks located and doing business in small towns in order to encourage them to stay in those locations and provide needed banking services to the residents. The Comptroller has turned this into a launching pad for nationwide insurance sales. In the OCC's view, so long as a bank has an office in a small town it can act as agent anywhere. Congress clearly did not intend this result, and it should say so. But it is not clear that saying so in the context of this affiliation proposal has any meaning. What bank will utilize the newly fashioned small town provision if it can become part of a holding company and either directly sell insurance without geographic restriction (in permissive states) or sell it indirectly through an affiliate (in restrictive states). What national banks will be left to be curbed by the clarified Section 92? It is a matter of shutting the barn door after the horse has left.

2. *Pre-Emotion of State Regulation of Bank Insurance Activities.*—Not only would the proposal preempt state laws prohibiting the insurance banking affiliation, it would more broadly preempt any state law or regulation that treated a bank or its affiliate differently than any other entity with regard to insurance activities. Thus, for example, the Michigan law that is the result of lengthy negotiations between the banking and insurance industries, which permits banks to engage in insurance sales but strictly regulates their activities in ways not applicable to non-banking entities, would be declared null and void. Any state law that required banks to make certain disclosures regarding the non-FDIC-insured nature of the insurance products they sell would be declared null and void. We can see no possible justification for this gross intrusion on state regulatory authority.

Bank complaints about state consumer protection laws that subject banks to requirements not imposed on other insurance actors fail to acknowledge the unique nature of banks. Banks' access to cheap funds, FDIC-insured status and control over credit, puts them in a position not held by others in the industry. Thus, even federal banking regulators acknowledge that banks have a responsibility to ensure that their customers understand that the insurance products they are purchasing are not FDIC-insured or otherwise backed by the government, and that physical location and advertising of the insurance business must be separated from the banking business to avoid customer confusion. Recent studies by the AARP found that the vast majority of consumers do not understand that the nonbanking products they purchase from banks are not FDIC-insured; some did not even understand that they were purchasing nonbanking products. These concerns simply do not apply to insurance agents not affiliated with banks—special protection are needed for consumers in the context of bank's involvement in marketing nonbanking products. And only the States are in a position to adequately impose such protection. Congress should not override that judgment.

3. *Comptroller Challenge to State-Law Determination of What Is "Insurance."*—We understand that the staff proposal would permit the Comptroller of the Currency to sue a state insurance regulator, in federal court, and challenge the regulator's determination that, under *state* law, a product is defined or regulated as "insurance." This would be an unprecedented provision. we can think of no other instance in which Congress has granted a federal regulator the right to challenge a state regulator's determination of state law. Frankly, we cannot image that Congress would condone such an intrusion into state sovereignty.

We know that national banks are deathly afraid that a State will redefine one of their "banking" products as "insurance" products and thereby force them to deal with the product through an affiliate (at least in restrictive states). But in the over 200 years that States have been regulating both banking and insurance, there has been no such problem. Banks have not cited one instance where an insurance regulator has encroached upon banking authority. To the contrary, the trend has been the opposite: federal banking regulators have redefined insurance products as "banking" products in order to enable banks to deal with them and then told the banks they can ignore state regulation. For over 200 years, States have regulated the banking and insurance industries within their borders. If there is a problem

with state law, there is recourse under state law. Congress should not inject itself—or the Comptroller—into that process.

These are only some of the provisions that have been proposed that we believe are contrary to this Congress' States-rights agenda and contrary to sound policy-making. We will oppose any such encroachments on state authority to regulate the insurance industry.

CONCLUSION

In sum, we urge continued maintenance of the separation of banking and insurance as a matter of federal law—a separation that serves the consumer as well as fair competition. Moreover, we urge Congress to respect the decisions of individual States as to whether banks should be permitted to engage in insurance agency activities or affiliate with insurance entities within the States' borders. All those who engage in the insurance business—including banks—must abide by state law regulating that business.

Congress has the opportunity now to clarify and strengthen the States' authority to regulate insurance. It should do so. We will fully support those efforts and we look forward to working with you to reach that end.

Mr. OXLEY. Mr. Cassidy.

STATEMENT OF ANDREW CASSIDY

Mr. CASSIDY. Thank you, Mr. Chairman. I would like to point out that Ann Kappler of Jenner and Block, who is counsel to this group, is here to take any technical questions, legal.

Good morning. I am Andrew Cassidy of Cassidy and Shilling Insurance Agency in Bethesda, Maryland and I am here representing the Council of Insurance Agents and Brokers where I serve as Chairman of the Task Force on Financial Services. The council represents the Nation's leading commercial and property casualty insurance agencies and brokerages, which collectively write more than $90 billion in premiums annually. This represents three-quarters of the commercial marketplace.

Obviously I agree with my colleagues on this panel and I hope I can shed further light on this important subject. We welcome this hearing because this debate presents a rare opportunity for the Commerce Committee to clean up some of the problems and uncertainty associated with the current status of bank insurance activities.

For as long as I have been in the insurance business and as long as my father was in the business before me and my grandfather before him, this debate has raged in Congress with the regulators and in the courts. When this committee meets to mark up H.R. 1062, it can take a great step forward in resolving many of these difficult and complex issues.

Not all insurance associations agree with one another about all issues, not even on the scope of Federal versus State regulation of our industry. But all of us on this panel agree that the problems that insurance agents are experiencing on this issue are in large part the result of a Federal system in which there is no balance.

There is no one in the Federal bureaucracy, no insurance voice, to stand up to the Office of the Comptroller of the Currency when it unilaterally grants banks insurance powers. Don't get me wrong. I am not calling for an insurance regulator in the Federal Government to fix this problem. But I am suggesting that the Comptroller of the Currency shouldn't be allowed to run amuck by expanding insurance powers in defiance of congressional intent.

In the States, there is a rough equilibrium of powers between the regulators of insurance and the regulators of banks. The system isn't perfect, but there is a balancing of interest.

Congress expressly vested insurance regulation to the States in the McCarran-Ferguson Act of 1945. Some States have chosen to allow bank affiliations; others have chosen not to allow affiliations. Without affirmation that States are the regulators of insurance, there is no balancing or influence on the Comptroller's crusade. We ask this committee to give us that affirmation.

A good example of the Comptroller's abusive power is the small town loophole issue. When Congress enacted section 92 in 1916, it wanted to give limited insurance agency authority to banks located and doing businesses in small towns. The Comptroller has turned this into a launching pad for nationwide insurance sales. As far the OCC is concerned, if a bank has an office in a small town, it can act as an agent anywhere. Congress clearly never intended this.

To add insult to injury, the OCC has advised national banks that they need not abide by State law when they engage in the insurance business, including State insurance agent broker licensing laws. To this, I say one thing, where do I sign up to become a national bank?

Each State enacts licensing laws to protect insurance consumers. It doesn't matter that a State legislature has made reasonable decisions about the circumstances under which anyone can engage in the insurance business. The Comptroller tells national banks they may simply ignore State law.

Mr. Chairman, like it or not, we have a State system of insurance regulation. There shouldn't be an exception for certain entities. H.R. 1317 would affirmatively reinforce the primacy of State regulation in this area of commerce. We appreciate Mr. Bliley and Mr. Dingell's introduction of H.R. 1317, and we are grateful that many members of this committee have signed on as supporters.

We look forward to continuing to work with you as banking reform legislation moves forward. Thank you for the opportunity to testify today.

Mr. OXLEY. Mr. Grace.

STATEMENT OF MICHAEL GRACE

Mr. GRACE. Thank you, Chairman Oxley, for holding this hearing today. I also want to thank Chairman Bliley and Congressman Dingell for their roles in this hearing and their thoughtful efforts to resolve this difficult issue before us.

I am grateful for the opportunity to speak with you this morning about the concerns that I and my fellow independent insurance agents share about efforts to grant banks increased access into the insurance industry. My name is Mike Grace. I am an independent insurance agent and a member of the National Association of Professional Insurance Agents.

PIA is a national trade association representing more than 180,000 independent agents, brokers, and their employees throughout the United States. The insurance agency that I represent has been a vital part of our community for more than 100 years and what you decide here in Washington will surely affect us back home.

The desires of big bank interests to affiliate with the insurance industry has little to do with the purported goal of enhanced global competitiveness and more to do with capturing a share of the domestic insurance producer's market. While we have concerns about H.R. 1062 in its present form because it does not address the OCC's increasingly brazen interpretations of national banking law, PIA is not opposed to reforming antiquated Glass-Steagall restrictions on banking activities.

We are, however, opposed to any compromise agreement that would pair Glass-Steagall reform with measures allowing banks increased access into insurance markets. Such a compromise would benefit only big business to the detriment of both consumers and independent insurance agents, who are predominantly small business owners.

Banks would gain an enormous competitive advantage over insurance producers if allowed to sell insurance. Banks may not face the same regulation and licensing requirements and they would have a captive audience to which they could market insurance. Banks would have access to ready-made customer lists and information about a potential client's financial status and insurance needs, i.e., does the banking customer have a line of credit, mortgage, car loan, own a business, et cetera, that would require insurance?

Information of this type would allow banks to selectively market insurance to only the most desirable of prospects. Furthermore, since certain loans require, as a precondition, homeowners and car loans, for example, the loan applicant could very well feel coerced into purchasing their insurance from the same entity from which they are borrowing money, lest their loan be declined.

Lastly, some consumers may mistakenly believe that FDIC protections which are enjoyed only by banks extend to insurance products sold by banks. They don't, of course, but some consumers could undoubtedly think so.

The most appropriate way to address bank desires to affiliate with the insurance industry is to add the Bliley Dingell bill, H.R. 1317, to H.R. 1062. The purpose of the Bliley-Dingell bill is simple and straightforward. It solidifies the States' authority to regulate the business of insurance. Every entity that engages in the underwriting and sale of insurance would be bound by State law regulating that activity and no entity would receive special treatment.

Given the current climate in favor of State's rights and against expanding the Federal bureaucracy, it makes no sense to preempt State laws and expertise in insurance matters so that large banks can secure a Federal right to get into the insurance business. In light of the OCC's recent activities, it is particularly important for the committee to add the Bliley-Dingell bill to H.R. 1062.

During the past few years, the OCC has brazenly expanded national bank insurance powers through dubious interpretations of Federal banking law. One outlandish position taken by the OCC is that national banks underwriting or selling insurance need not comply with State licensing or other regulatory requirements impacting those activities.

The OCC's officious intermeddling in an area of law once clearly the domain of State insurance commissions has created both uncer-

tainty and undermined effective regulation of some insurance activities. Congress must act to restore functional State regulation of insurance by attaching H.R. 1317, the Bliley-Dingell bill, to H.R. 1062. This is the best way for the committee to halt the Comptroller's indiscretions and return certainty to laws and regulation governing the business of insurance.

In conclusion, allowing banks to affiliate with the insurance industry on behalf only benefits big business interests. Consumers and independent agents would be harmed. PIA supports the rights of States to regulate the business of insurance and it implores the committee to amend H.R. 1062 by adding H.R. 1317, the Bliley-Dingell bill.

Unless the committee adopts H.R. 1317, the functional regulatory void created by the Comptroller's rogue forays into insurance matters will continue. Consumers will suffer as they are confronted by an increasing number of entities which view themselves immune from the reach of State insurance regulation.

Thank you again for this opportunity to testify. I appreciate the efforts of the chairman, the ranking member, and especially insurance counsel, Robert Gordon, to accommodate PIA during these hearings.

[The prepared statement of Michael Grace follows:]

PREPARED STATEMENT OF MICHAEL P. GRACE, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS

I. INTRODUCTION

Thank you Chairman Fields and Chairman Oxley for holding this hearing today. I also want to thank Chairman Bliley and Congressman Dingell for their roles in this hearing and their thoughtful efforts to resolve the difficult issue before us.

I'm grateful for the opportunity to speak with you this morning about the concerns I and my fellow independent insurance agents share about efforts to grant banks increased access into the insurance industry.

My name is Mike Grace. I'm an independent insurance agent and a member of the National Association of Professional Insurance Agents. PIA is a national trade association representing more than 180,000 independent insurance agents, brokers and their employees throughout the United States.

I'm with Wright and Percy Insurance in Baton Rouge, Louisiana. Our agency has been meeting the insurance needs of consumers since 1883, and although I may look like it, I haven't been there that long. This small business has been an important part of our community for more than 100 years. It's still a vital part of that community, and what you decide here in Washington will affect me, our employees and our customers back home in Louisiana. That's why it was so important for me to leave my business to come to Washington to talk with you today.

II. AMENDING H.R. 1062 TO ALLOW BANKS TO AFFILIATE WITH THE INSURANCE INDUSTRY IS BAD PUBLIC POLICY

The desires of big bank interests to affiliate with the insurance industry has little to do with the purported goal of "enhanced global competitiveness" and more to do with capturing a share of the domestic insurance producers market. While we have concerns about H.R. 1062 in its present form because it does not address the OCC's increasingly brazen interpretations of national banking law, PIA is not opposed to reforming antiquated Glass-Steagall restrictions on banking activities. We are, however, vehemently opposed to any compromise agreement that would pair Glass-Steagall reform with measures allowing banks increased access into insurance markets. Such a compromise would benefit only big business to the detriment of both consumers and independent insurance agents, who are predominantly small business owners.

Banks would gain an enormous **competitive advantage** over insurance producers if allowed to sell insurance. Banks may not face the same regulation and licensing requirements, and they would have a captive audience to which they could mar-

ket insurance. Banks would have access to ready-made customer lists and information about a potential client's financial status and insurance needs (i.e., does their banking customer have a line of credit, mortgage, car loan, own a business, etc. that would require insurance). Information of this type would allow banks to selectively market insurance to only the most desirable prospects. Furthermore, since certain loans require insurance as a precondition—homeowners and car loans, for example—loan applicants may feel coerced into purchasing their insurance from the same entity from which they are borrowing money, lest their loan be declined.

Consumers also don't stand to gain if banks are allowed to sell insurance. Credit insurance, the only type of insurance prevalently sold by banks at this time, is consistently sold at the highest possible rate. A 1990 Consumer Federation of America study found that credit life insurance, sold almost exclusively by banks, is "the nation's worst insurance rip-off". Nor can the insurance consumer expect to receive sufficient claims service during the existing bankers workweek, which is a far cry from the virtual 24-hour service provided by the typical independent insurance agent.

It is also important to note that insurance availability, scope of coverage, and price is set by the insurer not the seller. So, banks entry into the insurance market would provide no added benefit to the consumer in these areas. Lastly, some consumers may mistakenly believe that FDIC protections, which are enjoyed only by banks, extend to insurance products sold by banks. They don't, of course, but some consumers will undoubtedly think so.

Amending H.R. 1062 to allow banks into the insurance marketplace will not benefit consumers and will hurt the many small business owners who sell insurance for a living. My very livelihood may depend on the outcome of this Committee's deliberations about bank affiliation language.

III. STATE REGULATION OF INSURANCE AS ENVISIONED IN H.R. 1317 IS GOOD PUBLIC POLICY

The most appropriate way to address bank desires to affiliate with the insurance industry is to add the Bliley/Dingell Bill (H.R. 1317) to H.R. 1062. The purpose of the Bliley/Dingell Bill is simple and straight forward: it solidifies the States' authority to regulate the business of insurance. Every entity that engages in the underwriting or sale of insurance would be bound by state law regulating that activity. No entity would be free from such regulation or receive special treatment.

H.R. 1317 does not promote new or radical concepts. It merely builds upon and clarifies the statement of federal policy codified in the McCarran Ferguson Act—States regulate the insurance industry. In fact, when McCarran was enacted in the mid 1940's it was in response to a Supreme Court decision that put in to question the supremacy of State insurance regulation. The supremacy of State law in regards to insurance has been universally recognized since our country was formed.

A sophisticated State insurance licensing and regulatory structure has developed over the past 200 years. In contrast, no such federal regulatory scheme exists. Thus, the public has a substantial interest in the continued functional regulation of insurance by the States. The importance of insurance to a modern, industrial society has made the sale and underwriting of insurance one of the most regulated professions. States frequently revise and update their laws to ensure a solvent industry and adequate consumer protections.

Given the current climate in favor of State rights and against expanding the federal bureaucracy, it makes no sense to preempt State laws and expertise in insurance matters so that large banks can secure a federal right to get in the insurance business; especially when no system of federal regulation currently exists and creating such a federal system would duplicate an existing and capable State system of regulation.

The most viable alternative for the Committee is to reaffirm State rights to regulate insurance as called for in H.R. 1317. As Chairman Bliley has noted, such reaffirmation is required to ensure that all entities involved in insurance are on a level playing field and subject to the same consumer protection requirements, and that the insurance buying public has consistent assurances of quality.

Adding the Bliley/Dingell Bill to H.R. 1062 will not prohibit banks from affiliating with the insurance industry. It merely leaves that determination to State regulators, who are in the best position to make such a decision.

IV. THE OCC HAS EXCEEDED ITS MANDATE AND IS TRAMPLING STATE RIGHTS

In light of the OCC's recent activities it is particularly important for the Committee to add the Bliley/Dingell Bill to H.R. 1062. During the past few years the OCC has brazenly expanded national bank insurance powers through dubious interpreta-

tions of federal banking laws. One outlandish position taken by the OCC is that national banks underwriting or selling insurance need not comply with State licensing or other regulatory requirements impacting those activities. Since the Comptroller has neither the expertise or actual regulations on the book addressing insurance activities, his declaration that national banks need not comply with State laws has created a regulatory vacuum which is unacceptable and unworkable.

Although banks claim they are willing to submit to functional state insurance regulation, that assurance rings hollow. The OCC has repeatedly told national banks that they need not abide by state insurance laws when engaging in insurance-related activity. Banks have proclaimed their desire to enter the insurance business and look to the Comptroller to champion their interests. While national banks are presently acceding to State licensing requirements, there is no reason to believe they will do so in the future. In fact, banks have repeatedly informed State regulators and courts that they are only abiding by these laws "voluntarily".

The OCC is clearly thwarting Congressional intent by its rogue actions and is ignoring the competitive implications for independent insurance agents. National banks are not the only entities that seek to escape state insurance regulation. There have been problems with foreign insurance companies as well. Indeed, there have been problems with domestic companies issuing insurance contrary to state law—a very substantial problem if the company should be unable to pay the claims, because the policyholders will not be covered by state insurance insolvency funds.

The OCC's officious intermeddling in an area of law once clearly the domain of State Insurance Commissions has created uncertainty and undermined effective regulation of some insurance activities. Congress must act to restore functional State regulation of insurance. Attaching H.R. 1317, the Bliley/Dingell Bill to H.R 1062 is the best way for this Committee to halt the Comptroller's indiscretions and return certainty to laws and regulation governing the business of insurance.

V. CONCLUSION

While PIA recognizes the sincere efforts of Members and staff to craft a compromise amendment to H.R. 1062 that would address banks and insurance in the context of affiliation, we can not support such a compromise at this time. As I have stated earlier, allowing banks to affiliate with the insurance industry only benefits big business interests. Consumers and independent insurance agents would be harmed. PIA and the 180,000 insurance professionals it represents would vehemently oppose H.R. 1062 if any such affiliation language is added.

PIA supports the rights of States to regulate the business of insurance and implores the Committee to amend H.R. 1062 by adding H.R. 1317, the Bliley/Dingell Bill. Unless the Committee adopts H.R. 1317, the functional regulatory void created by the Comptroller's rogue forays into insurance matters will continue. Consumers will suffer as they are confronted by an increasing number of entities which view themselves immune from the reach of State insurance regulation.

Thank you again for this opportunity to testify. I appreciate the efforts of the Chairman and Ranking Member and especially Insurance Counsel, Robert Gordon, to accommodate PIA during the Committee's consideration of H.R. 1062.

Mr. OXLEY. Mr. Browne.

STATEMENT OF PETER C. BROWNE

Mr. BROWNE. Thank you, Chairman Oxley, for holding this hearing today and inviting the National Association of Life Underwriters to testify.

My name is Peter Browne and I am president of Price, Raffel and Browne, Incorporated, an insurance agency in New York City specializing in life and health insurance and employee benefits. I am Chairman of NALU's Federal Law and Legislation Committee and also Chairman of the Brace Coalition in New York State, which is a coalition of insurance agent trade associations that seeks to preserve the separation of banking and insurance.

There is no doubt that H.R. 1062 is an important bill for the banking industry, but it is equally important for the insurance industry, especially when there is talk about using Glass-Steagall re-

form as a basis for allowing banks increased access to insurance markets.

We cannot support H.R. 1062 in its current form because it is not insurance neutral. It permits alliances between banks and insurance entities, and while giving banks expanded powers, it does nothing to curb the excesses of the Comptroller of the Currency.

Unless H.R. 1062 is joined with H.R. 1317, the Bliley-Dingell bill, we will oppose H.R. 1062, and we will strongly oppose any attempt to join a provision that preempts State anti-affiliation laws.

If a State has decided that banks within its borders should not engage in insurance activities, it should not be affiliated with those who do. Congress should not override that judgment. New York has been studying this issue for longer than Congress. We enacted the law that formed the basis of the National Bank Act.

In New York, banks can sell credit-related insurance and they can sell annuities, but they cannot sell other forms of insurance. There have been suggestions for change. A commission several years ago recommended the very type of affiliation some would like to create through Glass-Steagall reform, but our elected representative decided it was not in the best approach for New York, and banks and the insurance industry have been thriving in the State.

Not every State has made the same judgment, but their judgment should be respected. States have been regulating the insurance industry throughout this country's history. For most of that history, Congress did not believe it had the constitutional authority to regulate the business. When the Supreme Court held otherwise, Congress quickly enacted the McCarran-Ferguson Act, reaffirming the States' supremacy in this area of Congress. There is no Federal substitute and there is no reason to create one, nor should there be a void. States have developed a complex system of laws designed to protect the consumer.

State licensing laws, for example, require me, as an insurance agent, to be qualified to market the life insurance products that I sell. Unfair trade practice laws govern my relationship with the insurance companies I contract with and the customers that I serve.

Every State has its own set of regulations. There is some degree of uniformity, but each State perceives the needs of its citizens differently. I could not pretend that the interest of insurance consumers in my State are the same as those of the citizens of Hawaii and Congress should not be stepping in to reshape those State-specific judgments.

At a time when Congress is returning more authority to the States, it should not take away authority States have had for over 200 years. Congress must insure that every entity that engages in insurance activities abides by these State laws. H.R. 1317 would do just that.

The major concern, of course, is the Comptroller of the Currency. This unelected Federal regulator has decided that national banks need expanded opportunities for fee income and so he has granted them expanded nonbanking powers. Insurance agency powers are the favored approach, and we have seen it especially in the life insurance area where the Comptroller has decided that annuities are not really insurance and that national banks can underwrite the CD annuity.

More disturbing at the same time, the OCC advises national banks that they need to abide by State insurance laws. A State cannot force them to be licensed to sell insurance. The banks need not abide by other laws that they do not like. This creates a totally unacceptable situation for the customer who must deal with this entity that has taken itself outside the regulatory system. It is also unfair to everyone else that must abide by the State rules.

If banks want to enter into this nonbanking business, they must play the same rules applicable to everyone else, and those are State-mandated rules. Now is the time to act and we urge you to clarify States' rights in this area and add H.R. 1317 to your Glass-Steagall reform package. We will fully support such a bill.

Mr. OXLEY. Thank you, Mr. Browne, and recognize the gentleman from Massachusetts.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Mr. Browne, let me ask you this question. The Bliley-Dingell legislation which is pending before this committee, in my opinion, is consistent with the prevailing view in Washington these days that the States are better positioned to identify and serve the needs of their citizens rather than the Federal Government.

In many areas of commerce that otherwise appear national in character, that has long been the operating philosophy. Why should we move away from this traditional and well-tested approach to insurance regulation, especially when that would seem to be inconsistent with the prevailing mood at the time?

Mr. BROWNE. Move away from States' rights?

Mr. MARKEY. Yes. Why would we want to move away from States'——

Mr. BROWNE. We wouldn't want to move away from States' rights. I mean, the purpose of our testimony here today is to give the regulatory authority to the States where they belong, where they now currently regulate the insurance laws.

Mr. MARKEY. It was a friendly question.

Mr. BROWNE. I am sure it was.

Mr. MARKEY. It was meant to be a watermelon.

Mr. BROWNE. I thank you, sir, for that.

Mr. MARKEY. Mr. Klagholz, we have been given a memo written by the American Bankers Association and submitted to all Members of the House of Representatives. In it, the ABA strenuously objects to the provision in the Bliley-Dingell bill that permits the States to define insurance contending that this unwisely fragments what is logically national in character.

Let me ask you, today, the United States is the largest and the most vibrant economy in the world with the deepest and the most liquid capital markets and with diverse financial services available to all citizens. All of this has been achieved even though the States, not the Federal Government, have been the principal regulators of insurance.

So what is so awful about H.R. 1317 restating what has been true implicitly for most of the Nation's history and has been true explicitly since the McCarran-Ferguson Act was passed in 1945?

Mr. KLAGHOLZ. Congressman, we enthusiastically support H.R. 1317 and are enthusiastically anticipating moving forward in that direction. As to——

Mr. MARKEY. Now the panel is getting into the spirit of my questions.

Mr. KLAGHOLZ. Thank you, Congressman. As to insurance regulation and a definition of insurance, as I mentioned in my testimony, insurance regulators at the State level have been regulating insurance for over 200 years and there has not been one example of an insurance regulator encroaching on banking products and defining them to be insurance.

The examples, however, in the other direction by the Office of the Comptroller of the Currency defining insurance products to be banking products, there is evidence in that regard.

Mr. MARKEY. That gives rise to my final question which, Mr. Grace, I would like you to answer if you would. Many Americans believe that privacy is violated when they receive something as relatively innocuous as junk mail and phone solicitations. I wonder what their reaction would be to efforts by banks to use information that they obtain from individuals in connection with obtaining a mortgage or other type of loan in order to sell them other products.

For example, is it fair or even responsible for a bank to know exactly the type and quantity of a borrower's assets or other investments and then use that information to attempt to sell the borrower competing products that other companies might also want to sell them?

And similarly, what if the bank knows that a large deposit has been made into an insured savings or checking account and then specifically targets that depositor in an effort to persuade him to buy an uninsured investment or insurance product which of course would provide a tidy fee to the bank if that deal was consummated?

Mr. GRACE. I can promise you that a lot of bankers would be staying in real close touch with their attorneys; I would feel relatively sure, and I can also promise you that each one of you members would be getting an awful lot of phone calls from your constituents at home, because I find it hard to believe that the American public would sit back, and when they are so particular about everything else that happens, they would sit back and allow someone to research their credit history and to cross-tie it in any fashion. I think it would raise big problems and I think you would hear an outcry from the public.

Mr. MARKEY. Okay. I thank you, Mr. Chairman. That is all I have at this time.

Mr. OXLEY. The gentleman from Washington State, Mr. White.

Mr. WHITE. Thank you, Mr. Chairman.

I just have a few questions and I am not sure I would characterize these as watermelons, but they are kind of the same questions that the gentleman from Massachusetts was asking but I am asking in a somewhat different way, and perhaps, Mr. Browne, we could start with you. I would like to hear what everybody on the panel would like to say about it.

The fact is, I think, if we did have one nationwide standard instead of 50 State standards, there would be some streamlining of the system there, and of course we do have a commerce clause in the Constitution that allows us to adopt a nationwide standard when we think it would improve the prospects for interstate commerce, and I would think that even for many of the people involved

in the insurance agencies, it would be easy to administer an insurance business if you had one standard rather than 50 that you had to deal with.

What kind of advantages do we get from a 50-state situation that outweigh the advantages of streamlining it and having one nationwide standard?

Mr. BROWNE. The States' regulation of insurance is somewhat, while not altogether—there is uniformity in the States' rights in terms of regulation—most of them regulate insurance basically the same way, the licensing provisions, the continuing education provisions. I don't know how you would handle that on a Federal level. It would be an enormous undertaking, and I am not sure that it would—I am sure it would not work, but there are too many things in the regulation of insurance that would argue against that. As I said, education, the licensing in itself is a major undertaking.

Mr. WHITE. You know, when I get—when I renew my insurance policy or as things happen throughout the course of the year on insurance, I get these little riders from my insurance companies and they all say "State of Washington" at the top and they kind of add the particular language that is necessary in my State.

Don't you think it would be an advantage if we didn't have to do that for 50 States, or am I missing there are some local concerns that are so important that they ought to be dealt with at the State level?

Mr. BROWNE. Yes, that is an important point, but I think the NAIC, National Association of Insurance Commissioners, is working towards some uniformity in that respect, and we may ultimately see that come into more play.

Mr. WHITE. Okay. So you think the industry itself may be able to come up with a more standardized, streamlined approach so you don't have to have national legislation to do it; is that what you are saying?

Mr. BROWNE. Correct, yes, sir.

Mr. WHITE. Any other members of the panel have comments on this?

Mr. CASSIDY. Congressman, the benefits that you get is, and I don't know if anyone in this room has ever experienced a situation where they had a problem with their insurance. They go to their State insurance commissioner or regulator which is located much closer. If they have problems in that area, they go to their State representative and that is where the problems can be taken care of.

They don't have to come to Washington to deal with an auto insurance question, a home owner's question. These issues have to do with their everyday life and I think it is important.

Mr. WHITE. Mr. Cassidy, you are not suggesting we couldn't take care of those auto questions here in Congress? We don't want to. I understand exactly.

Mr. CASSIDY. You don't want to, and as to the States' ability to—you get a rider specific to Washington, Colorado has terrible hail problems. If Colorado feels that they ought to address that in a certain fashion, then that is what Colorado should do. We don't have those problems in Maryland. Florida doesn't necessarily have those problems, but they have problems with wind. All of these issues are

specific to the problems in a given State having to do with obtaining insurance in that State.

Mr. WHITE. Appreciate that.

Mr. KLAGHOLZ. Congressman, may I make a remark in response to your question?

Mr. WHITE. Certainly.

Mr. KLAGHOLZ. I mentioned in my oral testimony that my office is in Seaside Park, New Jersey. My office is literally one block from the Atlantic Ocean, and the clients of my town in the county that I serve are dramatically different than the problems the insurance consumers face in the State of Washington or the State of Ohio, so that the problems in the insurance industry from a consumer's standpoint are very local in nature, and notwithstanding that, there is a great similarity in the definition of insurance among the 50 regulators. There are a commonality of policy forms for the various types of insurance policies.

On a different level, and in response to your question, the current mode and mood of this Congress is returning power to the most local level possible. Among the 50 insurance departments that involve literally thousands and thousands of employees, I don't think anyone in the current Congress would consider it wise to move that up to Washington.

Mr. WHITE. I appreciate your thoughts. You know, my home in Seattle is less than a mile from Puget Sound, so we share some similarities there. It is also on an earthquake fault, so I would have to agree with you there are different differences.

Mr. Grace.

Mr. GRACE. We have similar problems with hurricanes in Louisiana as you are all aware, but my colleagues have said it very well. The biggest problem that we have in Louisiana is we have a lot of oil and gas business that requires a special and specialized approach, and there are many other areas like that from State to State that can best be served by handling it on a State basis.

Mr. OXLEY. The gentleman's time has expired.

The gentleman from Pennsylvania.

Mr. KLINK. I thank the Chairman.

For the panelists, I want to start off here. I have a copy of an OCC interpretative letter that discusses State law, and in this case it is the State of Connecticut, and I want to read a portion of it and I would ask each of the four panelists to comment about this and tell me if this is the type of OCC action that you are concerned about.

It says that, "even if Connecticut law is amended to permit financial institutions to obtain licenses, licensing restriction of the statute would still be preempted by Federal law as it is related to national banks. Such licensing restrictions represents the State's attempt to license an activity which national banks are authorized to conduct without a license.

"The OCC has opined that the power to license is the power to prohibit, and that a State may not impose a licensing requirement on a national bank engaged in the sale of annuities. Thus, any attempt to require a national bank to obtain a license from the State would be preempted."

Mr. Klagholz, could I start with you?

Mr. KLAGHOLZ. Yes, Congressman.

I agree with you completely, and this is a very vivid example of the Comptroller of the Currency setting his own agenda. Virtually every player in every State must be licensed. There is a substantial investment involved in that. Many of the States, in conjunction with their licensing laws, have continuing education requirements and it is a continuing expense and investment on the part of a business owner to see that everyone in the agency is professionally competent, and that is the reason for State licensing. And as I said, every player at this moment must be licensed, but the Comptroller of the Currency has a history of carving out special niches for the banking industry.

Mr. KLINK. Mr. Cassidy.

Mr. CASSIDY. Congressman, the question in my mind, is the Comptroller more concerned about the bank's ability to not—or banks not being discriminated against and their ability to further their cause, or is it as insurance laws, licensing laws are constructed, the protection of the consumer?

As Jim pointed out, the issues of licensing have to do with making sure that the individuals that are selling insurance are competent to do so to the consumer and if—and I have to question, is the Comptroller just not concerned about that? Because if that is the case, then I think clearly we need to address the issue. The consumer is the person that I think we should be concerned about.

Mr. KLINK. Mr. Grace.

Mr. GRACE. Yes, you are absolutely correct. We are concerned because we feel exactly the same way, that the bottom line is that the licensing is the stopgap. That is what keeps people from stepping out of line. If you pull your license, you can't compete, and we feel that is the way it needs to be.

Mr. KLINK. Mr. Browne.

Mr. BROWNE. I consider myself a professional in this business, as I am sure all of my colleagues do up here, and why should I have to be licensed to sell products in the State of New York and Citibank not? I mean, that is the crux of the question.

What I have to do to keep my educational level up, to be constantly aware of what is going on in our industry and a bank would be prohibited from doing simply because they are not governed by the licensing laws of the State is just—it is indescribable to me. Why should I have to be licensed if they shouldn't? If you don't have that regulatory body protecting the consumer through the licensing laws, that is what we are here talking about.

Mr. KLINK. Well, Mr. Browne, just a "what if." What if we went the other way on this and said, you are right, but why have 50 different laboratories across this country deciding what should be done; let's do all at the Federal level so we have a Federal floor or Federal ceiling?

Mr. BROWNE. Because each State is unique unto itself, as was pointed out earlier by my colleagues. New York, Louisiana, Maryland, Washington all have unique problems unto themselves, and to have a Federal licensing law just does not seem probable to me.

Mr. KLINK. Mr. Grace, in your testimony, I wondered if you could just go back for a second, could you describe in a little greater detail, I hope we have time here, the role of the State insurance regu-

lators in assessing the solvency of insurance companies? And I would appreciate your view, both the strengths and the weaknesses of this, if you could give them to me.

Mr. GRACE. I am not sure I understand your question. In regards to how the commissioners——

Mr. KLINK. Yes.

Mr. GRACE. [continuing] regulate?

Mr. KLINK. Yes.

Mr. GRACE. I am sure each State is different, however, I do know that there is an accreditation program now that the States are trying to get across the country. I know Louisiana recently received their accreditation, which was a great asset for our commissioner. I think they are stepping a long way and I know the commissioner has made a concerted effort to make the regulation, as you said earlier, like on a Federal level, make it, you know, go across the country.

Mr. OXLEY. The gentleman's time has expired.

Mr. KLINK. Thank you. Appreciate it.

Mr. OXLEY. The gentleman, Mr. Deal.

Mr. DEAL. I have no questions, Mr. Chairman.

Mr. FIELDS. The gentleman, Mr. Crapo.

Mr. CRAPO. No questions, Mr. Chairman.

Mr. OXLEY. Bless you.

The gentleman, Mr. Frisa.

Mr. FRISA. Thank you, Mr. Chairman.

Mr. OXLEY. Go for it.

Mr. FRISA. I just wanted to share a thought as part of a question and then ask for your comments. Would it be more in keeping with devolving power to have a Federal standard or to allow each individual State to continue to regulate insurance?

Mr. BROWNE. We are here to further the States' rights, and in our opinion, or all of our opinion, we think that the States should regulate the insurance industry.

Mr. GRACE. I would just add that it has worked for 200 years, and the old adage, if it ain't broke, don't fix it.

Mr. CASSIDY. Once again, I come back to, if you have an insurance issue, I think the proper place to take it up is with the State. I come back to consumer concerns. Insurance, particularly, as you get down to the homeowners, the automobile, that affect people's everyday lives, if they have a concern or a problem in this area, they should be able to deal at the State level, not have to go to Washington in order to straighten out the problems that they may have with obtaining homeowner's insurance or automobile insurance, and I just don't feel that the Federal Government is equipped to handle that at this time.

Mr. KLAGHOLZ. Congressman, I believe, and I think it is the opinion of the current Congress, but I don't want to speak on their behalf, that when government is brought to the closest local level, government serves the population best, and we believe that regulation of insurance at the local level serves the insurance consumer best.

Mr. FRISA. I think essentially in many ways, you do speak for what I believe this Congress stands for in terms of devolving power from the Federal Government to the States and localities, in terms

of eliminating Federal departments and agencies and scaling back this central bureaucratic control. It would seem that this issue might be best handled at the State level instead of going against the flow and direction of this Congress.

I would thank each of you for your comments and, Mr. Chairman, I yield back the balance of my time.

Mr. OXLEY. The gentleman from Florida.

Mr. DEUTSCH. I am tempted to say no questions, but I was going to ask the gentleman if he had the same opinion on the products liability bill in terms of States' rights.

Mr. OXLEY. The gentleman would direct his questions to the panel.

Mr. DEUTSCH. Okay. Yield back the balance, Mr. Chairman.

Mr. OXLEY. The gentleman from Florida, Mr. Stearns.

Mr. STEARNS. Thank you, Mr. Chairman. I am going to follow up with some questions here that staff are interested in and I have perused their list of questions.

The first question, wouldn't the increased competition from allowing banks to provide insurance services ultimately result in lower prices and higher quality for the consumer?

Now, I don't necessarily agree with this, but they felt it was important to allow you to, for the record, shall we say, present your answer, and I guess Michael Grace of the National Association of Professional Insurance Agents might want to answer this.

Mr. GRACE. Yes I appreciate it. I will try to give you a quick answer. Let's say a large bank in your hometown is approached by a major insurance carrier that writes homeowner's and automobile insurance and he says, okay, guys, we want to target everybody in your bank that you have access to that makes more than $75,000 up to $200,000 and we are going to provide homeowner's and automobile at a very low price.

The independent agents sitting out on the street are going to lose business to the bank. They will very possibly lose their contract with that major insurance carrier because they can't provide them the business, and then the average main street type guy making $25,000 a year, blue collar worker that has been a good client for this major carrier, is going to lose his insurance as well because that insurance agent lost his contract with that company, and you are going to have a ground swell of people out there that are not going to be in a better position price wise; they are going to be in a worse position. They are going to have their insurance canceled and they are going to have nowhere to go, and this is a very likely problem.

Mr. STEARNS. Anyone else on the panel that would like——

Mr. KLAGHOLZ. Congressman, I would like to address that. First of all, if there is an assumption that the insurance business is a noncompetitive business, it is an erroneous assumption. As I mentioned in my oral statement, our association represents 300,000 insurance professionals and there are similar representations with the other members of the panel.

So insurance is a very, very competitive business.

There is one example, however, that I would like to give on the other side of the arena and that is in the area of credit life insurance, and that is probably the most expensive product of that type

available in the market, and where there is competition, the benefits to the consumer are significant.

Mr. STEARNS. Let me try and be balanced in this and try and give—allow both sides here, because as you know, we have friends on both sides of this position.

For the past 100 years, savings banks have been permitted to sell life insurance in New York, Massachusetts, and Connecticut. Does that experience indicate some success here or sort of go in opposition to some of your testimony regarding bank insurance sales?

Mr. BROWNE. Allow me to answer that question, Congressman.

Mr. STEARNS. Sure.

Mr. BROWNE. Being from New York, I am fairly familiar with the Savings Bank Life Insurance program. Savings bank life insurance companies were set up in the 1930's, I believe, ostensibly to provide a source of insurance for people that would want to walk into a savings bank to purchase insurance. They are not sold by agents. They are sold basically in the lobbies of the savings banks. It is a legal reserve life insurance company that abides by most of the laws of the State of New York, except that it enjoys some favorable tax treatment and somewhat is subsidized.

The question of whether it is competitive or not is one that we questioned in New York State approximately 8 years ago when we did a study to determine whether the savings bank life insurance were more economical, more competitive than purchasing life insurance from someone such as me.

The study that was concluded was that the marketing expense and the costs involved in that were as much or greater than the commissions that were paid to an agent.

Be that as it may, the savings bank life insurance has prospered and thrived in the State of New York, but it serves a specific market. It is maximum insurance that can be sold today is $100,000. It can be a little bit more if you purchase term insurance and it is limited to that and, as I say, it is marketed through agents—through the banks.

Mr. STEARNS. What I hear you talking, you talking about these conditions, you know, we are trying to come up with a compromise between the two industries. Do you think off of what you just said there are some compromise languages?

The staff has indicated that during these hundred years that the savings banks have been permitted to sell life insurance in New York, Massachusetts, and Connecticut, there has not been a single, single allegation of tying or coercion against these savings banks in these three States. I don't know if that is fact but that is what the staff has. Is that—let me ask you first of all, is that true to your knowledge?

Mr. BROWNE. I don't know that to be true.

Mr. STEARNS. The next question is, do you think off your statement that stipulations about the limit, the type and so forth would be a compromise between the banks and the insurance companies?

Mr. BROWNE. Well, if it were to be similar, you would have to be forming legal reserve life insurance companies that operate similar to the major life insurance companies. I don't think that that is practical in terms of national banks being in that arena.

Mr. OXLEY. The gentleman's time is expired.

Mr. STEARNS. Mr. Chairman, I think the other gentleman would like just to answer that question, too, if I could.

Mr. KLAGHOLZ. Very quickly, Congressman, it is not our intent to interfere with State decisions made by State regulators.

Mr. STEARNS. Thank you, Mr. Chairman.

Mr. OXLEY. Gentlelady from Arkansas.

Mrs. LINCOLN. No questions.

Mr. OXLEY. The gentleman from Oklahoma.

We thank you all for your testimony and this first panel is dismissed. Thank you.

The committee will stand in recess until the second panel is set up and Chairman Fields arrives.

[Brief recess.]

Mr. FIELDS [presiding]. The joint hearing on the Subcommittee on Telecommunications and Finance and the Subcommittee on Commerce, Trade and Hazardous Materials is called back to order.

We have our second panel. Mr. Matthew Fink, President of the Investment Company Institute; Mr. Mark Lackritz, President, Securities Industry Association; Scott Jones, Director, American Bankers Association; and Jeffrey Tassey, the Senior Vice President for the American Financial Services Association.

Mr. Fink, we will start with you and ask you, if you would, if you could confine your remarks to 5 minutes. At the end of 5 minutes, we will ask you to summarize. Your statement will be included in its entirety in the record.

STATEMENTS OF MATTHEW FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE; MARK LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION; R. SCOTT JONES, DIRECTOR, AMERICAN BANKERS ASSOCIATION; AND JEFFREY TASSEY, SENIOR VICE PRESIDENT, AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. FINK. Thank you, Mr. Chairman. In the view of the mutual fund industry, successful restructuring of the financial service industry requires satisfying a number of key elements. We are pleased that the bill as reported by the House Banking Committee addresses many of these elements in a very satisfactory manner.

For example, the bill would remove unnecessary legal barriers to bank activities in the mutual fund business and modernize the securities laws to reflect the entry of banks into the mutual fund business. But the bill is seriously deficient in that it does not adequately address other important issues that will arise from its proposed repeal of Glass-Steagall.

This is because the bill before you takes an approach basically based on banking regulation as opposed to securities regulation. In particular, the restrictions on affiliations in the bill will bar many securities firms from entering the banking business, and second, its granting to the Federal Reserve Board of broad regulatory authority will inevitably lead to securities firms that do enter the banking business being made subject to bank regulation. And let me explain.

Under the separation which we have had in this country under Glass-Steagall, commercial banks on the one hand and securities

firms on the other hand have developed very different laws, regulations and operating cultures. On the one hand, bank regulation is characterized by efforts to reduce risk; for example, by a tradition of not making public disclosures about problems for fear of creating runs on banks; for example, by strict prohibitions against affiliations with nonbanking entities; and finally, by regulation not only of the bank but of its holding company parent as well.

On the other hand, regulation of the securities industry takes a totally different tack. The emphasis is in fact on encouraging risk taking with full disclosure of risk. Securities firms forever have been free to affiliate with any type of entity they want to, and securities regulation, ever since the passage of the 1933 act, has been limited to the securities firm itself and does not extend to the holding company parent.

So you have two models of regulation. I would think that legislation that proposes to repeal Glass-Steagall and allow the uniting of the banking and securities industry would seek to accommodate these two very different approaches, but when you look at H.R. 1062, it doesn't do that. Instead, it simply takes the bank regulatory model and imposes it on the joint bank securities holding companies. I think this would be a gross disservice to the securities industry, and more importantly, to the capital formation process and to the economy as a whole. Let me just give you two examples.

The bill would impose on these new financial service holding companies the same affiliation rules that apply to banks. Thus, one of these companies generally could not have insurance affiliates, real estate affiliates or commercial affiliates. But securities firms have always had these affiliates and there is no apparent problems that have ever been revealed.

We recently conducted a snap survey of the mutual fund industry and we got results from about 60 percent of this Nation's $2.3 trillion mutual fund industry, 40 percent of the respondents have insurance affiliates, 14 percent have real estate affiliates, and 12 percent have nonfinancial affiliates.

If the bill was enacted in the form before you, it would create a vast competitive inequity. On the one hand, every single bank in this country would be free to enter the securities business because they don't have impermissible affiliations, but many securities firms would face a Hobson's choice; either they could break up their longstanding relationships with other lines of business in order to enter banking, or they could retain those existing businesses and stay out of banking but accept a permanent competitive disadvantage versus combined banking securities giants.

I am unaware of any public policy that is served by this result. Our written testimony offers several alternative approaches which attempt to accommodate the differing needs of the banking and securities industry. But the current bill before you ignores the need for any accommodation whatsoever and simply takes the affiliation rules in the banking industry and slaps them on the securities industry, and from the point of view of the mutual fund industry, this is totally unacceptable.

My second example relates to the proposal in the bill to have these new financial service holding companies, these bank securities conglomerates, regulated by an umbrella regulator, the Federal

Reserve Board. With all due respect to the Fed, we are very concerned that over time, this would inevitably mean a steady and dangerous extension of bank safety and soundness principles, securities activities. Such a result would be extremely damaging to our Nation's capital markets, which are the best in the world, which are premised on risk-taking by securities firms.

And let me say, our concerns are not theoretical. Last week, Chairman Greenspan of the Fed—last month, suggested that the Board's proposed role as an umbrella regulator could be to assess and take action to limit the actions of the nonbank affiliates and the holding companies.

And if you look at other countries, they demonstrate far better than I can orally how supervision of securities activities by bank regulators will stifle innovation and creativity, and I would just ask the committee or its staff to speak to the mutual funds and securities industries in Europe to find out how stifling bank regulation is to securities industries.

Mr. FIELDS. Mr. Fink, if we could ask you to summarize, please.

Mr. FINK. Finally, we give other examples and I would simply say again, here our testimony offers alternatives so the Fed will not become the umbrella regulator over the securities industry. I would hope as this moves along, the committee will just keep one thing in mind.

Financial services reform is not simply a matter of bank powers and bank regulation. Reform affects every segment of the financial industry, as well as all consumers of financial services and the economy as a whole. And finally, I would say the fatal flaw in the bill before you, it simply assumes that all of this involves is bank powers and bank regulation and that is not the case.

Thank you, Mr. Chairman.

[The prepared statement of Matthew Fink follows:]

PREPARED STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

I. INTRODUCTION

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry. The Institute's membership includes 5,569 open-end investment companies ("mutual funds"), 470 closed-end investment companies, and 12 sponsors of unit investment trusts. The Institute's mutual fund members have assets of over $2 trillion, accounting for approximately 95 percent of total industry assets, and serve over 38 million individual shareholders. The Institute's members include mutual funds advised by investment counseling firms, broker-dealers, insurance companies, and commercial firms. The Institute's members also include approximately 1200 mutual funds advised by banks, accounting for almost 90 percent of all mutual funds advised by banks. I am pleased to be here today to testify on H.R. 1062, the "Financial Services Competitiveness Act of 1995."

The Institute has been an active participant in the debate over financial services reform over the years. Most recently, the Institute testified on H.R. 1062 before the House Banking and Financial Services Committee.[1] The Institute's testimony endorses what we believe are six imperatives for successful legislative restructuring of financial services, namely—

(A) the need for Congress to establish competitive equality for securities firms wishing to engage in commercial banking;

[1] *See* Hearings concerning H.R. 1062, the "Financial Services Competitiveness Act of 1995" before the House Banking and Financial Services Comm. (March 7, 1995) (Statement of Matthew P. Fink, President, Investment Company Institute).

(B) the need for Congress to rationalize the role of the Federal Reserve Board vis-a vis the securities activities of financial services holding companies;

(C) the need for Congress to remove unnecessary legal barriers to bank mutual fund activities;

(D) the need for Congress to rationalize the respective functions of the various banking and securities regulators, both to eliminate regulatory burdens and duplication and to close gaps in regulation;

(E) the need for Congress to modernize the Investment Company Act to reflect bank entry into the mutual fired business; and

(F) the need for Congress to modernize the federal securities laws by removing certain exemptions for banks.

H.R. 1062 contains essential elements that help attain several of the above goals, including functional regulation, coordination among banking and securities regulators, and modernizing the Investment Company Act. Ultimately, however, the bill does not achieve an acceptable balance: it unfairly impedes the entry of securities firms, including mutual fund companies, into the banking business and grants the Federal Reserve Board unduly broad oversight of those securities firms that are able to do so. We urge this Committee to amend H.R. 1062 so as to address our concerns.

II. IMPERATIVES FOR SUCCESSFUL LEGISLATION

A. Competitive Equality

As reported by the House Banking Committee, H.R. 1062 would require that ownership of an insured bank occur through a financial services holding company and would dictate the types of businesses that would be permitted to affiliate within such a holding company. The bill's very restrictive approach permits the new financial services holding company to own a bank and a securities firm, but extends to that entity many of the other ownership restrictions that currently apply to bank holding companies. Thus, the bill would prohibit a new financial services holding company from owning any "nonfinancial" company and greatly restrict its ability to own an insurance company.[2] The bill incorporates principles of banking regulation by imposing these ownership restrictions on new financial services holding companies but does not recognize, to any significant extent, the different regulatory scheme that governs securities firms, which does not restrict such affiliations.

The consequence of this is that banks will be free to enter the securities business, because they currently are not engaged in any of the businesses deemed impermissible by the bill. By contrast, for securities firms, these restrictions win prove very problematic. Because there never have been legal restrictions on securities firms affiliating with other businesses, many of the nation's securities firms would be required to divest their nonfinancial businesses in order to gain reciprocal access to the banking business and avail themselves of the benefits of allowing banking organizations and securities firms to affiliate. (It is the belief in the existence of these benefits that is the premise of this legislation). While the bill also provides that financial services holding companies may own "financial" businesses, the bill's definition of "financial" is unduly restrictive in that it excludes insurance and does not clearly include real estate, both of which are commonly thought of as being financial. Because many securities firms are extensively engaged in insurance, this activity, too, would have to be divested or scaled back considerably for such firms to exercise the combined securities and banking powers granted by the bill.[3]

Simply put, the bill's treatment of permissible business combinations for financial services holding companies is unfair and inappropriate. Based on an Institute survey[4] of its members, it is dear that the bill would present many of them—unlike their bank competitors—with a Hobson's choice: to break up their current and long-standing lines of business in order to take part in the new opportunities presented—

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[2] The bill generally prohibits a financial services holding company from owning an insurance company but creates a narrow exception for certain securities firms that become financial services holding companies to retain ownership of certain "financial" companies up to 10% of the company's capital and surplus. It appears that the bill provides the Board with the flexibility to determine that insurance is a "financial" activity for this purpose. In addition, the bill does not make clear the extent to which financial services holding companies may own real estate companies. Rather, the bill vests the Board with the authority to make this determination.

[3] Since the bill's treatment of real estate is unclear, a securities firm would have to confirm with the Board whether it has to divest or reduce its interest in any real estate company owned.

[4] The Institute's survey results are based on responses from 129 mutual fund companies, which represent one-third of all mutual fund complexes and approximately 60% of industry assets. The survey results referring to assets do not include assets under management, including those from mutual fund operations. Mutual fund companies with a commercial bank affiliate were not included in the survey.

combined banking and securities firms—*or* to retain existing businesses and accept a permanent competitive disadvantage vis-a vis such new combined firms.

The survey results, set forth in detail in Attachment 1, demonstrate that—

- Approximately 40% of the survey respondents have an insurance company affiliate. A significant majority of these companies have more than half of their assets invested in the insurance business and derive more than half of their revenues from this business. **The bill would require these businesses to be divested or at least substantially scaled back.**
- Approximately 14% of the survey respondents have an affiliate engaged in the real estate business. Significant portions of these companies' assets are invested in the real estate business and significant portions of their revenues are derived from the real estate business. **At a minimum, the bill would require the company to seek the Board's approval to retain this type of business. The bill might also require the company to scale back or divest its interest in this type of company.**
- Approximately 12% of the survey respondents have nonfinancial affiliates. The nonfinancial affiliates of several of these companies account for a substantial amount of the company's assets and revenues. **The bill would require these businesses to be divested.**

The Institute urges the Committee to amend the bill to remedy these inequities.[5] The Institute has several recommendations which we believe will effectuate this purpose. First, in our judgment, the bill should explicitly provide that insurance activities are permissible financial activities for all financial services holding companies.[6] In addition, the Institute recommends that the Committee amend the bill to permit securities firms that become financial services holding companies to retain nonfinancial businesses to a greater degree. At a minimum, securities firms should be able to retain nonfinancial businesses that constitute up to a certain percentage of the overall assets of the company (*e.g.*, up to 10%), although other tests[7] (*e.g.*, revenue) should be available as alternatives. In applying this asset test, investment advisers should be able to count assets under management (including mutual fund assets) as financial assets. Assets under management by an investment adviser should be treated no differently than bank deposits for these purposes.

B. Rationalization of the Role of the Federal Reserve Board

As a practical matter, the approach taken in H.R. 1062 is likely to deter even those securities firms only engaged in permissible financial activities from becoming affiliated with banks. This is because any such securities firm would be forced to become a financial services holding company subject to regulation by the Federal Reserve Board. Since securities firms already are subject to extensive regulation by the SEC, the prospect of duplicative and inconsistent regulation, and the attendant costs and burdens, will act as a strong deterrent to *any* securities firm seeking to acquire a bank.

The bill as recently amended attempts to respond to Institute concerns regarding Bank Holding Company Act requirements that would be applicable to all financial services holding companies under the bill[8] by providing more streamlined Board oversight for companies engaged primarily in nonbanking activities.[9] Nevertheless,

[5] Other policy reasons also support modification of the bill to permit financial services holding companies to engage in a wide range of financial and nonfinancial activities. For example, restricting the entry of securities firms into the banking business could limit an important source of new capital for banks and reduce competition from new entrants that would likely benefit consumers. In addition, such a restriction would deny to securities firms the benefits of economies of scale and scope and increased asset and geographic diversification that would accrue to banks purchasing securities firms. Also, by limiting financial services holding companies to Board-determined financial activities, the bill would restrict their ability to adapt efficiently to changes in the market.

[6] The Institute also recommends that the big explicitly provide that real estate activities are permissible financial activities.

[7] Ideally, the Committee should permit securities firms, including mutual fund companies, with nonfinancial businesses to retain all existing businesses (*i.e.*, not limited to a percentage of the company's assets) while also permitting them to acquire insured banks.

[8] *See* Hearings, *supra* at note 1.

[9] To qualify for streamlined Board oversight, a financial services holding company would have to meet the following conditions: (1) the consolidated total risk-weighted assets of all banks controlled by the financial services holding company constitute less than 10% of the consolidated total risk-weighted assets of the financial services holding company; (2) the consolidated total risk-weighted assets of all banks controlled by the financial services holding company are less than five billion dollars; (3) each bank controlled by the financial services holding company is well-capitalized and well-managed; (4) the financial services holding company provides a written

Continued

H.R. 1062 in its current form does not fully and effectively address the objections raised by the Institute. First, while ostensibly limiting the Board's authority over financial services holding companies and their subsidiaries, the bill still would grant the Board broad flexibility to perform examinations, require reports, and apply capital standards. This degree of regulation by the Board would be, in the case of securities firms that become financial services holding companies, duplicative of the extensive SEC regulation to which such firms are already subject. In addition, while financial services holding companies would not have to provide notice to the Board before engaging in new financial activities previously approved by the Board, these companies still would be required to provide notice to the Board shortly *after* engaging in the new activity and still would be required to give notice and obtain prior approval to engage in new financial activities not previously approved by the Board. These restrictions on entering new lines of business in response to developments in the marketplace could be a significant impediment for securities firms, which never have been subject to these types of restrictions.

Beyond these specific concerns, the Institute believes that this aspect of the bill raises a broader, and more deeply troubling, concern because it does not safeguard the essential elements of the securities business from creeping bank regulation. Through taking on market risks, securities firms have helped to make the U.S. capital markets the deepest, most liquid, and strongest in the world. In 1994 alone, these markets raised $1 trillion in capital for companies to support new industries and create new jobs.[10] This capital was raised directly from the investing public, without the benefit of federal deposit insurance. The securities laws recognize the need for securities firms to have sufficient flexibility to succeed in their business and do not seek to limit risk-taking. Rather, the securities laws seek to ensure that issuers of securities provide full and fair disclosure of all material information, that fraudulent or deceptive practices are prohibited, and that conflicts of interest are minimized. With these protections in place, the market, not the securities regulator, determines which securities are brought to market, and which investments are made by mutual funds and other investors. If a particular securities issuance becomes worthless or a securities firm fails, there is no federal safety net to draw on and so the costs of such a failure are not borne by the U.S. Treasury. The failure even of a major brokerage firm, such as Drexel, Burnham & Lambert, ultimately did not cost the U.S. taxpayer a single penny.

By contrast, bank regulation is predicated on notions of "safety and soundness," a tradition of nondisclosure, and prudential regulation of holding company structures. Banking regulation traditionally has limited risk-taking by banks in order to minimize the ultimate cost to U.S. taxpayers of having to bail out federally insured banks. Moreover, banking regulators have generally discouraged the level of public disclosure required under the securities laws out of concerns over provoking runs on depository institutions. It also has been considered to be necessary to regulate bank holding companies in order to ensure that the safety and soundness of banks is not threatened by the activities of their affiliates. Finally, there is less emphasis on preventing conflicts of interest. For example, banks are permitted to engage in transactions with insiders to a far greater extent than mutual funds. The reason for this likely is that while depositors have the assurance of a federal guarantee, mutual fund shareholders have no such safety net.

The Institute is concerned that if the Federal Reserve Board is made the "super-regulator" of financial services holding companies, it may impose safety and soundness requirements on securities firms and potentially compromise and weaken the U.S. capital markets. Chairman Greenspan, for example, recently suggested such a view of financial services holding company regulation by stating that the core function of an umbrella supervisor is to monitor and assess the risks that the nonbank portions of the financial institution have on the bank subsidiary and generally on the safety net. He also stated that the umbrella supervisor must be able to take actions that reduce the acceptable levels of risk.[11]

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guarantee acceptable to the Federal Deposit Insurance Corporation to maintain each bank as well-capitalized; (5) the financial services holding company files a written notice with the Board electing to be governed by the streamlined procedures; and (6) the lead bank subsidiary and bank subsidiaries controlling at least eighty percent of the total risk-weighted assets of insured banks controlled by the financial services holding companies have achieved a "satisfactory record of meeting community credit needs" or better at its most recent examination.

[10] Hearings concerning the "Financial Services Competitiveness Act of 1995" and Related Issues before the House Comm. on Banking and Financial Services (March 15, 1995) (statement of Arthur Levitt, Chairman, United States Securities and Exchange Commission).

[11] Remarks by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the 31st Annual Conference on Bank Structure and Competition (May 11, 1995).

Indeed, history demonstrates that bank regulators given authority over securities activities *have* imposed requirements that are inconsistent with fundamental tenets of securities regulation. For example, the FDIC adopted a rule in 1984 that limited certain insured nonmember bank subsidiaries to underwriting investment quality securities.[12] The Release accompanying the rule stated that the FDIC's purpose in adopting the rule was to address the risk associated with bank subsidiaries underwriting securities. The Release also stated the FDIC's view that it had the authority to oversee the direct and indirect securities activities of insured nonmember banks and that it had the authority to address on a case-by-case basis practices, acts or conduct it found to constitute unsafe and unsound practices not specifically addressed by the rule. Finally, the Release stated that the FDIC would continue to monitor bank direct and indirect involvement in securities activities take whatever action is appropriate.

The danger also exists that a single umbrella supervisor might be tempted to stifle innovation and preclude new product developments by a securities affiliate on the grounds that they may compromise the competitive standing of banks. For example, Professor John C. Coffee, Jr. observed in a recent article that a single financial services regulator might have barred or restricted the growth of money market funds in the 1970's because of the competition these funds posed to bank accounts. Such an outcome not only would have been anticompetitive, but also a notable disservice to consumers and to the capital marketplace.[13]

In addition to concerns about the inappropriate application of banking regulation to securities firms, the danger of having an umbrella supervisor like the Board overseeing all of the activities of a financial services holding company is that the market may behave that uninsured bank holding company subsidiaries have available to them the subsidy implicit in the federal safety net.[14] Finally, vesting the Board with this potentially duplicative oversight authority appears to be an unwise use of government resources that is contrary to more general efforts to streamline government.[15]

The Institute urges the Committee to revise H.R. 1062 to address these concerns. We request that the Committee consider the approach taken in H.R. 814, the "Depository Institution Affiliation Act". A financial services holding company under H.R. 814 would be permitted to own insured depository institutions, securities firms, insurance companies, real estate companies, or any other financial or nonfinancial company. Each financial services holding company affiliate would be functionally regulated. There would be no umbrella supervisor such as that contemplated in H.R. 1062. For example, the SEC would regulate any financial services holding company securities affiliate.[16] In addition, in testimony before the House Banking and Financial Services Committee, Secretary of the Treasury Robert E. Rubin stated that the Administration supports permitting affiliations among banks, securities firms, and insurance companies. Secretary Rubin also suggested a regulatory framework of functional regulation.

We also urge that the Committee consider replacing the Board oversight contemplated by the current bill with a functional regulation model based on (he Mar-

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[12] Rule 337.4 under the Federal Deposit Insurance Corporation Act [12 C.F.R. 337.4].

[13] Money market funds have grown from 15 funds with almost $2 billion in assets in 1974 to more than 900 funds with more than $600 billion in assets in 1994.

[14] Hearings concerning H.R. 1062 before the House Comm. on Banking and Financial Services (February 28, 1995) (statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System.); Remarks by Alan Greenspan, supra, at note 11.

[15] Another aspect of the bill that concerns the Institute is the requirement that for a financial services holding company engaged primarily in nonbanking activities to be eligible for streamlined Board oversight, eighty percent of the financial services holding company's bank subsidiaries must have achieved a satisfactory record of meeting community credit needs or better during its most recent examination. The Institute believes that it is inappropriate to condition a company's eligibility for streamlined Board oversight on the company's bank subsidiary having such a record. This standard apparently is derived from the Community Reinvestment Act of 1977. There is no rational connection, however, between the purposes of the Community Reinvestment Act and a company primarily engaged in nonbanking activities being eligible for streamlined Board oversight. Finding that a company is eligible for streamlined Board oversight should focus on the limited nature of the financial services holding company's banking activities, the strength of the company's bank subsidiary, and the company's willingness to maintain the bank subsidiary's safety and soundness. The bill already contains such conditions. Financial services holding companies should not be burdened with having to satisfy an additional irrelevant condition to be eligible for streamlined Board oversight.

[16] Unlike H.R. 1062, however, as currently drafted, H.R. 814 would not amend the Investment Company Act to add the important investor protection provisions discussed in this testimony nor would it amend the Investment Advisers Act to require banks that advise mutual funds to register with the SEC. We strongly urge that H.R. 814 be amended to add such provisions.

ket Reform Act of 1990.[17] The Market Reform Act was crafted to balance the SEC's need for information with the need to provide for flexible, non-intrusive regulation of broker-dealer holding companies—including banks and bank holding companies. Under the Market Reform Act, the SEC may examine and require reports only from broker-dealers, and cannot regulate broker-dealer *holding companies* directly. The Act requires broker-dealers to obtain information and make and keep records concerning their policies, procedures, and systems for monitoring and controlling financial and operational risks resulting from the activities of affiliates. The Act also gives the SEC the authority to require broker-dealers to file regular, summary reports regarding any material risks to the broker-dealer from the financial and securities activities of its holding company and other affiliates. These summary reports are designed to provide the SEC with a snapshot overview on a periodic basis of any material risks to the broker-dealer posed by its affiliates.[18] In addition, the SEC may obtain immediate and more detailed information from the broker-dealer about the holding company's activities if the SEC reasonably concludes that it has concerns regarding a broker-dealer's financial or operational condition. The Market Reform Act, thus, is a useful model for the Committee to consider in determining the appropriate regulation of financial services holding companies.

At a minimum, the Committee should consider amending the bill so that a financial services holding company with the limited banking activities permitted by the bill (less than 10% of the company's assets—which should include assets under management) would not be subject to any direct oversight by the Board. There is no need for the Board to retain such extensive authority over a company with such limited banking operations, particularly in light of the bill's requirement that the bank subsidiary have no more than five billion dollars in assets and be well-capitalized and well-managed.[19]

The Institute would be pleased to work with the Committee on the approach taken in H.R. 814, the Market Reform Act approach, or other alternatives that would address the need to establish competitive equality between banks and securities firms as part of the proposed reform of financial services.

C. Expansion Of Bank Mutual Fund Powers

Banks and their affiliates currently are permitted to engage in a wide range of mutual fund-related activities. These activities include: (1) serving as a fund's investment adviser; (2) providing discount and full-service brokerage services with respect to sales of mutual fund shares; (3) providing administrative services to a fund; and (4) serving as a fund's transfer agent and custodian. The Glass-Steagall Act, nonetheless, continues to prohibit banks from underwriting shares of mutual funds.[20] In addition, the Glass-Steagall Act, as interpreted by the Board, bars officers, directors, and employees of any member bank from serving as a director, officer, or employee of a mutual fund.[21]

As part of a bill that would accomplish the broad purposes set forth earlier, the Institute supports the expansion of banks' mutual fund powers. The remaining restrictions on banks' participation in the mutual fund industry are increasingly perceived as "statutory vestiges" that serve no useful purpose in today's financial markets.

In particular, the Institute strongly supports H.R. 1062's amendment to Section 20 of the Glass-Steagall Act that would enable bank affiliates to sponsor, and underwrite and distribute the shares of, mutual funds. The Institute also strongly supports the bill's amendment to Section 32 of the Glass-Steagall Act that would permit an officer, director, or employee of a mutual fund, investment advisory firm, or securities firm to serve simultaneously as an officer, director, or employee of a member bank. The Institute is particularly pleased that the bill has been amended from its initial introduction to expressly remove the current restrictions on interlocking di-

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[17] Pub. L. No. 101-432, 104 Stat. 978.

[18] In 1993, the SEC staff was tracking financial reports from approximately 250 broker-dealers and 700 affiliated entities. SEC 1993 Annual Report.

[19] *See also Principles of Bank Reform: Guidelines for Assessing Pending Legislative Proposals* (May 22, 1995) (Statement of the Shadow Financial Regulatory Committee) (the potential risks associated with nontraditional activities will not undermine the soundness of the banking system so long as banks and their regulators meet prudential rules on adequate capital, prompt corrective action, and least cost resolution.)

[20] Sections 16 and 21 of the Glass-Steagall Act prohibit banks from sponsoring, or underwriting or distributing the shares of, mutual funds. Section 20 of the Act prohibits national banks and state banks that are members of the Federal Reserve System from affiliating with companies engaged in sponsoring, or underwriting or distributing the shares of, mutual funds.

[21] The Board has interpreted Section 32 of the Glass-Steagall Act to prohibit these interlocks.

rectorates between funds and banks and between advisers and banks, as suggested by the Institute.

D. Regulatory Rationalization

1. *Current Regulatory Environment and the Need for Functional Regulation.*—Exemptions for banks under current law, which are discussed more fully below, have prompted the federal banking agencies to establish their own competing regimes for regulation of bank mutual fund activities. The exemptions have created inconsistencies and conflicts in federal regulation. And they have occasioned needless and wasteful duplication of effort among federal regulators. Inevitably, this has placed unique and unnecessary regulatory burdens on banks engaged in the mutual fund business.

H.R. 1062 properly addresses the oversight roles that the SEC and the federal banking regulators should have over bank mutual fund activities by making clear that the federal banking agencies generally should defer to the SEC on matters regarding bank mutual fund activities. The Institute strongly supports this "functional" approach to regulation of bank mutual fund activities. First, it is an efficient and responsible use of taxpayer dollars and government resources. There is no justification for creating and training "mini-SECs" to do the job that Congress created the SEC to do and which the SEC has been doing for over 50 years. Second, functional regulation provides the greatest assurance of the continuing safety and soundness of banks engaged in the mutual fund business. If bank-sold or bank-advised funds are fully subject to regulation under the federal securities laws, there is a greater likelihood that banks will conduct their mutual fund activities subject to appropriate controls and thus avoid potential liabilities or losses. Third, having a single regulator overseeing a bank's securities activities will minimize the regulatory costs on banks and increase the likelihood of banks succeeding in the mutual fund business. Finally, and not least importantly, a single set of regulations uniformly applied will lead to better and more consistent protection for mutual fund investors. Accordingly, the Institute supports the provisions of H.R. 1062 that are intended to clarify the responsibilities of bank and securities regulators, subject to certain modifications noted below.

2. *Information Sharing Among the SEC and the Federal Banking Agencies.*—Section 221 of the bill would require the appropriate federal banking agency to share with the SEC the results of any examination, reports, records, or other information with respect to the investment advisory activities of any bank to the extent necessary for the SEC to carry out its statutory responsibilities. Similarly, the SEC would be required to provide all such information to the appropriate federal banking agency. The Institute supports this provision, which provides a practical response to a situation where more than one regulator has jurisdiction over the same entity, and each regulates a different aspect of that entity's business.

In addition, Section 104(m)(1)(A) of the bill would require the SEC and the federal banking agencies to establish a program for sharing information concerning compliance with the bill. Sections 104(m)(6) and (7) of the bill would require the SEC to notify the federal banking agencies, and the federal banking agencies to notify the SEC, when an enforcement proceeding is initiated against a broker-dealer or adviser that is affiliated with, or a separately identifiable department of, a bank. This part of the bill also requires such notification regarding investment companies affiliated with a bank or advised by a bank or bank affiliate. Section 104(m)(9) of the bill would require the SEC and the federal banking agencies to coordinate, to the extent practicable, enforcement actions where the actions are based on the same or related events. The Institute supports such coordination between the SEC and the federal banking agencies. Hopefully, these provisions of the bill will lead to less burdensome and more comprehensive and consistent oversight of banks engaged in the mutual fund business.

3. *Examination Authority.*—Section 104(m)(10) of the bill explicitly provides that the federal banking agencies do not have the authority to examine mutual funds not affiliated with banks. The Institute supports this provision. Any benefit to be derived from the banking agencies examining mutual funds that are not affiliated with banks would be far outweighed by the additional regulatory burdens and potential conflicts this would occasion.[22] Because the SEC already examines mutual funds,

[22] The Institute understands that the Office of the Comptroller of the Currency ("OCC") has drafted guidelines for its examiners to use in examining virtually all aspects of mutual fund operations when a bank or its affiliate "provides services" to the mutual fund. This appears to encompass mutual funds that are not advised by or otherwise affiliated with a bank.

it would be a grossly inefficient use of government resources for the banking agencies to duplicate its efforts.

Section 104(m)(4) of the bill would require the banking agencies, to the extent practicable, to use SEC examination reports of advisers, mutual funds, and broker-dealers affiliated with banks and to defer to such examinations for ascertaining compliance with the federal securities laws. The Institute previously has expressed its concern over the unique regulatory burdens placed on banks engaged in the mutual fund business and has urged that duplicative regulation by the SEC and the federal banking agencies be avoided.[23] This provision addresses this concern.

4. *Interpretations of the Federal Securities Laws.*—Section 104(m)(5) of the bill would require the federal banking agencies to defer to the SEC regarding all interpretations and enforcement of the federal securities laws relating to investment advisers and mutual funds. The Institute strongly supports this provision, which should promote more efficient and rational oversight by requiring one regulator with the most expertise to interpret the federal securities laws.

5. *Uniform Regulations.*—As stated above, Section 104(m)(10) of the bill explicitly would provide that the federal banking agencies do not have the authority to examine mutual funds not affiliated with banks. The Institute suggests strengthening Section 104(m)(10) and adding a new provision to the bill to further promote functional regulation and alleviate burdens on bank affiliated mutual funds. The amendment we suggest would make clear that the federal banking agencies do not have the authority to adopt regulations or issue interpretations or guidelines regarding any mutual fund that is not affiliated with a bank. The amendment would also provide that the federal banking agencies may adopt regulations or issue guidelines or interpretations regarding mutual funds affiliated with banks only after the banking agencies consult with the SEC. The amendment would require such consultation to include a consideration of existing requirements, coordination of new requirements, minimization of duplicative regulation, the degree of uniformity between the regulation of mutual funds affiliated with banks and other mutual funds, and an analysis of the benefits to be obtained by any unique regulatory burdens placed on mutual funds affiliated with banks.

Such an amendment dearly is in keeping with and would advance the purposes of the bill. It would help to establish a consistent regulatory regime for all mutual funds while still providing regulators the flexibility to respond to concerns that are unique to bank affiliated mutual funds. In addition, it would assist in conserving scarce government resources by helping to avoid duplication of effort by the federal banking agencies and the SEC.

6. *Coordinated Disclosure Requirement.*—Section 104(f)(1)(A)(v) would require a securities affiliate to make certain disclosures regarding the nature of securities sold by it, including disclosure that the securities are subject to "investment risks including possible loss of principal invested". In addition, Section 104 would vest the Board with the unilateral authority to modify or add to the required disclosure. The Institute is concerned that the Board would have the sole authority to regulate disclosure by a securities firm regarding risks associated with investments in securities, a role traditionally and responsibly fulfilled by the SEC. The Institute also is concerned about the particular disclosure that would be required because it is inconsistent with disclosure already required by SEC rule with regard to money market funds.

The Institute recommends that rather than mandating certain disclosures in the statute, the Committee amend the bill to grant the Board rulemaking authority, in consultation with the SEC, to require a bank-affiliated securities firm to disclose to customers that securities purchased from it are not insured and are subject to certain risks. Granting such rulemaking authority will accomplish the bill's purposes of facilitating the elimination of inconsistent and duplicative disclosures, while also providing regulators with the authority to design disclosure requirements that are tailored to the risks presented by particular investment products.

E. Modernization of the Investment Company Act

The Investment Company Act contains provisions that address the risk that an investment adviser will enter into transactions that benefit the adviser or a related party to the detriment of the fund's shareholders. While these provisions apply to any entity that advises a mutual fund (including any bank), they are specifically directed toward conflicts that may arise when a particular type of *securities firm* advises a fund. For example, Section 10(f) of the Act prohibits a mutual fund from pur-

[23] *See* Attachment 2 (letters from the Institute to the federal banking agencies, the SEC, and the National Association of Securities Dealers regarding regulatory burdens on bank affiliated mutual funds).

chasing shares during the existence of an underwriting if its investment adviser, or an affiliated person, is a principal underwriter of the offering. Section 17(a) prohibits an adviser to a mutual fund from selling securities or property to the fund while acting as principal. Section 17(e) is directed at brokers that advise mutual funds and limits the commissions that such brokers may accept in connection with a sale of securities to or for an affiliated fund.

These provisions logically are focused on securities firms, rather than banks because banks and their affiliates were barred from sponsoring or advising funds. Consequently, the Investment Company Act does not currently address parallel conflicts that may arise in situations where a bank or a bank affiliate sponsors or advises a mutual fund.

H.R. 1062 would amend the Investment Company Act by adding these types of investor protection provisions. In general, the Institute supports the bill's provisions, which are especially important given the expanded role of banks in the mutual fund business. These provisions address the core conflicts that can arise between a mutual fund and an affiliated bank, such as when a bank serves as a custodian for an affiliated fund, when a bank loans money to an affiliated fund, or when a bank causes its affiliated fund to purchase newly issued securities issued by a company of which the bank is a major creditor. Mutual fund shareholders should be assured of protection against these conflicts, just as they now enjoy protection from the analogous conflicts that can arise between a mutual fund and an affiliated securities firm. In addition, it should be noted that current *banking* laws do not address these conflicts.[24] The Institute also supports the recent amendments to H.R. 1062 that replace several of the *bill's* prohibitions on certain activities with grants of rulemaking authority to the SEC to regulate such activities.[25] Since banks are now major participants in the mutual fund business, the enactment of new prohibitions could prove to be unnecessarily disruptive.

Two of the amendments to the Investment Company Act included in H.R. 1062 as reported by the House Banking Committee, however, are problematic and should be revised. First, the bill's provision providing the SEC with additional authority to require disclosure that shares of mutual funds are not insured by the FDIC and are not obligations of, or guaranteed by, a bank is too broad because it provides authority regarding *all* mutual funds, rather than being limited to situations where there exists the potential for confusion, *e.g.*, mutual funds advised or sold by banks.[26]

The Institute also is concerned about Section 222 of the big as recently amended. This provision would clarify that the Investment Company Act's exclusion for common trust funds only is available for common trust funds that are used for *bona fide* fiduciary purposes and are not advertised or publicly offered. In addition, these funds could not be charged fees or expenses in contravention of fiduciary principles established under federal or state law. The provision is designed to ensure that the exemption for bank common trust funds under the federal securities laws is limited to those funds that are utilized as accommodations for pre-existing trusts and not as mechanisms to provide investment management to the public through the offer and sale of interests in the funds (in which case they would be the functional equivalent of mutual funds).[27]

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[24] For example, while Sections 23A and 23B of the Federal Reserve Act apply to certain transactions between member banks and their affiliates, including affiliated mutual funds, these are intended to protect the bank, not the mutual fund or its shareholders. Thus, for example, a lending arrangement between a bank and an affiliated fund on terms that are at least as favorable to the bank as it could obtain in an arm's length transaction with another borrower would not raise questions under Sections 23A or 23B, even though it could be contrary to the interests of the fund and its shareholders.

[25] Section 212 (Indebtedness to an Affiliated Person) and Section 213 (Lending to an Affiliated Person).

[26] Section 215 (Additional SEC Disclosure Authority). In addition, Section 215 would grant the SEC the authority to prohibit a mutual from having a name similar to a financial services holding company's *securities* subsidiary, even if the securities subsidiary's name is different from the name of its affiliated bank. As a result, the SEC would have the authority to prohibit funds advised by the Dreyfus Corporation to be named the Dreyfus funds, because of the Dreyfus Corporation's affiliation with Mellon Bank.

[27] When Congress codified the exemption for interests in common trust funds under the Securities Act, it noted that the exemption was "limited to interests or participations in common trust funds maintained by a bank for the collective investment of assets held by it in a bona fide fiduciary capacity and incident to a bank's traditional trust department activities; it would not exempt interests or participations in bank funds maintained as vehicles for direct investment by members of the public." Report of the Senate Committee on Banking and Currency to Accompany S. 2224, 91st Congress, 1st Session (1969) at 27. *See also In the Matter of the Commercial Bank and Marvin C. Abeene*, Administrative Proceeding File No. 30-8567 (December 6,

Continued

The Institute believes that, in order to carry out the purpose of the provision, the limits on fees must be tightened. As currently drafted, Section 222 would allow bank common trust funds to be exempt from the federal securities laws even if trust customers were to pay higher fees for a bank's fiduciary services than if they were not invested in the fund, so long as this was not in violation of federal or state banking laws.[28] To the extent, however, that bank trust customers pay additional fees for having their trust assets invested in a common trust fund, it can no longer be said that the common trust fund is being operated in its historic fashion as an administrative convenience for trust customers. If such were the case, costs to customers ought to be *lower*, or at least no higher, than if the trust accounts were managed on an individual basis. If this is not the case, the common trust fund will not be serving the limited purpose that Congress intended when it exempted common trust funds from regulation under the securities laws. Indeed, the common trust fund would be indistinguishable from a mutual fund and, thus, should be regulated as such. Especially in the context of legislation that would grant banks full entry into the mutual fund business, there is no reason not to close any potential loopholes. Accordingly, this Committee should amend Section 222 to ensure that any fees assessed by common trust funds are consistent with the limited purposes of these funds.

F. Functional Regulation of Investment Advisers and Broker-Dealers

1. *Bank Advisory Activities.*—H.R. 1062 wisely modernizes the federal securities laws by removing the Advisers Act exemption for banks and bank holding companies that advise mutual funds. In addition, the bill would permit a bank to conduct these advisory activities in a separately identifiable department or division of a bank. The Institute believes that banks and bank holding companies that advise mutual funds should be held to the same standards as other investment advisers. The Institute also supports permitting banks to conduct these activities in a separately identifiable department of the bank so long as the separately identifiable department is functionally regulated by the SEC, as H.R. 1062 provides.

2. *Bank Sales Activities.*—Most banks conduct their sales of securities through registered broker-dealers that are subject to regulation by the SEC and self-regulatory organizations that are supervised by the SEC. Banks that directly sell securities, however, are exempt from the definitions of broker and dealer under the Securities Exchange Act of 1934.[29] Consequently, such banks are not required to register with or be regulated by the SEC as brokers or dealers. Likewise, by definition, banks are excluded from membership in self-regulatory organizations such as the National Association of Securities Dealers, Inc. ("NASD").[30] Thus, bank employees engaged in sales activities are not required to complete professional licensing requirements applicable to personnel of other broker-dealers, nor are they required to comply with self-regulatory rules.[31] Similarly, bank employees who assume supervisory duties with respect to other employees involved in sales activities need not pass a qualifying examination. Moreover, because such persons need not obtain a license to sell securities, they are not subject to losing their license if they engage in improper sales practices.

H.R. 1062 recognizes the need to functionally regulate banks' retail brokerage activities. It would repeal the exemption from the definition of broker for banks that publicly solicit brokerage business or receive incentive compensation for providing brokerage, and that do not limit their activities as described in the bill. Similarly,

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1994) (where the Commission sanctioned a bank for operating a fund purporting to be a common trust fund, finding that, among other things, the bank operated the common trust fund as an investment vehicle for customers seeking investment opportunities for their individual retirement accounts).

[28] Under current federal banking regulations, banks are not permitted to charge a separate fee for managing a common trust fund if that would result in individual trusts paying higher total fees than they otherwise would pay. 12 CFR 9.18(b)(12). However, in 1990, the OCC proposed amending Regulation 9 to permit a broader range of fees, including management fees, which could exceed the total fees that would be charged to non-participating trusts of similar size and nature. The OCC did not adopt the proposal. We understand that the OCC considered proposing amendments to Regulation 9 again in 1994 that would permit a bank to charge common trust funds a management fee that could cause individual trusts to pay higher total fees than they otherwise would pay.

[29] Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act.

[30] *See* NASD By-laws, art. I, sections (d), (g).

[31] The four federal banking agencies jointly issued guidelines for banks last year, stating that banks should provide bank employees engaged in sales of securities with training substantively equivalent to that required for personnel of registered broker-dealers. Bank personnel, however, unlike personnel of registered broker-dealers, are not *required* to obtain such training. See Interagency Statement on Retail Sales of Nondeposit Investment Products (February 15, 1994.).

H.R. 1062 would amend the definition of dealer in the Securities Exchange Act to include banks, except those banks that engage in certain dealing activities described in the bill. The Institute supports these provisions of H.R. 1062.

III. CONCLUSION

H.R. 1062 would facilitate banks' full participation in the mutual fund business and would minimize duplicative and inconsistent regulation of bank mutual fund activities by requiring coordination among the SEC and the federal banking agencies. H.R. 1062 also would functionally regulate bank mutual fund activities by establishing a set of investor protection standards for banks that advise or sponsor mutual funds parallel to those applicable to securities firms that advise or sponsor funds and by otherwise modernizing the federal securities laws to reflect bank mutual fund activities. But, H.R. 1062 does not remove unnecessary barriers to securities firms seeking to enter the business of banking and H.R. 1062's reliance on Board oversight of the holding company is unacceptable.

The continued success of bank and nonbank participants in the mutual fund industry depends on the public's sustained confidence in mutual funds as a means to obtain the benefits of professional money management and diversification of investments. The Institute is committed to addressing the issues raised by bank participation in the mutual fund business, especially the need to ensure that such activities are conducted in a manner consistent with the protection of investors and subject to appropriate regulation. At the same time, we will press for securities firms to be permitted equal access to the banking business and not to be encumbered with bank-like regulation.

We thank you for the opportunity to present our views and look forward to working with the Committee as H.R. 1062 moves forward.

Attachment 1

SURVEY OF MUTUAL FUND AFFILIATIONS

The Investment Company Institute surveyed mutual fund complexes in April 1995 to assess the extent to which their other businesses might affect their eligibility to affiliate with commercial banks under bills pending in Congress to repeal the Glass-Steagall Act. One hundred twenty-nine mutual fund complexes, representing three-fifths of assets held by all mutual funds, responded to the survey. The thirty-five member complexes with commercial bank affiliates were not included in the survey.

The survey revealed widespread affiliations in both financial and nonfinancial activities. Eighty-four complexes, or 65 percent of the respondents, had affiliates outside the mutual fund business (table 1). Those with outside affiliates tended to be considerably larger than those without such affiliates: Assets of the former averaged about $15 billion per complex at the end of 1994, while assets of the latter averaged $3 billion per complex.

Fifty-two respondents, or 40 percent of the survey sample, reported having an insurance affiliate. For these organizations, insurance frequently represented the primary activity. For example, gross revenue arising from insurance exceeded 50 percent of gross revenues for the consolidated organization for 36 of the 48 complexes reporting such information (table 2). Thirty-nine of the 50 reporting complexes attributed more than 50 percent of consolidated assets to insurance activities.

Real estate and nonfinancial operations were significant activities for a number of companies. Eighteen complexes reported having a real estate affiliate, while fifteen had a nonfinancial affiliate (table 1). In most instances, revenues and assets associated with either real estate or nonfinancial activities constituted less than 10 percent of consolidated revenues or assets (table 2). Nonetheless, several mutual funds were affiliated with major nonfinancial businesses, which included a railroad company, a utility, a financial newspaper, a natural resources company, a distributor of household products, and a human resources consulting firm. Other nonfinancial lines of business that represented a minor proportion of revenues and assets included a health maintenance organization, an accounting and recordkeeping firm, an executive recruiting firm, a limousine service, a software developer, a travel agency, and a national buying service.

Table 1

MUTUAL FUND AFFILIATIONS AND AVERAGE ASSETS PER COMPLEX

Type of Affiliate	Number	Percent of All Respondents	Average Assets Per Mutual Fund Complex[2] (billions of dollars)
Insurance	52	40	20
Real estate	18	14	33
Nonfinancial	15	12	33
Bank-like[1]	31	24	31
Other financial	67	52	16
At least one of the above	84	65	15
None of the above	45	35	3

Source: ICI survey of nonbank-related members.
[1] Nonbank bank, credit card bank, industrial bank, trust company, or savings institution.
[2] December 31, 1994. Average assets per complex for those mutual funds not responding to the survey were $3.5 billion.

Table 2

PERCENT OF GROSS REVENUES AND ASSETS FROM INSURANCE, REAL ESTATE, AND NONFINANCIAL ACTIVITIES OF PARENT COMPANIES OF MUTUAL FUND COMPLEXES HAVING THESE AFFILIATIONS

	Number of Complexes		
Percent of gross revenue	Insurance[1]	Real Estate[2]	Nonfinancial[3]
0 - 10	10	17	7
11 - 50	2	0	3
51 - 100	36	0	3
Percent of assets			
0 - 10	10	17	8
11 - 50	1	0	2
51 - 100	39	0	4

Source: ICI survey of nonbank-related members.
[1] Four respondents did not report gross revenue; two respondents did not report assets.
[2] One complex did not report gross revenue and assets.
[3] Two complexes did not report gross revenue; one complex did not report assets.

Attachment 2

INVESTMENT COMPANY INSTITUTE

PAUL SCHOTT STEVENS
GENERAL COUNSEL

February 16, 1995

Julie L. Williams
Chief Counsel
Office of the Comptroller of the Currency
250 E Street, N.W.
Washington, D.C. 20219

Re: Examples of Inconsistent or Duplicative Regulation

Dear Ms. Williams:

Enclosed is a memorandum that reviews examples of bank regulatory agency requirements that conflict with or duplicate the regulation of bank mutual fund activities under the federal securities laws. The Institute prepared this memorandum based upon the concerns expressed by the Institute's bank proprietary fund members, its nonbank members who participate in bank mutual fund activities, and others. (The Institute's mutual fund members who are advised by banks have over 89% of the assets of all bank-advised funds.) The Institute intends to supplement the memorandum on a periodic basis as appropriate.

The memorandum cites numerous examples of inconsistent or duplicative regulation of bank sales activities and mutual fund operations. It also outlines various concerns with respect to the manner in which regulation has been developed and applied. As we have pointed out to the OCC previously, regulatory burdens of the sort described in the memorandum impose unnecessary costs, confusion and frustration on banks and other participants in bank mutual fund activities.

The Institute appreciates and supports the recent efforts of the banking and securities regulators to address certain aspects of this problem, such as the recent agreement concerning coordination of NASD and bank examinations. We would strongly encourage the Comptroller to continue to work closely with the other bank regulatory agencies, the SEC, and the NASD to develop uniform and consistent regulatory standards applicable to all securities activities.

Please call me at 202/326-5810 if you or members of your staff would like to discuss this important issues. We do appreciate your interest in and attention to this important matter.

Sincerely,

Paul Schott Stevens
General Counsel

Enc

cc: David P. Apgar
Stephen R. Steinbrink

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Examples of Inconsistent or Duplicative Regulation of Bank Mutual Fund Activities

This Memorandum reviews various examples of bank-regulatory agency requirements that conflict with or duplicate the regulation of bank mutual fund activities under the federal securities laws. It also discusses various problems occasioned by the manner in which the requirements have been developed and applied. The Institute prepared this Memorandum based upon consultations with, and the concerns expressed by, the Institute's bank proprietary fund members,[1] its nonbank members who participate in bank mutual fund activities, and outside counsel to its members.

1. **Sales Activities**

Institute members have expressed concern about various requirements imposed on bank sales activities. Following are two examples, concerning the treatment of fund sales materials and bank supervision of broker-dealers.

a. Inflexible Treatment of NASD-Approved Sales Material

The examination staffs of the banking agencies have been scrutinizing mutual fund advertising and sales literature. Even when sales material has been approved by the NASD and conforms with the bank regulatory agencies' Interagency Statement, bank examiners appear to have imposed technical, highly-detailed requirements, without offering much flexibility in the manner in which compliance is achieved. For example, we understand that examiners have required:

- that the legend concerning the uninsured status of nondeposit products appear on every page, or on the first page of the sales piece, even when space limitations make this requirement impractical. (We understand that examiners have refused to permit the legend to appear on the back cover of a brochure with only a cross-reference on other pages.)[2];

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[1] The Institute's mutual fund members who are advised by banks have over 89% of the assets of all bank-advised funds.

[2] The Institute itself has experienced problems arising from this requirement. The Institute prepares consumer brochures, all of which have been cleared by the NASD as generic sales literature. For an additional fee, the Institute "imprints" its consumer brochures with the name, address, and logo of the person ordering the brochures. To assist banks, the Institute also imprints the brochures with FDIC disclosure language. Some orders were recently cancelled because the banks determined that the disclosure must appear on the front cover of the brochures, which is often impossible due to space limitations. The Institute has offered several alternatives, including wrappers around the brochures and the insertion of cards in the brochure containing the disclosure, but banks have declined due to concerns about the cost and questions about whether any of these alternatives would be deemed acceptable.

- that the legend appear in type that is larger and bolder than the document's predominant type;[3]

- that the legend appear, word for word, as it appears in the Interagency Statement. (This requirement conflicts with other statements of the bank regulatory agencies indicating that they would be flexible in the precise disclosure language that must be used.[4]);

- that funds send all sales material directly to a central bank office, rather than to the registered representatives who need the materials for their sales activities.

Institute members have indicated that these requirements impose substantial costs on participants in bank sales activities. First, in order to comply with the requirements funds may have to redesign their sales material. For example, we understand that some sales brochures must be reformatted to allow sufficient space on the first page for the FDIC legend. The redesign of sales material in this manner can impose substantial costs on fund marketing activities.

Second, these requirements have been imposed apparently without sufficient consideration of the various contexts in which sales will occur. Some of these requirements thus may be inappropriate for nonbank distribution channels. For example, we understand that some broker-dealers outside the bank channel object to sales material that displays the FDIC legend more prominently than other required legends. In these cases, funds must issue two versions of the same sales material, one for the bank channel and one for the nonbank channel. The requirements thus impose significant inefficiencies and needless costs on the development and use of marketing material.

Similarly, bank regulatory agencies have required FDIC disclosure in "direct-marketed" sales activities in which there is little potential for investor confusion. For example, the OCC has required that one prominent direct-marketed fund group give FDIC-related disclosures during each telephone or other "sales presentation," even when the affiliated bank's name is not

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[3] The OCC's recent letter to all national banks states that the legend should appear in type that is larger and bolder than the predominant type in the document. See Letter from Stephen R. Steinbrink, Senior Deputy Comptroller, to the Chief Executive Officer of the National Bank Addressed (September 12, 1994) (attaching Consolidated Document Review Project) ("September Letter"). As discussed in Part 3 below, this requirement represented a change from the OCC's previous statements.

[4] See e.g., Letter from Frank Maguire, Senior Deputy Comptroller, to Michael E. Bleier, General Counsel, Mellon Bank, N.A., at 19 (May 4, 1994) ("The Interagency Statement does not proscribe the use of different language for these disclosures so long as the customer receives a disclosure conveying the same information."); Letter from John W. Stone, Executive Director, FDIC, to Matthew P. Fink, President, Investment Company Institute (January 31, 1994) ("We understand that there may be more than one way to address these concerns. If the disclosures given a customer fully and clearly address the issues of concern to the FDIC, then we would not take exception with their use.")

mentioned and the sales presentation does not occur on bank premises. (This disclosure requirement arises solely because the fund adviser is a bank subsidiary.) The disclosure must be made not only to new customers, but to existing customers who have previously received the disclosure, and we understand that the requirement is creating substantial customer annoyance and dissatisfaction. The OCC also has required FDIC disclosure in those funds' account applications, periodic account statements, confirmations, and mass media advertising, when none of these communications refers to the bank's name and the sale communication does not occur on bank premises.[5]

Ironically, while examiners focus intently on mutual fund sales material that is already highly-regulated, they apparently overlook bank product advertising that potentially may contribute to investor confusion. For example, we are aware that some banks have used advertisements that compare their money market accounts to money market funds in a manner that could confuse investors about the uninsured nature of those funds. (A copy of one such advertisement is attached.)[6]

b. Bank Supervision of Broker-Dealers

The federal securities laws impose upon broker-dealers the strict obligation to supervise their associated members -- a responsibility that is enforceable by the SEC and the NASD. Nevertheless, the Interagency Statement obligates a financial institution that has entered into a networking or affiliate relationship to "monitor the [broker-dealer] and periodically review and verify that the [broker-dealer] and its sales representatives are complying with its agreement with the institution."[7]

Institute members have expressed concern that this provision of the Interagency Statement could undermine the effectiveness of the broker-dealer's supervisory procedures. For example, under the Interagency Statement, a bank that is not subject to the supervisory requirements of the federal securities laws and that has little expertise in this area might regard it necessary to second-guess the supervisory procedures of a registered broker-dealer. These

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[5] See Letter from Frank Maguire, Senior Deputy Comptroller to Michael E. Bleier, General Counsel, Mellon Bank, N.A., at 20 (May 4, 1994). In its letter, the OCC did recognize to some degree the different contexts of direct marketed communications and communications on bank premises and permitted certain variances from the literal disclosure requirements of the Interagency Statement in some direct marketing activities. Nevertheless, it is at least arguable that these disclosures should not be required at all in these activities.

[6] The OCC apparently recognizes the confusion that the term "money market account" may cause. OCC Bulletin 94-13 declares, "[I]t may be inappropriate for the First National Bank to offer a mutual fund product named 'FNB Money Market Fund' if First National Bank were also offering an insured deposit product named 'FNB Money Market Account.'" OCC Bulletin 94-13, at 5 (February 24, 1994). According to published reports, SEC research has revealed that "[c]onfusion between money market accounts . . . and money market mutual funds . . . is rampant." "Money Markets' Mutual Misunderstanding," The Washington Post (June 22, 1994).

[7] Interagency Statement at 6.

procedures, however, could be unsuitable for the broker-dealer's structure and operations. Moreover, the procedures imposed by one bank could conflict with those demanded by another bank with whom the member also has a networking arrangement.

The Interagency Statement already requires that any broker-dealer that has entered into a networking agreement or is affiliated with a financial institution commit to the financial institution that the broker-dealer "will comply with all applicable laws and regulations."[6] This presumably includes the requirement to establish effective supervisory procedures. For this reason, it is not apparent that bank supervision of the broker-dealer's activities is necessary.

Moreover, the Interagency Statement does not define the term "monitor," and depending upon its meaning the provision could engender further requirements that duplicate or conflict with current SEC and NASD standards. Article III, Section 27 of the NASD's Rules of Fair Practice requires that broker-dealers adopt a specific list of procedures that are reasonably designed to achieve compliance with the securities laws. For example, a member must designate and qualify supervisory personnel for each type of the broker-dealer's business, conduct internal inspections, and investigate the good character and experience of registration applicants. It is unclear whether, under the Interagency Statement, banks may impose requirements that are inconsistent with or duplicate the specific standards in Section 27. If so, then this provision in the Interagency Statement will lead to further confusion and conflict, to the detriment of those investors whom the supervisory procedures are meant to protect.

Nor would such bank supervision appear to be desirable from a safety and soundness standpoint, in that it could expose banks to potential liability for inadequate supervision. Indeed, prior to issuance of the Interagency Statement, the bank regulatory agencies had ordered banks not to assume responsibility for broker-dealer operations precisely in order minimize the bank's potential liability and in recognition of the fact that broker-dealers were subject to SEC and NASD oversight.[7]

For these reasons, Institute members have recommended that the bank regulatory agencies only require that financial institutions obtain a commitment from broker-dealers that they will maintain the necessary supervisory procedures, as required by the federal securities laws.

2. Mutual Fund Operations

As they have heightened their scrutiny of bank sales activities, bank examiners also have become more inquisitive about the operation of bank-sold and bank-advised mutual funds. For example, we understand that examiners have requested that banks obtain copies of:

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[6] Interagency Statement at 5-6.

[7] See, e.g., OCC Staff Interpretive Letters Nos. 533 (October 5, 1990), 441 (February 17, 1988) and 406-408 (August 5, 1987).

- the minutes of fund board meetings;

- the funds' credit review files maintained under SEC Rule 2a-7;

- a list of funds' derivatives holdings;

- funds' policies on redemption, especially large-scale redemptions, and information on the portfolio's liquidity and its shareholder services; and

- funds' disaster recovery plans.

In requesting these documents, bank examiners appear to be primarily concerned with the ability of funds to meet redemptions and with the composition of fund portfolios.[10] The federal securities laws already address these concerns, and the fact that a fund is advised by or sold through a bank does not warrant additional scrutiny, or the adoption of specialized or more restrictive rules, by the bank regulatory agencies.

In addition, we understand that the bank regulatory agencies have requested that banks and their affiliates adopt detailed compliance procedures, often in reaction to specific concerns that could be better addressed in other ways. The cost of developing and implementing these procedures can be substantial. Moreover, some members are concerned that these detailed compliance procedures could heighten the liability exposure of the bank or its affiliates, for instance as a result of relatively minor failures to comply with the procedures.

3. <u>Bank Regulatory Agency Guidance</u>

In addition to these specific concerns, many of the Institute's members have expressed concerns about the process by which the bank regulatory agencies issue regulatory pronouncements and examine banks and their affiliates.

A. **Vague and Inconsistent Requests.** Institute members have stated that the bank regulatory agencies sometimes impose requirements that are so vague that they cause unnecessary confusion and inefficiency. For example, we understand that the bank regulatory agencies have required that banks obtain certain "due diligence" materials from funds that are sold through the bank. Because the bank regulatory agencies have not clearly articulated what information must be obtained, funds often receive inconsistent requests from various banks and must tailor-make their responses. Similarly, we understand that the bank regulatory agencies have requested that banks obtain a list of derivatives held by the fund, without defining the term "derivative."

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[10] Cf. OCC Bulletin 94-13, at 15 ("bank management will be expected to consider the [fund's] contingency plans for handling unusual surges in redemptions at the time such products are being considered").

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B. **Duplicative Examinations.** Bank members say that they often receive multiple and duplicative examinations of their securities business, within a short period of time, by bank and securities regulators. For example, one member received five examinations in five weeks by the OCC, the FDIC, the Federal Reserve Board, the SEC, and the NASD. We note that the bank regulatory agencies and the NASD recently entered into an agreement concerning coordination of their examinations.[11] The Institute encourages the bank regulatory agencies, the SEC, and the NASD to continue to work closely to prevent duplicative examinations and to develop uniform and consistent standards applicable to all bank securities sales activities.

C. **Changes of Position.** Institute members also have express concern that the bank regulatory agencies significantly alter their requirements without any advance warning. These changes of position can cause considerable confusion among examiners and industry participants and impose unnecessary costs on bank sales activities.

Attachment

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[11] See Agreement in Principle Between the Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Office of Thrift Supervision, and the National Association of Securities Dealers (January 3, 1995).

Amboy National BANK
Choice Banking

3590 U.S. Highway 9
Old Bridge, NJ 08857
Member FDIC

GEORGE E. SCHARPF
President & CEO

NOW ONE ACCOUNT GUARANTEES YOU A SUPERIOR RETURN OVER MAJOR MONEY MARKET ALTERNATIVES

Having been a banker for over 25 years, I've witnessed and have participated in the development of many new financial products and services. Frankly, none should excite you more than our new:

MANAGED MONEY MARKET ACCOUNT

In this one account, we provide you with the ability to maximize your earnings – without sacrificing liquidity or FDIC insurance.

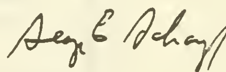
Amboy National designed the MANAGED MONEY MARKET ACCOUNT to be your first real Money Market alternative to non-FDIC-insured Mutual Funds, lower-earning bank Money Market Accounts and even the 3 Month U.S. Treasury Bill. You'll see in the enclosed brochure how your earnings can outperform those investments.

In fact, as the economy changes, you can earn a superior return – *without ever having to move your money!*

We're able to give you these higher earnings in an FDIC-insured account because the MANAGED MONEY MARKET ACCOUNT operates like a mutual fund: all account transactions are performed by mail, wire transfer, and Automated Teller Machine, rather than in person. These operating efficiencies are passed along to you through our guaranteed higher rates.

I've included a convenient application/postage-paid reply envelope so you can open your account right now. The minimum is $35,000. The maximum is $100,000. Please do not hesitate to call **1-800-94-AMBOY** if you have any questions. We're here to serve you.

Sincerely yours,



P.S. As part of the celebration of our bank's 106th anniversary, we are offering a **SPECIAL INTRODUCTORY RATE OF 5.50% (5.64% Annual Percentage Yield)**, guaranteed for 90 days, for all accounts opened prior to October 31, 1994. (See enclosed insert for details.)

0011039

AMBOY
BANCORPORATION
STATEMENT OF
CONDITION

First Six Months
June 30, 1994

Amboy National
"Choice Banking" BANK

AMBOY BANCORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CONDITION

(Unaudited)

(dollars in thousands)

	June 30	
ASSETS	**1994**	1993
Cash and due from banks	$ 30,681	31 003
Federal funds sold	7,500	48 000
Total cash and cash equivalents	38,181	79.003
Securities available for sale	86,530	12.266
Investment securities at cost	83,807	177.596
Loans	658,462	609.580
Less allowance for loan losses	17,431	15.492
Net loans	641,031	594.088
Bank premises furniture and equipment, net	10,984	9 732
Other real estate owned	23,175	26.655
Accrued interest receivable and other assets	14,842	15.971
	$ 898,550	915.311

LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits		
Noninterest bearing demand deposits	$ 80,832	85.599
Interest bearing deposits		
Savings	258,581	251.666
Time	218,231	220.574
Time deposits $100 000 and over	198,181	231.774
Total deposits	755,825	789 613
Securities sold under agreements to repurchase	8,678	8 409
Borrowed funds	32,300	30.000
Accrued interest payable and other liabilities	16,431	10.370
Total liabilities	811,227	838.392
Commitments and contingent liabilities		
Shareholders' equity		
Preferred stock, no par value. Authorized 1,000,000 shares: none issued	—	—
Common stock, par value $6 per share. Authorized 5 000 000 shares: issued and outstanding 1 977 815 in 1994 and 1 967.621 in 1993	11,888	11.806
Surplus	27,886	26.876
Retained earnings	48,237	38.237
Total shareholders' equity	87.112	78 919
	$ 898,550	915.311

AMBOY BANCORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(in thousands except for per share amounts)

	Six Months Ended June 30	
Interest income:	**1994**	1993
Interest and fees on loans	$ 26,577	25 082
Interest on securities available for sale	2,018	—
Interest on investment securities		
Taxable	3,114	6 307
Tax-exempt	728	856
Interest on Federal funds sold	465	955
Total interest income	32,903	33 200
Interest expense:		
Interest on savings and time deposits	7,665	9 176
Interest on time deposits $100 000 and over	3,584	4 472
Interest on securities sold under agreements to repurchase	227	208
Interest on borrowed funds	866	532
Total interest expense	12,302	14 390
Net interest income	20,601	16 810
Provision for loan losses	1,500	2 000
Net interest income after provision for loan losses	19,101	16 810
Noninterest income:		
Service fees on deposit accounts	1,121	1 012
Fees and other income	529	683
Total noninterest income	1,650	1 695
Noninterest expense:		
Salaries and employee benefits	3,887	3 609
Net occupancy expense	730	902
Equipment expense	398	421
Other noninterest expense	3,348	3 449
Total noninterest expense	8,373	8.381
Income before income taxes	11,878	10 124
Income taxes	4,400	4 058
Net income	$ 7,478	6 066
Net income per share of common stock	$ 3.67	3 03
Weighted average shares outstanding	2,036,424	1 999 39.

HIGHER EARNINGS
FDIC-INSURED

GUARANTEED
HIGHER EARNINGS,
LIQUIDITY &
FDIC-INSURED,
ALL IN ONE
ACCOUNT.

Amboy National
BANK
"Choice Banking"

RIGHT NOW,

YOU CAN EARN

AT LEAST

1/4% MORE

THAN THE

AVERAGE YIELD ON

GOVERNMENT

MONEY MARKET

FUNDS AT

MERRILL LYNCH,

FIDELITY AND

DREYFUS...

...YOU CAN EARN

AT LEAST

1/4% MORE

THAN THE

AVERAGE YIELD ON

MONEY MARKET

ACCOUNTS AT

MIDLANTIC,

FIRST FIDELITY

AND

UNITED JERSEY

BANK...

INTRODUCING

NEW JERSEY'S FIRST

REAL ALTERNATIVE TO

...NON-FDIC-INSURED

MONEY MARKET

MUTUAL FUNDS

...LOW-EARNING BANK

MONEY MARKET ACCOUNTS

...AND TREASURY BILLS

THAT TIE UP YOUR MONEY

FOR THREE MONTHS.

AMBOY

NATIONAL

BANK'S

NEW...

GUARANTEED HIGHER EARNINGS

Amboy National Bank's new Managed Money Market Account gives you superior earning power! You earn 1/4% above the highest average yield among these three short-term investment alternatives:

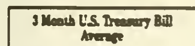
- **Wall Street Money Market Mutual Funds (Government)**
  Earn at least 1/4% more than the index (average yield) of Merrill Lynch. Dreyfus and Fidelity Government Money Market Funds
- **NJ Bank Money Market Accounts**
  Earn at least 1/4% more than the index (average yield) of First Fidelity, Midlantic and United Jersey Bank Money Market Accounts
- **3 Month U.S. Treasury Bill**
  Earn at least 1/4% more than the 3 Month Treasury Bill rate

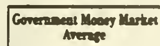
You receive the guaranteed highest rate, automatically! On the 25th of every month, Amboy National Bank will compute and review each of the above alternatives and select the highest yielding index. The bank will then add 1/4% to that yield and pay that interest to your account for the subsequent month. This will insure that you receive the highest rate possible, without having to switch among Money Market Mutual Funds. Bank Money Market Accounts or Treasury Bills. A statement detailing your earnings and account activity will be mailed to you quarterly.

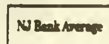
AMBOY'S MANAGED MONEY MARKET ACCOUNT ALWAYS PAYS 1/4% ABOVE THE HIGHEST YIELD OF THE THREE ALTERNATIVES

Look at this Money Market comparison.

4.56% APY *

4.31% APY


3.55% APY


2.44% APY


For current rates and yields, call 1-800-94-AMBOY.

LIQUIDITY

Your funds are always liquid in the Managed Money Market Account. In fact, you can withdraw funds anytime by check (draft) or wire transfer—up to 9 times quarterly. Funds also can be deposited anytime by mail, wire transfer, direct deposit through the Automated Clearing House and at MAC ATMs located in New Jersey, New York and Pennsylvania.

FDIC INSURANCE

Your money in the Managed Money Market Account is secure. It is insured by the Federal Deposit Insurance Corporation (each depositer insured up to $100,000). As the economy changes, you can earn a superior return—without ever having to move your money into an uninsured investment.

YOUR DEPOSITS DESIGNATED TO MAKE THE STATE GROW

Along with Amboy National's commitment to pay you the highest return on your investment, we also pledge to put your money to work right here in New Jersey, building homes, creating jobs and stimulating the overall economy.

OPEN YOUR MANAGED MONEY MARKET ACCOUNT NOW!

Start earning a maximum return on insured savings and be guaranteed continued higher earnings no matter where yields go in the future! Simply complete the Account Opening Form on the enclosed envelope and return it with your check for $35,000 or more (maximum $100,000). **For current rates and yields or any other questions, call 1-800-94-AMBOY.**

*Managed Money Market Account Annual Percentage Yield (APY) shown is based on adding 1/4% to the current 3 Month U.S. Treasury Bill Index (Weekly Auction Average) as of July 25, 1994. On the first calendar day of the month, the bank will adjust the yield to 1/4% above the highest of the three alternatives (Wall Street Government Money Market Mutual Funds, NJ Bank Money Market Accounts, 3 Month U.S. Treasury Bill). Rates and yields may change after account is opened. Account balances that fall below $25,000 will earn 3.25% (3.30% APY). Balances that fall below $10,000 will earn 2.50% (2.53% APY).

...YOU CAN EARN

AT LEAST

1/4% MORE

THAN A

3 MONTH

U.S. TREASURY BILL,

BUT WITH

LIQUIDITY

AND

FDIC INSURANCE

SPECIAL INTRODUCTORY RATE

INTEREST RATE

5.50%

ANNUAL PERCENTAGE YIELD

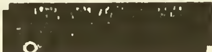
5.64%

Minimum $35,000. Maximum $100,000.

LOOK AT THIS MONEY MARKET COMPARISON

(AS OF 9/19/94)

4.86% APY *



4.61% APY — 3 Month U.S. Treasury Bill Average

3.91% APY — Government Money Market Average

2.50% APY — NJ Bank Average

* The Managed Money Market Account Annual Percentage Yield (APY) in the chart is based on adding 1/4% to the 3 Month U.S. Treasury Bill Index (Weekly Auction Average) as of September 19, 1994.

For current rates and yields, call 1-800-94-AMBOY.

Accounts opened by October 31, 1994 earn a special introductory rate of 5.50% (5.64% APY), guaranteed for 90 days. On the first calendar day of the month, the bank will adjust the yield to 1/4% above the highest of the three indexes described in the enclosed brochure (Wall Street Government Money Market Mutual Funds, NJ Bank Money Market Accounts, 3 Month U.S. Treasury Bill). Rates and yields may change after account is opened. Account balances that fall below $25,000 will earn 3.25% (3.30% APY). Balances that fall below $10,000 will earn 2.50% (2.53% APY).

Complete the information below and enclose [illegible]

[ ] **YES, I WANT TO EARN A GUARANTEED HIGHER YIELD! OPEN AN INSURED MANAGED MONEY MARKET ACCOUNT FOR ME!**

Enclosed is my check for $__________ (Minimum $35,000)
made payable to: **Amboy National Bank**

Taxpayer Identification Number Certification:
Under penalties of perjury, the Accountholder(s) certify that (1) my Social Security Number is correct and (2) that, under provisions of the Internal Revenue Code, the Accountholder(s)

[ ] is (are) not subject to backup withholding
[ ] is (are) subject to backup withholding

(CHECK APPROPRIATE BOX)

Name ______________________

Social Security # ______________ Birth Date ______

Address ______________________

City/State/Zip ______________________

( ) Day Phone ______ ( ) Home Phone ______

Signature ______________ Date ______

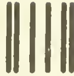
Name (IF JOINT ACCOUNT) ______________________

Social Security # ______________ Birth Date ______

[ ] **YES**, I/we want a MAC card for deposits.

[ ] **NO**, I/we do not want a MAC card for deposits.

Joint Signature ______________ Date ______



BUSINESS REPLY MAIL
FIRST CLASS MAIL PERMIT NO 23 OLD BRIDGE, NJ

POSTAGE WILL BE PAID BY ADDRESSEE

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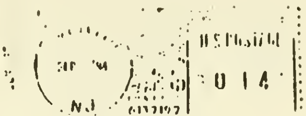
AMBOY NATIONAL BANK
PO BOX 1076
OLD BRIDGE NJ 08857-9976

Amboy National BANK
"Choice Banking"

3590 U S Highway 9
Old Bridge, NJ 08857



EARN MORE THAN YOUR MONEY MARKET ACCOUNT AT

Merrill Lynch...Fidelity...
Dreyfus...Midlantic...
First Fidelity...and
United Jersey Bank...

INVESTMENT COMPANY INSTITUTE

PAUL SCHOTT STEVENS
GENERAL COUNSEL

November 23, 1994

Julie L. Williams, Esq.
Chief Counsel
Office of the Comptroller of the Currency
250 E Street, N.W.
Washington, D.C. 20219

Re: Regulation of Bank Mutual Fund Activities

Dear Ms. Williams:

The Investment Company Institute[1] is writing to express its views on the regulation of mutual funds that are sold or advised by banks or bank affiliates.

As we have previously indicated in testimony before Congress and in correspondence with the Office of the Comptroller of the Currency ("OCC") and other federal banking agencies[2], the Institute believes that it is in the best interest of mutual fund shareholders as well as the investment company industry (including the important segment of the industry involving bank participants) that mutual funds continue to be regulated in a uniform manner and subject to consistent standards. In particular, we believe that the regulatory scheme established under the federal securities laws (most importantly, the Investment Company Act of 1940) has served mutual fund shareholders exceedingly well.

Accordingly, the Institute believes that it is extremely

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 5,248 open-end investment companies ("mutual funds"), 462 closed-end investment companies and 13 sponsors of unit investment trusts. Its mutual fund members have assets of about $2.118 trillion, accounting for approximately 95% of total industry assets, and have over 38 million individual shareholders. Our mutual fund members who are advised by banks have over 89% of the assets of all bank-advised funds.

[2] See Statement of Matthew P. Fink, President, Investment Company Institute, Before the House Subcommittee on Telecommunications and Finance (April 14, 1994); Statement of Matthew P. Fink, President, Investment Company Institute, Before the House Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance (March 8, 1994); Letter to Karen Carter, Disclosure Unit, Office of the Comptroller of the Currency, from Paul Schott Stevens (March 28, 1994); Letter to William P. Bowden, Jr., Chief Counsel, Office of the Comptroller of the Currency, from Paul Schott Stevens (January 17, 1994).

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important that all responsible federal agencies take such steps as are necessary to harmonize and coordinate any requirements they seek to impose on banks involved in the distribution of, or acting as investment adviser to, one or more mutual funds. The implementation of regulatory standards that are duplicative of, or inconsistent with, the federal securities laws will give rise in the mutual fund industry to the same problems that have resulted from the multiplicity of banking agencies.

Problems with Multiple Bank Regulators

The OCC itself has recognized the problems inherent in a system of multiple bank regulators, which currently characterizes the state of banking regulation. As Comptroller Ludwig recently testified:

> While there clearly remain significant differences to be resolved concerning the preferred model for restructuring, there is to my knowledge no disagreement about the basic facts -- our [banking] supervisory structure is too complex, unnecessarily redundant, and too costly.[3]

In addition, Treasury Secretary Bentsen has observed that the current bank regulatory system prevents the individual banking regulators from gaining the "larger perspective [that] is crucial both for effective supervision of the particular [institution] and for an understanding of broader industry conditions and trends."[4] This can lead to situations in which no single agency exercises an appropriate level of oversight[5] and can encourage agencies to seek to expand their authority by, for example, promulgating rules that encourage more institutions to submit to their jurisdiction.[6]

Finally, duplicative and inconsistent regulation often imposes unnecessary costs and burdens on banks. As the

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[3] Statement of Eugene A. Ludwig, Comptroller of the Currency, Before the Senate Committee on Banking, Housing and Urban Affairs 2 (March 2, 1994).

[4] Statement of Lloyd Bentsen, Secretary of the Treasury, Before the Senate Committee on Banking, Housing and Urban Affairs 20 (March 1, 1994).

[5] See, e.g., S. Rep. No. 167, 102d Cong., 1st Sess. 78 (1991) (FDICIA provisions designed to "ensure that information does not fall through the cracks because each regulator believed the other was on top of a situation").

[6] See, e.g., Statement of Lloyd Bentsen, Secretary of the Treasury, Before the Senate Committee on Banking, Housing and Urban Affairs 13 (March 1, 1994).

President-Elect of the American Bankers Association observed, this regulatory duplication "results in a very costly burden on banking organizations in terms of time spent sorting out and complying with the regulatory interpretations of different agencies."[7]

Concerns such as these have prompted the Clinton Administration to propose the consolidation of the four bank agencies, a legislative initiative strongly supported by Comptroller Ludwig and others.

Regulation of Mutual Funds

The Institute is concerned that, absent timely and effective coordination among interested federal agencies, problems similar to those noted above will arise in connection with the regulation of bank-sold and bank-advised mutual funds. Indeed, there already are indications of such problems.

In January, the Institute conveyed to the OCC our comments on the OCC's standard mutual fund disclosure language as it applied to money market funds, noting that the language (and similar language subsequently called for by the Interagency Statement on Retail Sales of Nondeposit Investment Products) was inconsistent with SEC requirements. We appreciated the response we received from former Chief Counsel William Bowden, indicating the OCC's flexibility with respect to the precise language required by the disclosure. Nonetheless, we have been informed by our members that some OCC examiners continue to insist upon the literal Interagency Statement disclosure for money market fund advertisements and prospectus cover pages.

The Interagency Statement also prescribes disclosures for mutual fund confirmation statements with respect to shares of funds sold on bank premises when the confirmation statement contains the name or logo of a bank or bank affiliate. This requirement can lead to serious operational problems for fund transfer agents, which normally are responsible for issuing confirmation statements, resulting in considerable time and expense in system reprogramming.[8] Given the (at best) marginal

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[7] Statement of Howard L. McMillan, Jr., President-Elect, American Bankers Association, Before the Senate Committee on Banking, Housing and Urban Affairs 1 (March 3, 1994).

[8] The Federal Reserve Board takes an approach apparently designed to avoid these administrative burdens, by only requiring the disclosure in certain confirmation statements that "are provided by the bank or an

(continued...

Julie L. Williams, Esq.
November 23, 1994
Page 4

benefits of such post hoc disclosure (which would follow identical disclosures made when the account was opened and in advertising and promotional materials), we question whether these costs are justified.

Of greater potential concern to the Institute are indications that the banking agencies may be preparing to embark on substantive regulation of mutual fund administration and operations. In particular, we understand that the Comptroller intends to implement certain examination procedures, entitled "Mutual Fund Services," that expressly contemplate Comptroller examination (and hence substantive regulation) of virtually all aspects of mutual fund operations when a bank or an affiliate "provides services" to the fund. Among other matters, the guide would require examiners to inspect the fund's "contingency liquidity plans"; its code of ethics; its compliance with registration and shareholder reporting requirements; its calculation of net asset value of fund shares (and money market fund compliance with SEC Rule 2a-7); the fund adviser's fee structures; the fund's custodial and transfer agency arrangements; and the fund's recordkeeping.

As you know, all of the above matters already are comprehensively regulated under the federal securities laws by the SEC. Indeed, the National Association of Securities Dealers, Inc., the self-regulatory organization authorized under the federal securities laws, is considering a proposal to regulate bank sales activities of member broker-dealers.[9] Moreover, we are not aware of anything unique about the operation of bank-sold and bank-advised mutual funds that would necessitate the promulgation of separate or different standards by the banking agencies in these areas. It is clearly foreseeable, however, that such regulation will be a special burden to bank participants in the fund industry, negatively affecting their profitability and success in the business. It also could occasion significant costs and burdens for all funds and their shareholders, compromise the consistent and highly effective framework of regulation to which the industry historically has been subject, and result in less clear standards and oversight responsibilities.

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[8](...continued)
affiliate." Thus, confirmation statements that are provided by fund transfer agents apparently would not have to contain the disclosure. Federal Reserve Board Examination Procedures for Retail Sales of Nondeposit Investment Products (May 31, 1994).

[9] See, e.g., "NASD Ponders Plan Regulating Dealers at Banks," The Wall Street Journal (November 17, 1994).

Julie L. Williams, Esq.
November 23, 1994
Page 5

Recommendations

The Institute urges the OCC to take steps necessary to avoid the types of problems noted above. As a general matter, we would urge that the banking agencies work most closely with the SEC on regulatory concerns that are already addressed by the federal securities laws. As is the case with the issues that would be covered under the draft examination procedures, these concerns normally are not unique to bank-sold or bank-advised funds. Moreover, the bank agencies should seek to avoid indirectly regulating activities that are already subject to securities regulation (e.g., by requiring banks to offer only those mutual funds that satisfy certain standards adopted by the banking agencies).

The Comptroller recently adopted an approach similar to our recommendation in his amendments of the disclosure rules applicable to bank securities.[10] The amendments replaced regulations that had detailed the contents of offering documents, with a requirement that offering documents comply with SEC disclosure standards. As the Comptroller's release adopting the rules states, "[T]he OCC's adoption of the SEC registration requirements, while reducing regulatory burden through the elimination of a duplicate (yet sometimes slightly dissimilar) set of disclosure rules, will maintain the quality of disclosure received by investors."[11]

The Institute recognizes there may be specific regulatory issues that are unique to banks involved in the mutual fund business and that may require action by the banking agencies. In such circumstances, however, we believe it is imperative that any such regulatory initiative be taken only after consultation and coordination with the SEC (and, as appropriate, the NASD). This coordination should serve to avoid unnecessary duplication or conflict. In addition, we strongly recommend that such actions only be taken after notice and opportunity for public comment. In the case of the confirmation statement disclosure requirements, for example, we believe that many of the problems noted above could have been avoided had the mutual fund industry been provided a meaningful opportunity to comment.

Finally, with respect to examinations and inspections, we would urge that the banking agencies and the SEC consult and coordinate with one another in order to avoid unnecessary

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[10] See OCC Securities Offering Disclosure Rules, 59 Federal Register 54789 (November 2, 1994).

[11] Id. at 54790

Julie L. Williams, Esq.
November 23, 1994
Page 6

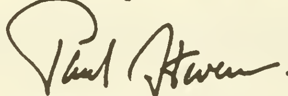
duplication of efforts (and consequent burdens upon the industry). Congress recently adopted a similar approach when it enacted the Community Development Banking Act. Section 305 of the Act requires the federal banking agencies to coordinate their examinations and to establish a system for determining which banking agency will be the lead agency responsible for managing a unified examination of each bank and its affiliates. Congress intended that this system "reduce the regulatory burden experienced by institutions that confront multiple duplicative exams from the four agencies [and] resolve disagreements that arise among the different regulators," reasoning that "[s]uch duplication and disagreement undermine industry confidence in federal regulation."[12]

It would be similarly preferable for the SEC to have primary responsibility for ensuring that the operations of a bank-affiliated mutual fund are being carried out in conformity with the federal securities laws, and to share with the banking agencies any findings that may impact upon the safety and soundness of the affiliated depository institution (or otherwise implicate matters appropriately within the purview of the banking agencies). In other cases (for example, with respect to sales practices of bank employees not subject to registration under the Securities Exchange Act), the banking agencies should have primary responsibility for inspections.

* * *

The Institute would be pleased to discuss these matters with you and your colleagues. As the national association of the investment company industry (and specifically as representative of over 89% of the assets of all bank-advised funds), we would welcome a more active and productive dialogue on investment company issues with the federal banking agencies. We share with you a commitment to effective regulation and investor protection and look forward to working with you to accomplish these goals.

Sincerely,



Paul Schott Stevens
General Counsel

[12] H.R. Rep. No. 652, 103d Cong., 2d Sess. 169 (August 2, 1994).

Julie L. Williams, Esq.
November 23, 1994
Page 7

cc: Ellen Seidman, Special Assistant to the President
for Economic Policy

Douglas Jones, Acting General Counsel
Federal Deposit Insurance Corporation

Carolyn Lieberman, Acting Chief Counsel
Office of Thrift Supervision

Virgil Mattingly, General Counsel
Board of Governors of the Federal Reserve System

Barry Barbash, Director
Division of Investment Management
Securities and Exchange Commission

Brandon Becker, Director
Division of Market Regulation
Securities and Exchange Commission

R. Clark Hooper, Vice President
National Association of Securities Dealers, Inc.

INVESTMENT COMPANY INSTITUTE

MATTHEW P. FINK
PRESIDENT

January 17, 1994

The Honorable Eugene A. Ludwig
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Dear Gene:

Thank you for meeting with us on January 11th. We intend to cooperate with your Office as you continue to address issues related to bank mutual fund activities. As you may know, the Institute has supported the adoption of guidelines by your Office and other federal banking regulators concerning bank sales practices.

We also have strongly encouraged that the guidelines of the various agencies be uniform to the greatest extent possible. In this connection, you should be aware of a current inconsistency between the OCC's standard mutual fund disclosure language as it applies to money market funds and the money market fund disclosure requirements of the Securities and Exchange Commission. This issue is discussed further in the enclosed letter to your Chief Counsel. I would urge that your Office, in consultation with other bank regulators, the SEC, and the NASD, seek to arrive at a single standardized format for disclosure in this area.

We would be pleased to provide any additional information concerning this matter. Letters similar to that enclosed have been directed to the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

Sincerely,

Matt

Attachment

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INVESTMENT COMPANY INSTITUTE

PAUL SCHOTT STEVENS
GENERAL COUNSEL

January 17, 1994

William P. Bowden, Jr., Esquire
Chief Counsel
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Re: Money Market Mutual Fund Disclosure Requirements

Dear Mr. Bowden:

The Investment Company Institute[1] is writing to urge that the Office of the Comptroller of the Currency ("OCC") address a significant problem that has arisen as a result of its July 19, 1993 guidelines concerning bank sales of mutual funds and other nondeposit products.

As you know, the Institute has strongly supported the adoption of uniform guidelines for the bank sale of mutual funds and other nondeposit products. For this reason, in July 1993 the Institute submitted model guidelines to the OCC as well as other federal regulatory agencies. We are pleased that each of the federal banking regulators has issued its own regulatory guidelines in this area.

These guidelines are intended to provide important protections for bank customers and investors. Insofar as there are significant inconsistencies among the guidelines of the different agencies, however, this objective will be more difficult to achieve. The Institute is particularly concerned about the OCC's standard mutual fund disclosure language as it applies to money market funds, because it is inconsistent with current disclosure requirements of the Securities and Exchange Commission.

The Comptroller's guidelines state that when uninsured investment products are sold or marketed to retail customers,

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1 The Investment Company Institute is the national association of the American investment company industry. Its membership includes 4,582 open-end investment companies ("mutual funds"), 433 closed-end investment companies and 13 sponsors of unit investment trusts. Its mutual fund members have assets of about $1.92 trillion, accounting for approximately 95% of total industry assets, and have over 38 million individual shareholders.

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there must be prominent disclosure that the products are not FDIC-insured or obligations of or guaranteed by the bank, and that they "involve investment risks, including the possible loss of principal." This disclosure would have to appear conspicuously in all written or oral sales presentations, advertising, prospectuses, and periodic statements that include information on both deposit and nondeposit products.

By contrast, the SEC requires that all advertisements containing performance information concerning money market funds and prospectuses for those funds disclose that:

> (1) an investment in the fund is neither insured nor guaranteed by the U.S. Government and (2) there can be no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share.[2]

Disclosure in the above form was mandated by the SEC in 1991 and is now standard throughout the industry.

With respect to the risk of loss of principal, this disclosure accomplishes the same purpose as the Comptroller's disclosure but is, in our view, tailored more precisely to the characteristics of money market funds. The SEC's disclosure makes clear that, despite the fund's objective of maintaining a stable net asset value of $1.00 per share, there can be no assurance that this objective will be met.

The SEC also requires prominent, cover-page disclosure on every prospectus for a mutual fund sold by or through a bank (including a money market fund), of the fact that "shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank . . . ."[3] The National Association of Securities Dealers, Inc., requires that advertisements for mutual funds sold through banks (including money market funds) disclose that the fund shares "are not deposits or obligations of, or

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[2] Rule 482(a)(7); Item 1, Form N-1A. The SEC also has proposed to amend Rule 134, to require inclusion of this disclosure in so-called "tombstone advertisements" that generally describe money market funds. <u>See</u> SEC Release No. IC-19959 (December 17, 1993).

[3] <u>See</u> Letter to Registrants from Barbara J. Green, Deputy Director, Division of Investment Management (May 13, 1993).

guaranteed by, the bank . . . ."[4]

In order to avoid inconsistent and duplicative disclosures, the Institute urges the Comptroller to clarify that money market fund advertisements and prospectuses containing the SEC- and NASD-required language will satisfy relevant requirements contained in the OCC's guidelines. Alternatively, should the OCC conclude that disclosure in the form mandated to date by the SEC and the NASD is in some respect deficient, we urge that it consult and coordinate with the SEC and the NASD on some single revised disclosure format acceptable to all three agencies. Either approach would be distinctly preferable to the current situation.

We would be pleased to provide any additional information concerning this matter. We have sent similar letters to the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

Very truly yours,

Paul Schott Stevens
General Counsel

cc: Barry Barbash
Director, Division of Investment Management
Securities and Exchange Commission

R. Clark Hooper
Vice President, Advertising/Investment Companies Regulation
National Association of Securities Dealers, Inc.

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[4] *See* NASD Notice to Members 93-87 (December 1993). The NASD'S disclosure requirement applies to bank-affiliated members and members participating in bank networking arrangements. The NASD's Notice also requires its members to advise their bank affiliates that their unregistered employees should provide similar disclosure.

INVESTMENT COMPANY INSTITUTE

PAUL SCHOTT STEVENS
GENERAL COUNSEL

January 17, 1994

Virgil Mattingly, Esquire
General Counsel
Board of Governors
 of the Federal Reserve System
20th & C Streets, N.W.
Washington, D.C. 20551

Re: Money Market Mutual Fund Disclosure Requirements

Dear Mr. Mattingly:

The Investment Company Institute[1] is writing to urge that the Board of Governors of the Federal Reserve System address a significant problem that has arisen as a result of its June 17, 1993 supervisory letter concerning bank sales of mutual funds.

As you know, the Institute has strongly supported the adoption of uniform guidelines for the bank sale of mutual funds and other investment products. For this reason, in July 1993 the Institute submitted model guidelines to the Federal Reserve Board as well as other federal regulatory agencies. We are pleased that each of the federal banking regulators has issued its own regulatory guidelines in this area.

These guidelines are intended to provide important protections for bank customers and investors. Insofar as there are significant inconsistencies among the guidelines of the different agencies, however, this objective will be more difficult to achieve. The Institute is particularly concerned about the Federal Reserve Board's standard mutual fund disclosure language as it applies to money market funds, because it is inconsistent with current disclosure requirements of the Securities and Exchange Commission.

The Federal Reserve Board's letter states that when an account for the purchase of mutual fund shares is established, customers must be informed that the mutual funds are not deposits or other types of bank or government obligation, and that they

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are:

> subject to risk that may cause the value of the investment to fluctuate, and that when the investment is sold, the value may be higher or lower than the amount originally paid by the customer.

By contrast, the SEC requires that all advertisements containing performance information concerning money market funds and prospectuses for those funds disclose that:

> (1) an investment in the fund is neither insured nor guaranteed by the U.S. Government and (2) there can be no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share.[2]

Disclosure in the above form was mandated by the SEC in 1991 and is now standard throughout the industry.

With respect to the risk of loss of principal, this disclosure accomplishes the same purpose as the Federal Reserve Board's disclosure but is, in our view, tailored more precisely to the characteristics of money market funds. The SEC's disclosure makes clear that, despite the fund's objective of maintaining a stable net asset value of $1.00 per share, there can be no assurance that this objective will be met.

The SEC also requires prominent, cover-page disclosure on every prospectus for a mutual fund sold by or through a bank (including a money market fund), of the fact that "shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank . . . ."[3] The National Association of Securities Dealers, Inc., requires that advertisements for mutual funds sold through banks (including money market funds) disclose that the fund shares "are not deposits or obligations of, or

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[2] Rule 482(a)(7); Item 1, Form N-1A. The SEC also has proposed to amend Rule 134, to require inclusion of this disclosure in so-called "tombstone advertisements" that generally describe money market funds. See SEC Release No. IC-19959 (December 17, 1993).

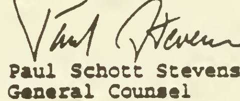
[3] See Letter to Registrants from Barbara J. Green, Deputy Director, Division of Investment Management (May 13, 1993).

guaranteed by, the bank . . . ."[4]

In order to avoid inconsistent and duplicative disclosures, the Institute urges the Federal Reserve Board to clarify that money market fund advertisements and prospectuses containing the SEC- and NASD-required language will satisfy relevant requirements contained in the Federal Reserve Board's guidelines. Alternatively, should the Federal Reserve Board conclude that disclosure in the form mandated to date by the SEC and the NASD is in some respect deficient, we urge that it consult and coordinate with the SEC and the NASD on some single revised disclosure format acceptable to all three agencies. Either approach would be distinctly preferable to the current situation.

We would be pleased to provide any additional information concerning this matter. We have sent similar letters to the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

Very truly yours,



Paul Schott Stevens
General Counsel

cc: Barry Barbash
Director, Division of Investment Management
Securities and Exchange Commission

R. Clark Hooper
Vice President, Advertising/Investment Companies Regulation
National Association of Securities Dealers, Inc.

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[4] See NASD Notice to Members 93-87 (December 1993). The NASD'S disclosure requirement applies to bank-affiliated members and members participating in bank networking arrangements. The NASD's Notice also requires its members to advise their bank affiliates that their unregistered employees should provide similar disclosure.

INVESTMENT COMPANY INSTITUTE

PAUL SCHOTT STEVENS
GENERAL COUNSEL

January 17, 1994

Douglas H. Jones, Esquire
Acting General Counsel
Federal Deposit Insurance Corporation
555 17th Street, N.W.
Washington, D.C. 20429

Re: Money Market Mutual Fund Disclosure Requirements

Dear Mr. Jones:

The Investment Company Institute[1] is writing to urge that the Federal Deposit Insurance Corporation ("FDIC") address a significant problem that has arisen as a result of its October 8, 1993 supervisory statement concerning bank sales of mutual funds and annuities.

As you know, the Institute has strongly supported the adoption of uniform guidelines for the bank sale of mutual funds and other investment products. For this reason, in July 1993 the Institute submitted model guidelines to the FDIC as well as other federal regulatory agencies. We are pleased that each of the federal banking regulators has issued its own regulatory guidelines in this area.

These guidelines are intended to provide important protections for bank customers and investors. Insofar as there are significant inconsistencies among the guidelines of the different agencies, however, this objective will be more difficult to achieve. The Institute is particularly concerned about the FDIC's standard mutual fund disclosure language as it applies to money market funds, because it is inconsistent with current disclosure requirements of the Securities and Exchange Commission.

The FDIC's supervisory statement requires disclosure that the products are not bank deposits, are not FDIC-insured, and are not guaranteed by or obligations of the bank. The statement also requires disclosure of the "investment risks . . . including the

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Douglas H. Jones, Esquire
January 17, 1994
Page 2

potential for fluctuations in investment return and the possibility of loss of some or all of the principal investment." This disclosure would have to appear in all written and oral language sales presentations and advertising.

By contrast, the SEC requires that all advertisements containing performance information concerning money market funds and prospectuses for those funds disclose that:

> (1) an investment in the fund is neither insured nor guaranteed by the U.S. Government and (2) there can be no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share.[2]

Disclosure in the above form was mandated by the SEC in 1991 and is now standard throughout the industry.

With respect to the risk of loss of principal, this disclosure accomplishes the same purpose as the FDIC's disclosure but is, in our view, tailored more precisely to the characteristics of money market funds. The SEC's disclosure makes clear that, despite the fund's objective of maintaining a stable net asset value of $1.00 per share, there can be no assurance that this objective will be met.

The SEC also requires prominent, cover-page disclosure on every prospectus for a mutual fund sold by or through a bank (including a money market fund), of the fact that "shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank . . . ."[3] The National Association of Securities Dealers, Inc., requires that advertisements for mutual funds sold through banks (including money market funds) disclose that the fund shares "are not deposits or obligations of, or guaranteed by, the bank . . . ."[4]

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[2] Rule 482(a)(7); Item 1, Form N-1A. The SEC also has proposed to amend Rule 134, to require inclusion of this disclosure in so-called "tombstone advertisements" that generally describe money market funds. See SEC Release No. IC-19959 (December 17, 1993).

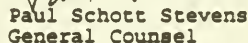
[3] See Letter to Registrants from Barbara J. Green, Deputy Director, Division of Investment Management (May 13, 1993).

[4] See NASD Notice to Members 93-87 (December 1993). The NASD'S disclosure requirement applies to bank-
(continued...)

In order to avoid inconsistent and duplicative disclosures, the Institute urges the FDIC to clarify that money market fund advertisements and prospectuses containing the SEC- and NASD-required language will satisfy relevant requirements contained in the FDIC's guidelines. Alternatively, should the FDIC conclude that disclosure in the form mandated to date by the SEC and the NASD is in some respect deficient, we urge that it consult and coordinate with the SEC and the NASD on some single revised disclosure format acceptable to all three agencies. Either approach would be distinctly preferable to the current situation.

We would be pleased to provide any additional information concerning this matter. We have sent similar letters to the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Very truly yours,



Paul Schott Stevens
General Counsel

cc: Barry Barbash
Director, Division of Investment Management
Securities and Exchange Commission

R. Clark Hooper
Vice President, Advertising/Investment Companies Regulation
National Association of Securities Dealers, Inc.

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[4] (...continued)
affiliated members and members participating in bank networking arrangements. The NASD's Notice also requires its members to advise their bank affiliates that their unregistered employees should provide similar disclosure.

INVESTMENT COMPANY INSTITUTE

PAUL SCHOTT STEVENS
GENERAL COUNSEL

January 17, 1994

Carolyn Lieberman, Esquire
Acting Chief Counsel
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

Re: Money Market Mutual Fund Disclosure Requirements

Dear Ms. Lieberman:

The Investment Company Institute[1] is writing to urge that the Office of Thrift Supervision address a significant problem that has arisen as a result of its September 8, 1993 Thrift Bulletin 23-1 concerning bank sales of mutual funds and other securities.

As you know, the Institute has strongly supported the adoption of uniform guidelines for the bank sale of mutual funds and other investment products. For this reason, in July 1993 the Institute submitted model guidelines to the OTS as well as other federal regulatory agencies. We are pleased that each of the federal banking regulators has issued its own regulatory guidelines in this area.

These guidelines are intended to provide important protections for bank customers and investors. Insofar as there are significant inconsistencies among the guidelines of the different agencies, however, this objective will be more difficult to achieve. The Institute is particularly concerned about the OTS's standard mutual fund disclosure language as it applies to money market funds, because it is inconsistent with current disclosure requirements of the Securities and Exchange Commission.

The OTS's bulletin requires disclosure that (1) the mutual fund shares are not FDIC insured, (2) the return is not guaranteed, (3) the "value of the investment may fluctuate," and (4) a "[l]oss of the principal investment is possible." This disclosure would have to be given by sales representatives and

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should be provided in writing when mutual fund shares are sold.

By contrast, the SEC requires that all advertisements containing performance information concerning money market funds and prospectuses for those funds disclose that:

> (1) an investment in the fund is neither insured nor guaranteed by the U.S. Government and (2) there can be no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share.[2]

Disclosure in the above form was mandated by the SEC in 1991 and is now standard throughout the industry.

With respect to the risk of loss of principal, this disclosure accomplishes the same purpose as the OTS's disclosure but is, in our view, tailored more precisely to the characteristics of money market funds. The SEC's disclosure makes clear that, despite the fund's objective of maintaining a stable net asset value of $1.00 per share, there can be no assurance that this objective will be met.

The SEC also requires prominent, cover-page disclosure on every prospectus for a mutual fund sold by or through a bank (including a money market fund), of the fact that "shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank . . . ."[3] The National Association of Securities Dealers, Inc., requires that advertisements for mutual funds sold through banks (including money market funds) disclose that the fund shares "are not deposits or obligations of, or guaranteed by, the bank . . . ."[4]

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[2] Rule 482(a)(7); Item 1, Form N-1A. The SEC also has proposed to amend Rule 134, to require inclusion of this disclosure in so-called "tombstone advertisements" that generally describe money market funds. <u>See</u> SEC Release No. IC-19959 (December 17, 1993).

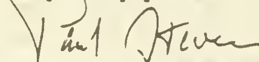
[3] <u>See</u> Letter to Registrants from Barbara J. Green, Deputy Director, Division of Investment Management (May 13, 1993).

[4] <u>See</u> NASD Notice to Members 93-87 (December 1993). The NASD'S disclosure requirement applies to bank-affiliated members and members participating in bank networking arrangements. The NASD's Notice also requires its members to advise their bank affiliates (continued...)

In order to avoid inconsistent and duplicative disclosures, the Institute urges the OTS to clarify that money market fund advertisements and prospectuses containing the SEC- and NASD-required language will satisfy relevant requirements contained in the OTS's guidelines. Alternatively, should the OTS conclude that disclosure in the form mandated to date by the SEC and the NASD is in some respect deficient, we urge that it consult and coordinate with the SEC and the NASD on some single revised disclosure format acceptable to all three agencies. Either approach would be distinctly preferable to the current situation.

We would be pleased to provide any additional information concerning this matter. We have sent similar letters to the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

Very truly yours,



Paul Schott Stevens
General Counsel

cc: Barry Barbash
Director, Division of Investment Management
Securities and Exchange Commission

R. Clark Hooper
Vice President, Advertising/Investment Companies Regulation
National Association of Securities Dealers, Inc.

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[4](...continued)
that their unregistered employees should provide similar disclosure.

Mr. FIELDS. Mr. Lackritz with the Securities Industry Association, and of course I have butchered your name every time I have tried to pronounce it and I apologize for that.

STATEMENT OF MARK LACKRITZ

Mr. LACKRITZ. Thank you very much, Mr. Chairman, members of the subcommittee. Mr. Chairman, thank you very much for the invitation to be here to testify on this bill. My name is Mark Lackritz, and I am president of the Securities Industry Association, and I want to outline if I could to the subcommittee some of the concerns that we have with the bill that is before you now.

This bill—we have supported, and the securities industry actually needs and wants, modernization and comprehensive financial restructuring legislation. It needs it and wants it because, over the years, the banking regulators have slowly deregulated, by fiat, regulatory fiat, the banking industry and permitted its extension into the securities industry without any of the comparable protections that investors have or that the markets have from SEC style regulation, and one of our biggest concerns about this bill as it is structured now is the way that functional regulation is not provided adequately in this bill.

Let me just say, there are four concerns that we have. One is in the area of functional regulation. The second concern is that there is not an adequate full, two-way street in this bill. The third is—our concern with the role of the Fed; and fourth is that we need to promote more competition by permitting affiliation of wholesale uninsured institutions and retail depository institutions. Let me just touch briefly on each of those four areas if I could.

With respect to functional regulation, Mr. Chairman, full functional regulation should be a central element of any comprehensive financial restructuring legislation. The act, as it is structured, falls far short. It contains a series of loopholes that allow banks to engage directly in a number of securities activities without even registering with the SEC as a broker-dealer. It also gives banks the option of placing these activities in a separately identifiable department or a SID, which would register as a broker-dealer but would be exempt from SEC net capital standards.

In effect, these loopholes greatly diminish the SEC's ability to regulate securities activities. We believe that all securities activities should be conducted in a separately capitalized securities affiliate subject to SEC regulation and net capital requirements.

The SEC's statutory framework, expertise and examination and enforcement procedures are best designed to oversee securities activities, capital markets and to protect investors. At a minimum, the act should not allow banks to engage in any new securities activities inside the bank and the bill should clearly be amended to delete the provision that makes municipal revenue bonds bank-eligible activities.

The act should also be amended to provide that once a financial services holding company establishes a section 10 affiliate, all securities activities should be conducted in that affiliate.

With respect to the two-way street, we are concerned that this bill does not achieve a full two-way street because it limits the abilities of securities firms to affiliate with banks as has been de-

scribed more fully by my colleague, Mr. Fink, in his statement. The only requirement for banks to affiliate with a securities firm is that they be well capitalized and well managed.

However, securities firms that would affiliate with banks would be subject to a number of restrictions that focus on their insurance and nonfinancial activities and have little to do with their financial condition. We firmly believe that any securities firms should be allowed to affiliate with banks or wholesale financial institutions without requiring substantial changes to its operations.

A far more competitive and fair approach in this bill would be to remove any arbitrary and capricious business restrictions and divestiture requirements which are in there now.

Third, the role of the Federal Reserve Board. Under the act, the financial services holding companies and their affiliates will be regulated under a system essentially designed for bank holding companies and emphasize the safety and soundness and minimization of risk to insured depository institutions. We believe this regulatory structure is inappropriate for securities firms which typically relied on market discipline to control risks. We think the SEC should have sole regulatory authority over section 10 affiliates, including adhering to special regulatory and disclosure requirements for issues that are unique to the financial services holding company structure.

When a bank affiliate becomes undercapitalized, the board should be required to seek SEC approval, not mere consultation, before imposing restrictions on a section 10 affiliate. The role of the board should be confined to enforcing restrictions on interaffiliate transactions and insuring the holding company has the resources to serve as a source of strength for its bank affiliates.

With respect to affiliation with retail wholesale banks, the act authorizes an investment bank holding company structure under which all depository institutions must be uninsured wholesale banks. The act would prohibit a holding company from owning both a wholesale uninsured bank and an insured depository institution. Firms that have both an institutional and a retail customer base should not be put at a competitive disadvantage to other financial services providers, and we believe there is no public policy reason to prevent affiliations between these institutions since such affiliations would not put deposit insurance funds at risk.

In conclusion, we believe it is time to modernize our financial services system and we support these efforts to move the process forward. As the bill stands before you, it is not modernization; it is mere codification of the status quo in the marketplace.

We need a regulatory structure, Mr. Chairman, that won't fade into obsolescence as soon as the ink is dry on the legislation, and we don't want to replace a Rube Goldberg contraption that has evolved over the years now with yet another Rube Goldberg contraption that is going to be outmoded as soon as the bill is passed. So we would urge amendments in the nature we have stated. We would be willing to work with the committee in effecting those amendments.

Thank you very much.

[The prepared statement of Marc E. Lackritz follows:]

Prepared Statement of Marc E. Lackritz, President, Securities Industry Association

INTRODUCTION

I am Marc E. Lackritz, President of the Securities Industry Association ("SIA").[1] I would like to thank Chairman Fields, Chairman Oxley, and the Subcommittees for the opportunity to participate in this hearing on the Financial Services Competitiveness Act of 1995 (H.R. 1062) and the regulatory and competitive implications of restructuring the financial services industry. My testimony will focus on how H.R. 1062 should be amended to: Extend full functional regulation to exempt bank securities activities by moving them to securities affiliates or requiring banks to comply with SEC registration and net capital requirements; Provide for a full "two-way street" by permitting securities firms that engage in significant insurance and nonfinancial activities to affiliate with banks; Reduce regulatory burdens by restricting the Federal Reserve Board's supervisory authority over securities affiliates of financial services holding companies; and Promote competition by allowing affiliations between wholesale and retail depository institutions.

SIA strongly supports Congressional efforts to enact comprehensive financial restructuring legislation to serve consumers and to make it possible for all financial services intermediaries to operate more flexibly and competitively, both domestically and internationally. We believe modernization of the financial services regulatory structure is critical to maintaining the preeminence of our capital markets and to meeting the competitive challenges from abroad. In the era of global markets, it is time for Congress to replace the patchwork of Depression-era laws, regulations, and court decisions with a rational regulatory framework that will benefit everyone—investors, consumers, and providers of financial services.

SIA'S PRINCIPLES FOR COMPREHENSIVE FINANCIAL SERVICES REFORM

Fair competition among all financial services providers is certainly an objective of any financial services legislation, but the overriding concern is whether the proposal truly benefits the public. That is why SIA believes if commercial banking organizations are to be granted expanded authority to compete in the securities business, they must do so without federal subsidies, with safeguards to enhance the safety and soundness of the federal deposit insurance system, and with a balanced appreciation for the competitive integrity of the capital markets. To achieve those objectives, we have consistently advocated that any comprehensive financial services restructuring legislation should, at a minimum, adhere to the following three principles:

1. **Competition Without Federal Subsidies.** Securities activities should be performed in separately capitalized affiliates of banks, and those affiliates should have no access to the deposits or credit power of the federally insured bank.
2. **Two-Way Street.** Banking organizations should have the ability to own full service securities firms. Conversely, full service securities firms should also be able to own banks and bank holding companies.
3. **Functional Regulation.** The same activity should be subject to the same set of rules administered by the same regulatory agency, regardless of the type of financial institution engaging in the activity. Functional regulation is an integral part of any financial restructuring legislative proposal because it protects investors and eliminates unfair competitive advantages.

SIA CONCERNS WITH H.R. 1062

On May 11, the House Banking and Financial Services Committee voted to report comprehensive financial restructuring legislation. The *Financial Services Competitiveness Act of 1995* ("the Act") basically recasts bank holding companies as financial services holding companies ("FSHCs") and allows commercial banks to affiliate with securities firms, subject to various restrictions and firewalls, through the FSHC structure. While the Act represents an important step in moving the debate forward, SIA believes the Act is flawed in several important areas:

[1] The Securities Industry Association is the securities industry's trade association representing the business interest of about 700 securities firms in North America, which collectively account for about 90% of securities firm revenue in the United States. SIA member firms are active in all phases of corporate and public finance, serving individuals and institutional investors, corporations, and government entities.

1. It does not provide full functional regulation because it allows banks to engage in numerous securities activities without registering as broker-dealers or complying with SEC net capital rules.

2. It does not provide an adequate "two-way street" for all securities firms to get into banking because it limits the amount of insurance and non-financial activities in which a securities firm may engage if it is affiliated with a bank.

3. It increases regulatory burdens by giving the Federal Reserve Board authority over the activities of registered broker-dealers affiliated with financial services holding companies.

4. It hinders competition by prohibiting the affiliation of wholesale and retail depository institutions.

SIA believes these provisions must be amended if the Act is to achieve the goal of expanding the competitive opportunities for all financial services providers. Otherwise, the Act will create an overly complex and burdensome scheme of regulation with numerous restrictions, exceptions, loopholes, and complex levels of regulation that could stifle innovation and risk-taking in the securities markets.

1. Functional Regulation

The U.S. capital markets and the financial services industry today are the most competitive, dynamic, and innovative in the world. This industry is a tremendous natural resource, affecting all areas of the U.S. economy, providing low-cost capital to business and government, and seeking new opportunities for private and public investors. Because the regulatory system that governs financial services providers is so critical to the efficiency, liquidity, and confidence in our capital markets system, SIA believes functional regulation should be a central element of any comprehensive financial restructuring legislation. By giving a single regulator authority over specific activities—regardless of the charter of the institution engaged in the activities—functional regulation ensures that the rules will be applied consistently and efficiently, promotes competition among all financial services providers, and results in greater investor protection and confidence in the financial markets.

The Act generally prohibits an insured depository institution affiliated with an FSHC from underwriting and dealing in securities and mutual funds, and engaging in other securities activities. Instead, these activities must be performed in a separately capitalized securities affiliate ("Section 10 Affiliate"). The Act, however, does not require banks to move all securities activities into a Section 10 Affiliate, but builds in a number of loopholes to allow banks to engage directly in a number of securities activities without registering with the SEC as a broker-dealer, including: Underwriting and dealing in municipal revenue bonds, which the Act classifies as bank-eligible securities; Underwriting and dealing in "bank-eligible" securities, such as U.S. Treasury securities, general obligation bonds, GSE securities; and Making private placements to accredited investors.[2]

In general, banks must register as a broker-dealer to engage in retail brokerage activities, but the Act creates the following 11 exemptions from this requirement: Third party brokerage arrangements; Trust activities; Transactions in "exempted securities" such as U.S. government securities; Transactions in municipal securities; Transactions for employee and shareholder benefit plans; Sweep accounts invested in registered money market funds; Transactions for bank affiliates; Private placements; De minimis exemption for up to 1,000 transactions annually;[3] Safekeeping, custody, clearance, settlement, securities lending, and holding certain pledged securities; and Banks that are not currently required to register as a broker-dealer, and that are members of a national securities exchange, are exempt from the definition of broker.

The Act also allows a bank to conduct these activities in a separately identifiable department ("SID"), which would have to register with the SEC as a broker-dealer, but would not have to comply with SEC net capital standards. In addition to the above-listed activities, SIDs would also be able to: Underwrite asset-backed securities, including those backed by credit card receivables and 1-4 family residential mortgages; and Effect transactions in any security the Federal Reserve Board determines to be a banking product.

In its report language, the House Banking Committee said, "It is expected that most banks will conduct [securities] activities through a subsidiary or an affiliate that is registered with the Commission or through an arrangement with an unaffiliated broker-dealer," but at the same time it allows banks to create a SID and it

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[2] If the bank is affiliated with an FSHC, private placement activities must be conducted in a separately identifiable department or division.

[3] If the bank is affiliated with an FSHC, it may not take advantage of the de minimis exemption for 1,000 brokerage transactions.

carves out a long list of exemptions for "traditional banking activities," essentially eliminating the need to form a Section 10 Affiliate. Indeed, the Act expands this list to include new authority to underwrite and deal in municipal revenue bonds.[4]

It is contrary to sound public policy for the Act to create a structure for the affiliation of banks and securities firms that includes firewalls to safeguard the deposit insurance funds and prevent conflicts of interest, while simultaneously creating a structure that allows banks to avoid these safeguards. SIA believes that all securities activities should be conducted in a separately capitalized securities affiliate that must register with the SEC as a broker-dealer and be subject to oversight by a self-regulatory organization ("SRO"). At a minimum, the Act should not allow banks to engage in any new securities activities. In that regard, the Act should be amended to delete the provision that makes municipal revenue bank-eligible securities. In addition, the Act should also be amended to provide that once an FSHC establishes a Section 10 Affiliate, all securities activities—including transactions in bank-eligible securities—should be conducted in the Section 10 Affiliate.

In general, the Act provides for functional regulation of FSHC subsidiaries—bank affiliates are regulated by bank regulators, and securities affiliates are regulated by the SEC. The loopholes described above for bank securities powers, however, are also loopholes in the overall regulatory scheme that result in differing levels of oversight, supervision, and investor protection depending on what entity is engaging in the securities activity. SIA believes that securities activities by any entity—be it a broker-dealer or a bank—require a regulatory system that fundamentally stresses investor protection and fair and efficient operation of securities markets.

It is particularly troubling that the Act gives the banking regulators, and not the SEC, authority to adopt "standards," rather than rules, to govern exempt bank securities activities. Because the Act does not require these standards to mirror SEC rules and regulations, investors who buy securities from a bank will not receive the same level of investor protection as those who buy securities from an SEC-regulated firm. We believe the SEC's statutory framework, expertise, and examination and enforcement procedures are best designed to oversee securities activities to ensure a strong and fair regulatory scheme. The SEC and self regulatory organizations have developed an extensive body of rules and regulations—including customer protection rules, duty to supervise employees, suitability standards, and SIPC insurance for brokerage accounts—that are specifically designed to protect investors. SEC net capital requirements are also designed to protect investors, and are not a cushion to guard against losses in a federal insurance fund. Since securities activities are not backed or covered by federal deposit insurance, there is no sound public policy reason to exempt so many bank securities activities from SEC regulation.[5]

2. Two-Way Street

SIA is also concerned that the Act does not achieve a full "two-way street" because it places arbitrary limits on the ability of securities firms to affiliate with banks. The Act allows FSHCs to own both banks and securities affiliates. Banks, in general, must be well-capitalized, well-managed, and in compliance with the Community Reinvestment Act in order to affiliate with a securities firm. These requirements address the fundamental soundness of the bank and the risk that it will cause losses to the deposit insurance funds. Securities firms that affiliate with banks, however, are subject to a number of restrictions that have little to do with their financial condition.

The Act permits a securities firm to affiliate with an insured bank if, in each of the past two years before the acquisition: 1. At least 50 percent of the firm's gross revenue was derived from certain securities activities; and 2. Less than 10 percent of the firm's capital and surplus is devoted to insurance or other non-financial activities.

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[4] It is important to note that most of these "traditional banking activities" (with the exception of municipal revenue bonds) have been approved by the regulators over the years; and given the activist nature of the federal banking agencies, it is not likely they will scale back the ever-expanding level and type of securities activities in which banks may engage even if the Act becomes law. For example, in November 1994, the OCC proposed revisions to their procedural rules which, if adopted, would permit the OCC to authorize operating subsidiaries of national banks to engage in activities in which even the parent bank could not engage. See *Rules, Policies, and Procedures for Corporate Activities*, 59 Fed. Reg. 61034 (Nov. 29, 1994).

[5] In addition to concerns about investor protection, banks receive an unfair competitive advantage because their securities activities are not subject to the same regulation as broker-dealers. Banks already operate with a subsidy implicit in the federal safety net. Subjecting them to less extensive regulation of their securities activities provides them with additional cost savings that gives them yet another advantage in the marketplace.

This provision would effectively prevent some "full service" securities firms from affiliating with an insured bank, because at least 50 percent of the firms' business involved insurance or other non-securities activities. To further complicate matters, it is not clear how the Act measures whether "more than 50 percent of the business" of a securities firm involves securities activities. Is such a determination to be made by reference to revenues, profits, or assets allocated to a particular business, or some other measure?

The Act also limits the ability of a securities firm to continue engaging in non-financial activities after affiliating with a bank to circumstances when: 1. The Federal Reserve Board has authorized such "financial activities"; 2. The securities firm engaged in such activities through a subsidiary; 3. The securities firm acquired the shares of that subsidiary at least two years prior to acquiring the bank; and 4. The securities firm's investment in those shares (as well as the shares of subsidiaries engaging in other activities not now permissible for a bank holding company) did not exceed 10 percent of the total consolidated capital and surplus of the securities firm.

The Act would also require a securities firm to divest the shares of any companies engaging in non-financial activities (as determined by the Board) between 5 and 10 years after the date of enactment, and would limit a securities firm to those non-financial activities in which it engaged on the date it acquired the bank.

The Act would generally prevent a securities firm from acquiring an uninsured wholesale financial institution and becoming an investment bank holding company if more than 7.5 percent of its total risk-weighted assets are invested in shares of companies engaged in certain activities—such as insurance underwriting—that the Board has not determined to be "financial in nature." As a result, an IBHC could not own shares of a subsidiary engaged in insurance underwriting activities if those activities exceed the 7.5 percent limit.

We believe that a securities firm should be allowed to affiliate with commercial banks or wholesale financial institutions without requiring the securities firm to make substantial changes to its operations. The Act, however, would force securities firms to choose between expanding into banking, or continuing to engage in insurance and other non-financial activities. These provisions will compromise the ability of U.S. firms to compete successfully in the global marketplace. Financial services providers require the flexibility to form fully-diversified holding companies that can offer a full array of financial products and services in order to maximize returns and lower funding costs. Rather than the arbitrary business restrictions and divestiture requirements of the Act, we believe a more competitive and fair approach would be to permit securities firms to continue engaging in insurance and non-financial activities without limits, and to impose prudential restrictions to prevent conflicts of interest and other inappropriate transactions with affiliated banks.

3. Role of the Federal Reserve in the Regulation of FSHCs

Under the Act, FSHCs and their affiliates will be regulated under a system essentially designed for bank holding companies that emphasizes the safety and soundness and minimization of risk to insured depository institutions. SIA believes this is an unnecessarily complicated and burdensome regulatory structure, particularly for securities firms which have typically relied on market discipline to control risks. The Act gives the Federal Reserve Board, in its role as regulator of the holding company, unprecedented authority over securities firms to: Restrict the permissible activities of Section 10 Affiliates through the ability to define what activities are "financial in nature"; Subject new securities activities to prior notice procedures; Set consolidated capital requirements for FSHCs, and possibly require higher capital for Section 10 Affiliates than other securities firms; Restrict the activities of a Section 10 Affiliate based on the undercapitalization or poor management of an affiliated bank; and Impose new examination and reporting requirements as part of consolidated holding company supervision.

The Act somewhat limits the Board's authority over FSHCs that primarily control non-depository institutions:

The FSHC would not have to obtain formal approval by the Board before engaging de novo or by acquisition in previously-approved financial activities.

The FSHC generally would not be subject to minimum capital requirements for holding companies.

The Board could exempt an FSHC from other reporting requirements of the Act, although the Board would have access to examination reports, audits, and other reports submitted to other agencies.

The FSHC and its non-depository affiliates would not be subject to Board examination unless the Board deems an examination to be necessary because its operations pose a material risk to an affiliated depository institution, it appears to have

insufficient resources to meet required guarantees, or the Board cannot otherwise carry out its responsibilities under the Act.

These "Fed-Lite" provisions apply only to FSHCs with bank assets that amount to less than 10 percent of holding company assets and less than $5 billion,[6] and do not address the issue of Board control over the activities of most Section 10 Affiliates. At a minimum, the Fed-Lite provisions should be expanded to include a greater number of FSHCs.

In the interest of functional regulation and streamlining regulatory burdens, SIA believes the SEC should have sole regulatory authority over all Section 10 affiliates to the same extent it regulates securities firms that are not affiliated with banking organizations. If there are legitimate regulatory issues that arise with Section 10 Affiliates, the SEC should be authorized (after consultation with the Board) to adopt regulations concerning those issues, to require Section 10 Affiliates to disclose any appropriate information relevant to those concerns in their periodic reports, and to inspect Section 10 Affiliates to determine compliance with regulatory and disclosure requirements. Of course, all SEC examination and supervisory documents will be shared with the Board. And in instances when a bank affiliate becomes undercapitalized, the Board should be required to seek SEC approval before imposing restrictions on a Section 10 Affiliate. This would reduce the likelihood that the Board would do more harm to the FSHC by restricting the activities of a healthy and profitable affiliate.

The Board's oversight responsibility for a holding company that contains both banking and Section 10 Affiliates should be confined to:

1. Enforcement of any restrictions on transactions between the insured bank and the other affiliates within the holding company.
2. Ensuring that there is sufficient capital in the holding company to provide that it serves as a source of strength for the insured bank.

We believe this would be the appropriate level of umbrella oversight to ensure that all holding company affiliates are operating within the rules without placing unnecessary regulatory burdens on securities firms.

4. Affiliations of Wholesale/Retail Banks

The Act authorizes a new type of bank holding company called an "investment bank holding company" ("IBHC") under which all depository institutions held by an IBHC must be uninsured state-chartered banks. Wholesale financial institutions would have access to the payment system and the discount window, but because they would not be able to accept retail deposits, they would not affect the deposit insurance system. Accordingly, an IBHC or its affiliates that engaged in securities activities would have no access to deposits or the credit power of a federally insured bank. SIA strongly supports the non-federally insured bank approach because it provides the necessary synergies without putting federally insured deposits at risk or allowing federal deposit insurance to create an unfair competitive advantage over firms which cannot be (or choose not to be) affiliated with a federally insured commercial bank.

However, the Act prohibits a holding company from owning both a wholesale uninsured bank and an insured depository institution. Firms that have both an institutional and a retail customer base should not be put at a competitive disadvantage to other financial services providers. We believe there is no public policy reason to prevent affiliations between wholesale and retail depository institutions, since such an affiliation would not put the deposit insurance funds at risk.

CONCLUSION

In conclusion, Mr. Chairman, SIA believes it is time to restructure the financial services system, and supports Congressional efforts to move the process forward. H.R. 1062, as reported by the House Banking Committee, however, essentially takes the existing regulatory system and adds several new layers of overly complex, burdensome, and costly regulation. This is not modernization, it is codification of the status quo. We must design a regulatory structure that will not fade into obsolescence the minute financial services providers create new products or services to meet the ever-changing needs of their customers. The freedom to innovate and change is essential to the U.S. securities industry and this bill, if it is not amended, places significant restrictions on that freedom without affording any greater protection to investors.

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[6] "Fed-Lite" also applies to Investment Bank Holding Companies with wholesale financial institutions assets that amount to less than 25 percent of holding company assets and less than $15 billion.

The legislation should be amended so that it provides for true functional regulation of all securities activities, achieves a full two-way street to allow all securities firms to affiliate with banks, reduces the role of the Federal Reserve Board in regulating securities affiliates, and allows affiliations between retail and wholesale financial institutions. Unless these changes are made, H.R. 1062 will not promote competition, increase consumer choices, or strengthen the position of U.S. financial services firms in the global market place. SIA looks forward to working with the Commerce Committee on this very important issue, and will be happy to assist in your efforts to make the changes to H.R. 1062 suggested in my testimony.

Mr. STEARNS [presiding]. Thank you.
Mr. Jones.

STATEMENT OF R. SCOTT JONES

Mr. JONES. Mr. Chairman, thank you for inviting me to participate in these important hearings on the structural reform of the financial services industry today. As a banker, I can tell you that competing successfully in today's market, while constrained by our out-of-date regulatory framework, is getting more and more difficult every day. And as a community banker from Red Wing, Minnesota, I can tell you that this is not just a big bank issue, as you have heard from our previous panel. It is not an urban bank problem as well.

So my message this morning is really quite simple. I would like to, at the onset, make three primary points. First of all, the legal and regulatory structure of our financial system must be modernized. We believe that H.R. 1062 takes an important first step in establishing a flexible framework for securities activities.

The second point, allowing banks to provide securities and insurance products will benefit consumers. More financial services providers means more competition. More competition leads to more choices for consumers and more choices inevitably leads to lower prices.

The third point is that financial modernization must not be used to impose new restrictions on bank insurance authorities. The ABA will strongly oppose any bill that reduces the ability of banks to offer insurance products.

As you know, Mr. Chairman, our financial markets have been transformed by a tidal wave of technological advances. While markets change and the regulatory structure does not, distortions always develop. The regulatory structure itself, and not the marketplace, has determined which firms can supply which products. This is not a healthy situation for financial services providers, but more importantly, not for their customers.

In the short time that I have here this morning, I would like to tell you how this situation affects my bank and my customers. About a decade ago, there was not much direct competition between securities firms, insurance companies, and banks. Basically our markets were segmented. Now, however, my biggest competitors are not other banks and savings associations; my biggest competitors in Red Wing, Minnesota are firms like Merrill Lynch, Edward D. Jones, IDS, and GMAC.

I estimate in the past year, the past 12 months, that somewhere in the neighborhood of $15 million has flowed out of my bank into these nonbank competitors, and that means $15 million less for home mortgages, small business loans, farm loans, and other types

of credit available in Red Wing, and I can assure you that Red Wing, Minnesota, with a population of only 15,000 people, still thinks that $15 million is a lot of money.

My point of this example, Mr. Chairman, is that financial services modernization and competitive equity are essential today if banks of all sizes can serve their customers and communities effectively. In recent times, Glass-Steagall has been viewed as really an anachronism in the technologically advanced and integrated financial markets of the 1990's.

Mr. Chairman, if my bank is to survive, I must be allowed to modernize to keep up with the competition, but most importantly, to keep up with the needs of my customers. My bank has acted as a business and economic leader in Red Wing for over 120 years, but if I can't compete, Red Wing will lose an important source of local capital.

There is a lot of controversy, as we have heard, over whether the bill should be broadened to include insurance. We believe that, ultimately, banking organizations must be allowed to offer all types of financial services, including insurance. And I think as you know, the ABA has been willing to come to the table repeatedly in order to work out compromises in this regard.

Our concern, however, is that this modernization effort may be used to restrict rather than enhance bank's involvement in the provision of insurance products. Wouldn't it be a cruel irony to see a bill that is supposed to modernize the banking system and banking law in effect be turned into a vehicle to protect certain groups from competition? That simply is not right.

While ABA strongly supports modernization, and, therefore, H.R. 1062, we will oppose any bill that restricts the ability of banks to compete. We simply cannot afford to go backwards.

Mr. Chairman, a discussion of some of the specific issues relative to questions asked in your invitation letter are included in my written testimony and in the appendix. I look forward to working with the committee and answering any questions that you may have.

[The prepared statement of R. Scott Jones follows:]

PREPARED STATEMENT OF R. SCOTT JONES, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. Chairmen and members of the Subcommittees, I am Scott Jones and I am Chairman of the Board and CEO of Goodhue County National Bank in Red Wing, Minnesota. I serve on the Board of Directors of the American Bankers Association and am Vice Chairman of ABA's Government Relations Council. The ABA is the only national trade and professional association serving the entire banking community, from small community banks to large bank holding companies. ABA members represent approximately 90 percent of the commercial banking industry's total assets, and about 94 percent of ABA members are community banks with assets of less than $500 million.

I am pleased to be here this morning to present the views of the American Bankers Association ("ABA") on the need to move forward on modernizing the structure of our financial system. The issue of modernization—including bank involvement in securities, insurance and other financial services—has been the subject of debate for many years. Although Congress has not yet acted, the marketplace has not stood still. In fact, the financial services industry has undergone some very dramatic and fundamental changes over the past decade. The traditional distinctions between the financial products supplied by banks, securities firms and insurance companies no longer exist. It is time to remove the structural roadblocks to financial modernization, and allow free and fair competition among financial service firms.

In my statement today, I would like to make three key points:

- **There is a critical need to modernize our financial system.** H.R. 1062 takes an important step toward achieving financial modernization by establishing a framework that would permit banks to engage in certain securities activities and would allow banking organizations to affiliate with securities firms.
- **Consumers will benefit from bank provision of securities and insurance products.** More financial service providers means more competition—and more competition means more choices and lower prices for consumers. There is considerable evidence that bank involvement in both securities and insurance has been good for consumers. Any limitation or roll-back of existing authorities would not be in consumers' best interest.
- **Under no circumstances should the financial modernization effort be used to impose new restrictions on existing bank insurance authorities.** ABA will strongly oppose any bill that reduces the ability of banks to offer insurance or securities products and services.

In the remainder of my statement, I would like to discuss: first, our views on the need for financial modernization; second, our support for the Glass-Steagall reforms embodied in H.R. 1062; and third, our support for insurance authorities for banking institutions and our strong opposition to any efforts to impose new restrictions on bank insurance authorities. A discussion of some specific bill-related issues, including the questions raised in your letter of invitation, is presented in an Appendix to this statement.

Financial Markets Need Modernization

The financial services industry is in the midst of a sea change. Revolutionary improvements in technology and escalating competition are redefining the financial services business. Today, my customers have the option to write a check on a money market fund to pay their bills; they can have a credit card issued by AT&T; and they can get a home mortgage from General Motors. And the list of non-traditional suppliers of financial services competing for my customers gets longer every day.

For example, just a few weeks ago, the American Automobile Association—a national car club—announced its intention to form a financial services company that will own an FDIC-insured banking institution. They intend to offer personal credit lines, travel loans, vehicle financing, mortgage loans and home equity loans. AAA already has an affinity credit card program that has issued 3.8 million cards, and is the largest single seller of American Express travelers checks ($2.5 billion annually).

In this dynamic market, the ability to quickly and efficiently respond to changing customer needs is critical. Successful firms must be flexible, innovative, and able to offer a broad range of financial services. As a banker, I can tell you that finding ways to compete successfully in today's market without running into the out-dated regulatory framework is no easy task—and it is absorbing a considerable amount of time, energy, and resources of large and small banks across the country. And as a community banker, I can tell you that *all* banks need modernization. Red Wing, Minnesota, my home town, and thousands of other smaller communities, are not isolated from the changes in the financial services industry. Non-bank financial firms are competing for my customers every day.

Because non-bank providers of financial services do not operate under the same constraints as banks, affiliations between securities firms, insurance companies, and real estate brokerage firms are common. Insurance firms such as Prudential, John Hancock, Travelers and Transamerica offer everything from consumer and commercial loans to credit cards to securities in addition to insurance. Many of these "securities" and "insurance" firms also own FDIC-insured savings institutions or so-called "non-bank" banks. As Table 1 clearly shows, in today's market, the line between banking firms and other financial firms exists only in theory—in practice, it has been overrun by market forces.

Table 1—FINANCIAL ACTIVITIES OF SELECTED NON-BANK FIRMS

Firms	FDIC Insured Depository	Consumer Loans	Credit/ Debit Cards	Mortgage Banking	Commercial Lending	Mutual Funds	Securities	Insurance
Ford	√	√	√	√		√	√	√
General Motors		√	√	√			√	√
General Electric	√	√	√	√	√	√	√	√
Prudential	√	√	√	√	√	√	√	√
John Hancock	√	√	√	√	√	√	√	√
American Express	√	√	√	√	√	√	√	√
Travelers	√	√	√	√	√	√	√	√

Table 1—FINANCIAL ACTIVITIES OF SELECTED NON-BANK FIRMS—Continued

Firms	FDIC Insured Depository	Consumer Loans	Credit/Debit Cards	Mortgage Banking	Commercial Lending	Mutual Funds	Securities	Insurance
Beneficial Corp	√	√	√	√	√	√	√	√
Transamerica		√	√	√	√	√	√	√
Merrill Lynch	√	√	√	√	√	√	√	√

For example, look at the breadth and depth of the financial activities of the largest securities firm in the country, Merrill Lynch (total assets of $153 billion):

- Merrill Lynch owns Merrill Lynch Bank and Trust Company, an FDIC-insured bank with $1.7 billion in assets—larger than 97 percent of the banks in the country. Merrill Lynch offers FDIC-insured deposits; a complete range of securities services including underwriting and brokerage; options, commodities, and financial futures contracts; money market funds and mutual funds; cash management services for both businesses and consumers; retirement account management; debit/credit cards; retail and corporate lending; and underwriting and sales of life insurance and annuities. In 1993, Merrill Lynch had an underwriting volume of $193 billion; held private client assets of $536 billion; originated about $1.5 billion in mortgages; made about $1.6 billion in home equity loans; held more retirement plan assets than the top 140 commercial banks combined; had more than 400,000 small business accounts with over $105 billion in assets and $960 million in loan commitments to small and mid-sized businesses. Recently, Merrill Lynch launched a direct lending program for their large corporate customers, allowing them to provide their corporate clients with a full menu of funding options ranging from equities to a variety of long- and short-term debt instruments.

Under the current regulatory regime, it is no surprise that banks have lost traditional market share to other financial services providers. In fact, while the assets banks' hold have increased, banks' market share of total assets held has fallen steadily over the past two decades, from about 40 percent in 1973 to 25 percent in 1994 (see Chart 1). Moreover, the share of total credit extended by banks has also fallen, from 39.2 percent in 1980 to 32.5 percent in 1994. In contrast, the share of credit extended by insurance companies grew from 16.8 percent in 1980 to 20.6 percent in 1994.

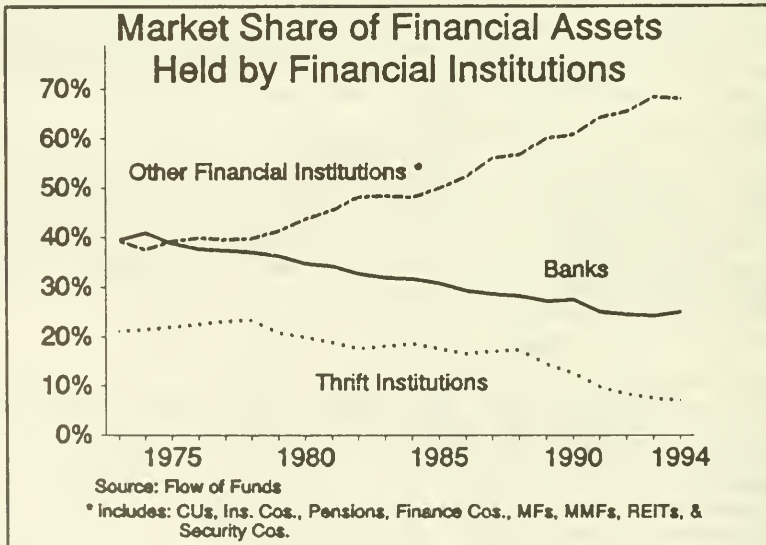

Chart 1

The bottom line is that banking organizations should have the option to enter other lines of financial business—including securities and insurance. Whether they do so or not is a business judgment that each individual institution should be free to make. It simply makes no sense to create a system that limits free and fair competition. To do so means that customers will not be as well served.

Bankers are not alone in supporting financial reform. The Administration, the Federal Reserve and the bank regulators have all testified to the need for modernization and a return to market driven, competitive markets.

We must design a financial framework that: allows banks and banking organizations to offer a broader array of products and services, and promotes free and fair competition among different sizes and types of firms; is flexible enough to adjust to changing customer demands, market conditions and technological advances; provides adequate protections to ensure the safety and soundness of the system without adding unnecessary costs; and provides consistent regulation by function, treating all financial service providers equally regardless of structural entity.

It is noteworthy that this framework, which has been ABA's long-held position, is remarkably similar to the principles for reform contained in a May 23rd letter to Chairman Bliley signed by the American Financial Services Association, the Financial Services Council, the Investment Company Institute, and the Securities Industry Association. ABA is committed to work with the Congress, the Administration, the regulators, and other financial services providers to achieve modernization.

ABA believes that H.R. 1062 is consistent with the spirit of this framework and will form a solid base upon which to build. It provides a framework for offering banking, securities, and other financial services. If it is felt appropriate to broaden the bill to deal with the insurance issue, ABA will be very willing to participate in that effort. We remain very concerned, however, about efforts to restrict or severely limit bank involvement in the provision of insurance products. *While ABA strongly supports modernization, we will strongly oppose any bill which reduces the ability of banks to compete. Banks can simply not afford to go backwards.* It would be a cruel irony to see a bill that is supposed to modernize banking law and increase competition turned into a vehicle to protect certain groups from competition.

The Benefits of Glass-Steagall Reform

Let me now turn to securities services. The growing integration of financial markets offers many opportunities to improve the efficiency of production and delivery of financial services, all of which will benefit consumers and the economy as a whole. Removing Glass-Steagall restrictions and allowing banks of all sizes to offer securities services would certainly help banks provide more and better products to a wide range of their customers—including consumers, state and local governments, and businesses.

State and local taxpayers would realize significant cost savings if banks were allowed to underwrite and deal in municipal revenue bonds, as provided in H.R. 1062. Increased competition in the municipal market would reduce costs for all issuers, and would offer small municipalities an important option for financing needed community infrastructure improvements. Local banks already provide a wide range of financial services to their communities—they clearly have the knowledge and the expertise necessary to underwrite revenue bonds. But Glass-Steagall prohibits them from performing this service, resulting in less competitive municipal bond markets, and leaving many small communities with fewer financial choices.

Allowing banking organizations to underwrite corporate debt and equities would provide similar benefits to businesses. More underwriters means more competition—and more competition means more choices and lower prices. Corporate securities underwriting markets are today quite concentrated—the five largest underwriters of corporate debt control about 65 percent of the market, and the five largest underwriters of common stock account for half the market.

In many cases, smaller businesses do not have the same access to securities services that is available to larger businesses. Similarly, customers in less populated areas do not have access to securities services that is available to businesses in metropolitan areas. Because of their local presence, banking organizations are likely to extend the reach of securities markets to small and regional businesses for whom such financing options may not now be available. Building on existing relationships with their business customers, banking institutions could extend underwriting and market-making services to small and mid-sized businesses, giving them access to capital markets. Since lack of access to capital is among the most serious problems facing many businesses large and small, participation in corporate debt and equity markets is likely to be particularly beneficial.

As I mentioned at the outset of my statement, 94 percent of ABA's members are community banks, and any Glass-Steagall reform bill must carefully consider their

needs. While community banks may not want to underwrite, they badly need the flexibility to offer retail securities services in a regulatory structure that is compatible with how they do business. Today, when a customer withdraws funds from a bank and places those funds with a securities firm, the bank not only loses the funds, but may also lose the customer. That community bank may never have the opportunity to work with that customer again, to put his or her funds back into the community.

Let me give you an example from my market. In 1990, I saw literally hundreds of thousands of dollars in deposits leave our bank as customers saw the need for annuity products in their investment portfolios. Our bank petitioned the federal regulatory authorities to be able to sell this product—and as a result, customers can now buy annuity products from their local bank, from people they know and trust.

Today, we are in much the same position with regard to securities firms. We estimate that some $15,000,000 of deposits flowed out of the bank last year to Merrill Lynch, Edward D. Jones, IDS and others. That means $15,000,000 less in funds available to make home mortgages, small business loans and farm loans—and in a town of 15,000 people, $15,000,000 is a lot of money.

Glass-Steagall Reform and International Competitiveness

As technology pulls markets around the world closer together, competition from foreign financial institutions in both global and domestic markets is intensifying. International competitive pressures have sparked a wave of regulatory reforms in other industrialized countries, giving foreign financial markets and institutions a head start in developing innovative services to meet the needs of the future. The greater their head start, the harder it will be for our institutions to catch up.

Losing our competitive edge in international financial markets has serious implications for the U.S. economy. The effects go beyond jobs and productivity in the financial sector—losing our financial leadership will have an impact on the competitiveness and market share of other U.S. industries as well, especially export-oriented industries. It is sometimes argued that money owes no national allegiance and that U.S. firms will have the same access to credit whether they are dealing with U.S. banks or foreign banks. However, we live in an imperfect world and the market does not always operate according to text book principles. Many governments look upon their banks as an integral part of their long-term export promotion strategy. The U.S. will face an up-hill battle to remain a leading player in the global economy if it's banks are being swept aside in the competitive arena.

Glass-Steagall Restrictions on Bank Securities Activities Are Unnecessary

The historical importance of Glass-Steagall restrictions is shrouded in legend and myth. The truth is that the Glass-Steagall provisions were only one small part of the government's overall response to risk in the financial system in 1933. A closer look shows that Glass-Steagall was not crucial to the government program addressing problems in the securities and banking industries in 1933, nor is it necessary today.

The Banking Act of 1933, the Securities Act of 1933, and the Securities Exchange Act of 1934 were the basic government responses to the crises in the stock market and the banking system. The most important provisions of the Banking Act of 1933 included the creation of the Federal Deposit Insurance Corporation (FDIC); the creation of the statutory basis for the Federal Reserve Open Market Committee; increased minimum capital for national and member banks; restrictions on extensions of credit by member banks to their affiliates (Sec. 23A of the Federal Reserve Act); and restrictions on the use of the credit facilities of the Federal Reserve for purposes of speculating in securities and real estate.

The Securities Act of 1933 and the Securities Exchange Act of 1934 made fundamental changes in the supervision of public offerings of securities and the regulation of securities markets. Those laws established the SEC; required federal regulation of public offerings of securities; prohibited fraudulent, manipulative or deceptive practices; required federal registration of broker-dealers; and mandated a host of other protections to the public from unscrupulous market participants.

These changes to the banking and securities laws served to stabilize financial markets in the 1930s and are the basis for today's regulation of the banking and securities business.

In comparison, the Glass-Steagall provisions were not crucial to restoring stability to the financial markets in the 1930s because the activities they addressed were not the cause of either the stock market collapse or the collapse of the banking system in the 1930s.

A closer look at the facts shows that there is no truth to the myths about the importance of Glass-Steagall.

- Securities activities of commercial banks and their affiliates were not a significant cause of the collapse of the banking system in the 1930s. There is no credible evidence, even in the hearings that were held at that time, that banks with securities affiliates failed because of the activities of those securities affiliates. In fact, banks with securities affiliates survived the difficult times of that period better than those without such affiliates. The overwhelming number of banks which failed were small rural banks that did not underwrite securities.
- The Glass-Steagall provisions in the Banking Act of 1933 were added because Senator Glass believed in a banking doctrine which is now irrelevant. Senator Glass believed that the only safe function of commercial banks was to make short-term, self-liquidating loans to support commercial firms in commercial transactions—the "real bills doctrine." Adhering to this belief, Senator Glass viewed loans to brokers as unproductive, and he attempted a number of times to pass legislation to make it difficult for banks to provide such credit. He succeeded only when hearings in Congress produced evidence which (in the drama of the times) was sensationalized and produced an atmosphere conducive to passage. The real bills doctrine has since been discredited, and certainly can not be used to defend Glass-Steagall in today's world.
- Even the Glass-Steagall Act does not mandate a total separation of commercial and investment banking. A common error is to describe the Glass-Steagall Act as prohibiting commercial banks from underwriting or dealing in all securities. That is simply wrong. Glass-Steagall explicitly allows banks to underwrite and/or deal in securities such as Treasuries and general obligation bonds. (At the time Glass-Steagall was passed, municipal revenue bonds basically did not exist, so these instruments were not addressed in the legislation; otherwise, banks certainly would have been permitted to underwrite them.) In recent years, courts have also held that Glass-Steagall does not prohibit banks or their affiliates from engaging in retail securities brokerage and a significant range of securities underwriting activities.

Safety and Soundness Considerations

There are several key points related to safety and soundness: History has shown that bank involvement in other financial services, including securities, *lowers* the risk profile of banking institutions; A sound banking system must be allowed to change with changing financial markets. The greatest risk to safety and soundness is to confine institutions to compete under out-of-date laws, unable to offer consumers new and innovative products; There are already strong safeguards in place; and It makes no sense to allow new authorities while at the same time making them uneconomical to provide by imposing regulatory restrictions.

Let me elaborate on these points. First, U.S. banks are currently allowed to underwrite certain securities within the bank, and recently some banking organizations have been authorized to conduct broad securities activities through holding company affiliates (so-called Section 20 subsidiaries). Foreign banks have engaged in securities and insurance activities for years, and many U.S. banking companies have securities operations overseas. There is no evidence that any of these activities is inherently riskier than traditional banking activities, nor that the combination of banking with these other financial activities raises the risk profile of the banking organization. In fact, there is good reason to believe that diversification of activities may actually contribute to greater depository institution stability.

Second, as I mentioned earlier, it has been widely documented that traditional banking is steadily losing market share. It is noteworthy that banking organizations' stock continues to sell at price/earnings ratios significantly below market norms despite the industry's recent record earnings. In other words, the market perceives banking as an industry whose earnings potential is severely handicapped by out-dated laws and excessive regulation. In the long-run, an industry which is unable to compete can not truly be strong and sound, and can not support economic growth. Doing nothing to modernize our banking laws poses the greatest risk to safety and soundness.

Third, there are extensive regulations already in place to protect against any potential problems that may arise between an insured depository and an affiliated entity. Over the past fifty years, a highly sophisticated regulatory regime has been developed to govern the activities of banks, bank holding companies, and securities firms. These include Sections 23A and 23B of the Federal Reserve Act and Section 106(b) of the Bank Holding Company Act Amendments of 1970 which deal specifically with transactions between a bank and its affiliates, plus extensive prudential regulations imposed on both banks and securities firms.

Sections 23A and 23B of the Federal Reserve Act place strict limits on the terms and conditions of credit extensions and other transactions between banks and their

affiliates. Section 23A restricts loans to one affiliate to 10 percent of the bank's capital and surplus (20 percent of capital and surplus for all affiliates), and requires that all transactions be fully secured and consistent with safe and sound banking practices. Section 23B requires that all transactions, including purchases and sales of assets, between a bank and its affiliate be "arms length"; that is, that the terms and conditions of the transaction must reflect prevailing market conditions. The restrictions in Sections 23A and 23B reach transactions with third parties that would benefit a bank's affiliate. Taken together, Sections 23A and 23B insulate banks from their affiliates and effectively restrict harmful loan and securities transactions between banks and their affiliates.

Banks, like all other businesses, are subject to the anti-tying rules of the antitrust laws. But banks are also subject to a special, much more restrictive law. Section 106(b) of the Bank Holding Company Act Amendments of 1970 eliminates any possibility that banks and their affiliates might enter into improper "tying" arrangements. Section 106(b) makes it illegal for banks to condition the availability of one service on the purchase of another, even though the bank may not have any "market power" over the service. In fact, section 106(b) is so tight that it has severely restricted the competitiveness of banking organizations in some cases.

In addition to these regulatory restrictions dealing specifically with inter-affiliate transactions, there is also a whole body of banking and securities laws and regulations which deal with prudential operation of covered institutions. For example, the banking industry is subject to a comprehensive network of state and federal regulations dealing with capital adequacy and safe and sound operating procedures, extensive reporting requirements, and thorough examination and supervision. FDICIA gave the FDIC authority to impose additional bank capital requirements for non-traditional activities if such action is necessary. The Securities Exchange Commission and the self-regulatory agencies, such as the National Association of Securities Dealers, impose a series of financial adequacy regulations, conduct standards, and reporting and examination requirements on securities firms.

Fourth, so-called firewalls that prevent banking institutions from competing effectively will undermine the very purpose of modernization. As previously noted, many companies, including some of the largest in the country, already offer virtually all financial services—including traditional banking services—basically without any firewalls. It is these companies that banking organizations must compete with on a daily basis. Often, calls for firewalls by some of banking's competitors are nothing more than calls for protection from competition.

ABA believes that H.R. 1062 makes an important contribution by providing a flexible framework that will be responsive to changing market conditions. Without such flexibility for regulatory changes, the banking industry may find itself locked in by regulatory restrictions that undermine bank competitiveness for years, even if virtually everyone agrees that the particular restrictions should be modified. History shows us that having to come back to Congress for fine-tuning is just not workable. ABA pledges to work with the Commerce Committee to fine-tune the framework in H.R. 1062 to meet Members' concerns.

ABA Will Oppose New Anti-Competitive Restriction on Bank Insurance Activities

While we support the Glass-Steagall reforms contained in H.R. 1062, we do believe that ultimately we must move to a more comprehensive financial structure, and we are willing to work with the Commerce Committee, the Banking Committee and others toward that end. Banking organizations (and other financial service providers) should be allowed to offer all financial services, including insurance, in a flexible framework with functional regulation.

The ABA position has long been that such a comprehensive structure should be based on the following principles:

- A bank should be allowed to affiliate with an insurance underwriter in a structure where each entity is functionally regulated—the bank by the banking regulators and the insurance company by state insurance commissioners—under nondiscriminatory rules.
- Banks should be able to directly engage in the low-risk, fee income activities of insurance agency and brokerage, again subject to nondiscriminatory state regulation.
- Banks and their insurance subsidiaries and affiliates should be able to freely market and advertise all of their products to their joint customer bases because consumer choice means nothing unless consumers are aware of their choices.
- Insurance agents who enter into business relationships with banks should have the option of having a physical presence on bank premises; but we have no objection to reasonable rules, like the ones we already comply with, to assure that consumers understand the difference between insured bank deposits and insur-

ance products and services, and to eliminate any possibility of coercion where insurance is required in connection with a loan.

The structure above would provide banks with the same competitive freedoms that are already enjoyed by savings and loans, credit unions, insurance companies, and other nonbank financial competitors, and we are willing to do it under a regulatory framework which frankly imposes more burdens and duties on us than our competitors encounter now.

Bankers simply cannot understand why they are singled out for discriminatory treatment in the sale of insurance while all other creditors—including those with federal deposit insurance—can sell insurance without any of the restrictions imposed on banks. Why should a $100 million national bank not be permitted to sell insurance, while others in the same town—including, for example, a $200 million credit union, a $500 million S&L, a multi-billion dollar finance company, a subsidiary of General Motors, Ford or Chrysler, and a Farm Credit System Bank—can sell insurance products without restrictions? In Red Wing, my bank competes with two credit unions, a farm credit bank, an IDS office, and a GMAC office, all of which can sell insurance without restrictions.

Consumer Benefits of Bank Insurance Activities

Today, nearly half of the U.S. population resides in states and locales where banks can engage in broad insurance sales and brokerage activities. Insurance activities in banks are now permitted from Alaska and California across the continent to Virginia and Delaware. To the extent that a separation of banking from insurance ever existed, it is quickly and properly being swept into the dust bin of history by marketplace developments.

Many consumer groups recognize that there are significant benefits to be gained from bank involvement in the sale of insurance products including lower costs, more convenient service, and better product and cost information. In addition, banks can reach out to a broader spectrum of consumers, making insurance products accessible to more people.

A recent survey released by Prophet Market Research, a financial consulting and testing service in San Francisco, shows some significant problems in the insurance industry regarding the information given to potential buyers of annuities and mutual funds—for example, 27 percent of prospects were not told about sales charges associated with specific products and 48 percent were not told about the product's operating expenses and management fees. The survey also found that 40 percent of agents did not inquire about income levels of the prospect and 58 percent did not ask about a prospect's tax bracket, even though most were pitched annuities or other "tax-advantaged" investment products. Twenty-five percent of agents did a poor job inquiring about a prospect's investment history, assets, investment objectives and risk tolerance.

A study done for the Consumer Federation of America (CFA) found that the present life insurance system imposes excess annual costs on consumers, and that allowing banks to participate in insurance markets has the potential to save consumers $5 billion to $10 billion per year in life insurance sales alone. The CFA study included a nationwide survey of insurance sales practices and found that "banks are more responsive to consumer requests for information" than captive or independent agents. The study reported that "... every one of the [survey] comparisons shows that bank's sellers of life insurance were more forthcoming with information than agents ... the policies sent by bank-based setters were much lower in cost."

Just a few weeks ago, in an April 6 letter to the Capitol Hill newspaper *Roll Call*, former Texas Insurance Commissioner Robert J. Hunter, now Director of Insurance for the CFA, refuted a misleading ad placed in the previous week by the Independent Insurance Agents of America (IIAA). The CFA letter stated: "Ever since CFA exhaustively studied the issue a decade ago, and in several studies since, we have believed that bank entry into insurance sales, with proper consumer protections as to tie-in sales and disclosures, has the potential to save consumers billions of dollars every year. We have, as IIAA well knows, characterized the entry of banks into insurance sales as a likely 'boon' to consumers."

Similarly, in Congressional testimony, the President of the National Insurance Consumer Organization, stated: "Banks are a logical source of insurance. Sales outlets in banks would be convenient for consumers and should be extremely efficient points for sale. The incredible reaction of insurance agents against bank entry is due in the main to their inefficiency and high cost."

Consumer group support has been crucial to the enactment of bank insurance sales powers in several states including California and Virginia. For example, the Virginia Citizens Consumer Council (VCCC) was one of the strongest proponents of

the authorizing legislation. I would like to quote from testimony presented by Jean Ann Fox, President of VCCC, before the Virginia Senate Commerce and Labor Committee on February 26, 1990:

> Virginia Citizens Consumer Council supports HB 335 to permit banks to sell insurance. We believe that this bill balances the need for greater competition in the sale of insurance with the important goal of safeguarding consumers.
>
> The artificial barriers between insurance companies and financial institutions are already crumbling, with insurance companies acquiring banks and offering financial services... My insurance carrier is offering to loan me money. My bank is offering to sell me insurance. This bill simply recognizes the trend to financial supermarkets.
>
> VCCC is actively involved in trying to improve the competitiveness of the insurance market... We look on HB 335 as one more measure to improve competition at the retail sales level by increasing the choices for consumers.

In late 1990, the General Accounting Office (GAO), the Congress's investigatory arm, released an extremely comprehensive report discussing all the salient policy issues raised by the sale of insurance by banks. This September 1990 study, "Bank Powers—Issues Relating to Banks Selling Insurance", is the most exhaustive and well researched third party study of this subject that we are aware of. The GAO spent more than one year in its research and analysis. GAO consulted with grandfathered bank holding companies, banking industry organizations, insurance agent and underwriter trade associations, insurance companies, consumer organizations, and academic and independent experts.

The GAO study refitted virtually all the major arguments used by the insurance industry in protest against potential bank entry into insurance sales. The GAO study on bank provision of insurance found: real opportunities to reduce consumers' cost of purchasing insurance; no significant safety and soundness risks; no consumer coercion problems which cannot be ameliorated through appropriate regulation and other safeguards; and no unfair or unique competitive advantage vis-a-vis other insurance providers.

In fact, the GAO conclusions reinforce all of the points the banking industry has raised over the years in its testimony on this subject. The GAO report continues a long string of impartial, third party studies which found substantial potential consumer benefits from bank insurance sales and no strong countervailing reasons to prohibit such activities. In fact, not surprisingly, the only studies we are aware of which have come up with contrary findings have been those directly funded by the insurance industry.

Part of the reason banks can provide low-cost and efficient insurance services to consumers is because the network of banks and branches—almost 64,000 office locations across the country—gives banks an ideal delivery system for retail insurance products. Bank expertise in administrative functions and data processing technologies will contribute significantly to lower insurance costs. And the convenience of bank branches will make consumer access easier and more efficient.

Banks can also provide an increase in overall service levels. This can be especially important for lower income households. Banks have relationships with nine out of ten households with annual incomes of less than fifteen thousand dollars. This market segment has not been well served historically by the insurance industry—only seven percent of life policies insure individuals with incomes of less than ten thousand dollars. The modest, low-commission term life policy that is most suitable for such an individual is not a product which many insurance agents will devote their marketing time to because of the high cost of individually prospecting customers; however, such products can be distributed very efficiently through banks—witness the great success of savings bank life insurance in the Northeast.

Banks also can enhance the overall availability of good product and cost information, as was demonstrated by the Consumer Federation of America study mentioned above. Consumers will not only save money by selecting the product best suited to their needs, but their broader knowledge of available products, suppliers and prices is a strong antidote to anti-competitive market practices.

In light of this evidence, it simply makes no sense to restrict in any way banking organizations' involvement in insurance.

The Myth of Bank Coercion

The principal charge heard over and over again from the insurance lobby in opposition to bank involvement in insurance activities is that banks will supposedly use their market power as lenders to coerce customers into purchasing insurance products and services which they do not want as a precondition of obtaining a loan. But despite continuing charges of coercion by insurance agents, *none of the many studies*

of bank insurance activities—including those conducted by the Federal Reserve Board, General Accounting Office and consumer groups—have found evidence of significant coercive tying activities by banks selling insurance.

The coercion arguments made against banks selling insurance apply equally to all other credit grantors who offer combinations of insurance and lending. This includes savings and loans, credit unions, mortgage companies, finance companies, and insurance companies themselves. Yet, it is only commercial banks that have significant restrictions on their ability to sell insurance. As previously stated, it is very hard for our industry to understand why it is alright for all these other types of firms to sell insurance and make loans, but it is somehow not alright for commercial banks.

If there are concerns about the linkage of providing credit and selling insurance, and we believe such concerns are basically unfounded, then these should be dealt with by consumer protections applicable to all credit grantors, not by discriminatory prohibitions on one sector of the financial services market.

Consumer Protections

The ABA recognizes that certain protections may be necessary to ensure that consumers are fully informed about the products they purchase. By and large, these protections, at least for the banking industry, already exist. For example, Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972) prevents consumers from being required to purchase other corporate products as a condition of obtaining a bank product. Such illegal "tie-ins" would subject violators to substantial damages.

Banks take great pains to assure that consumers fully understand the difference between federally insured deposit products and non-deposit investment products, both to maintain good customer relationships and, quite frankly, to protect themselves against being sued if an investment declines in value. Over the last two years, banks' efforts to increase consumer disclosure and levels of understanding have grown dramatically. In addition to extensive voluntary efforts by ABA and other bank trade associations, bank sales of annuities and other non-deposit investment products are subject to a February 1994 Interagency Statement issued by all the federal banking regulators. This Statement contains explicit requirements and guidelines, enforced during the examination process, for physically separate insurance sales areas, suitability standards, advertising and disclosure, staff training and qualifications, and incentive compensation. Further, the Statement requires banks to obtain a signed statement from customers indicating that they understand the disclosures, particularly that an annuity or other investment product purchased from a bank is not FDIC-insured and has investment risk, including possible loss of principal. H.R. 1062 writes many of these guidelines into law.

Finally, we believe it is important that Congress impose *the same consumer protection standards to all providers of similar financial services.* Combining Prudential Insurance Company with an FDIC-insured bank raises the same issues as combining Citicorp with an insurance underwriter. Anyone can own an S&L (and call it a bank) and sell insurance, securities, and other financial services in combination with a federally insured institution. Bank-like products are being offered by a host of "nonbank" institutions including insurance companies. Yet these companies are not subject to the same types of regulatory concerns and administrative burdens that banks now face. This dual standard raises important consumer protection concerns.

The banking industry stands ready to work with legislators to construct appropriate safeguards which would adequately address the consumer's need for protection while not negating the consumer benefits of bank insurance sales. But these safeguards should be applied even-handedly to all financial services providers.

Insurance Groups Are Seeking Protection From Competition

ABA has no quarrel with the goal of assuring that everyone involved in underwriting or selling insurance is subject to the same state insurance regulation. We do, however, oppose authority that could, and would, be used to prohibit some participants from competing at all. While we do not believe there is a need for such federal legislation, we are willing to work with the Commerce Committee on designing a functional regulatory approach that will assure that all regulation is applied equally without imposing any limitation on who may sell or underwrite insurance.

On May 22, ABA testified before the Subcommittee on Commerce, Trade and Hazardous Materials on the specifics of H.R. 1317, detailing our concerns about the bill. In that statement we refuted the claims of insurance groups about the supposed benefits of the bill. I will not go into detail, as we did in the earlier testimony, but

I wanted to simply summarize our comments as they may apply in the context of the Committee's consideration of H.R. 1062.

- **H.R. 1317 is not necessary to get banks to comply with state regulation.** Banks which participate in insurance *already* obtain state insurance licenses and comply with state rules. The real impact of the bill is to permit state insurance commissioners to use state laws to **prevent,** directly or indirectly, national banks from setting insurance. Let me emphasize that there is a fundamental difference between *prohibiting* competition and *setting the rules under which all participants must compete.*
- **H.R. 1317 would rewrite the McCarran-Ferguson Act and completely upset the balance of federal and state interests.** McCarran-Ferguson is a federal statute, not a state statute. Therefore, what constitutes "insurance" for purposes of the McCarran-Ferguson Act is a matter of federal, not state law. This question was discussed in the first *VALIC* case (SEC v. Variable Annuity Life Insurance Company of America, 359 U.S. 65 [1959]), where the court found that variable annuities were not "insurance" in spite of state statutes to the contrary. Later, the Federal Court of Appeals for the Ninth Circuit found in *U.S. v. Title Insurance Rating Bureau of Arizona, Inc.*, 700 F.2d 1247 at 1250 (1983) that

  > ...it is not dispositive that Arizona law defines the 'business of title insurance' to include 'the performance by a title insurer or title insurance agent of escrow services'...because the definition of 'business of insurance' for McCarran Act purposes is a matter of federal law.

  Thus the legal effect of H.R. 1317 is to alter one of the basic tenets of the McCarran-Ferguson Act, that is, the ability of Congress and the federal courts to define what constitutes "insurance."
- **H.R. 1317 would undermine Court decisions that have opened up the marketplace.** The bill would subvert the Supreme Court's unanimous ruling in the recent *VALIC* case, thus opening up a new round of litigation. It would also lead to new state initiatives to prohibit national bank sales of annuities.

ABA has been discussing with Committee staff possible approaches to achieving the goals of H.R. 1317 in the context of permitting the affiliation of banks and insurance companies and agencies. While the principle of functional regulation at the state level is clear, devising an approach which protects the legitimate state role while not permitting discrimination against banks is difficult because of the many diverse state and federal approaches to banking and insurance which have developed over many decades.

Again, ABA feels strongly that H.R. 1062 should not be turned into a vehicle for protectionism, and we will continue to work with the Committee to try to reach a satisfactory solution. We greatly appreciate the opportunity Chairman Bliley and his staff have given us to participate in these discussions.

Conclusion: Competition, Not Protectionism

Despite the significant consumer benefits of bank participation in both securities and insurance markets, some in the insurance industry are seeking to use the growing momentum for financial modernization to add new restrictions on bank insurance activities. Such efforts are blatantly protectionist and anti-consumer, and we will strongly oppose them.

We believe that the most beneficial public policy is one which promotes free and fair competition in the sale and distribution of financial products, including insurance and investment products. It is clearly not in the public interest to protect certain industries against competition from new market entrants. We ask you to move forward to help build a competitive framework for financial service providers which will serve the needs of consumers. This new Congress has an historic opportunity to modernize the laws of the 1930s, which are totally out of date, and to create a framework for offering financial services that will work in the twenty-first century.

Thank you for this opportunity to share our views.

APPENDIX

BANK HOLDING COMPANY STRUCTURE

H.R. 1062 would permit banking organizations to underwrite corporate debt and equity securities and mutual fund shares. That activity must be conducted in a sep-

arately capitalized bank holding company subsidiary,[1] subject to regulation by the Securities and Exchange Commission ("SEC"). H.R. 1062 would not permit these activities to be conducted in a bank subsidiary.

The ABA is on record in supporting functional regulation. The ABA believes, however, that banking organizations should be given maximum flexibility to structure their securities underwriting activities in a manner that best suits the needs of their particular organization and client base. While the ABA supports H.R. 1062 and its requirement to house corporate debt and equity underwriting in a bank holding company subsidiary, the ABA would prefer legislation that would permit bank subsidiaries also to have the option to underwrite corporate debt and equity. Like the bank holding company subsidiary, the bank subsidiary would be subject to SEC jurisdiction and any potential risks and perceived conflicts of interest associated with securities underwriting could be addressed by putting adequate safeguards in place.

SEPARATELY IDENTIFIABLE DIVISION OR DEPARTMENT ("SIDD")

The ABA is in full support of those provisions of H.R. 1062 that recognize that it may, in certain circumstances, be appropriate to conduct certain securities activities in a separately identifiable division or department ("SIDD") of the bank, rather than in a separate bank holding company subsidiary. In permitting (but not requiring) certain securities activities to be conducted in a SIDD, H.R. 1062 strikes a balance between securities and banking. Specifically, H.R. 1062 would require securities activities conducted in a SIDD to be regulated like all similar securities by the appropriate securities authorities. At the same time, H.R. 1062 recognizes that certain securities activities cannot easily be divorced from traditional banking activities offered in the bank.

In this same connection, H.R. 1062 recognizes that it is appropriate not to subject the SIDD to the SEC's net capital rule so long as the bank remained adequately capitalized under the banking laws. This is because the net capital rule, which unlike bank capital requirements focuses on liquidity risk rather than credit risk, would require disproportionately high levels of capital for illiquid instruments like bank loans.

For example, allowing banks to offer municipal revenue bonds through a SIDD recognizes that securities and banking products[2] targeted to state and local governments have been developed side-by-side and that the most efficient and effective way to serve these customers is to offer them a whole array of products to serve their financial needs. Carving out securities products from all other products offered is inefficient and leads to increased costs and burdens.

Moreover, under bank capital rules, banks are required to hold more capital for shorter maturity municipal revenue bonds than broker-dealers. Only when the maturity of the municipal revenue bond is greater than 7 years will the SEC's net capital rule require broker-dealers to hold more capital. Rarely do banks hold securities with maturities greater than 7 years. Therefore, as a practical matter, banks will hold more capital against municipal revenue securities than the SEC's net capital rules require of broker-dealers.

INCREASED FEDERAL RESERVE BOARD AUTHORITY

H.R. 1062 gives increased authority to both the Federal Reserve Board ("FRB") and the SEC. This grant of increased authority is entirely appropriate.

For example, under H.R. 1062, the SEC has now gained authority to regulate bank securities activities. Once the SEC determines that an instrument is a security under the federal securities laws and is not otherwise exempt that activity will generally become regulated by the SEC.

In recognition of the fact that there is a convergence between banking and securities products and that clear lines between the two cannot easily be drawn, the FRB, in interpreting the banking laws, can permit that activity to be conducted in the bank through a SIDD. This ability on the part of FRB does not, however, take away from the fact that H.R. 1062 gives the SEC increased jurisdiction over bank securities activities. Specifically, the SEC has jurisdiction over many bank securities activities, including most securities activities conducted in the bank through a SIDD.

[1] H.R. 1062 would redesignate bank holding companies as financial services holding companies or "FSHC".

[2] Banks service their state and local government customers in a number of different ways including offering treasury services to handle receivables and accounts payable, providing cash management accounts, lending money for equipment purchases and certain other purposes, providing financial advice and underwriting general obligation bonds.

Similarly appropriate is H.R. 1062's grant of additional authority to the FRB to adjust the statutory firewalls between banks and securities underwriting affiliates. Rigid, inflexible firewalls that are incapable of being adjusted as market circumstances and situations dictate, force banking organizations to comply with burdensome, outmoded and unnecessary laws. All of this adds cost to the products offered to the detriment of consumers.

CAPITAL ADEQUACY REQUIREMENTS

H.R. 1062 requires that before a banking organization may affiliate with a securities underwriting firm, it must be meet rigid capital standards. Specifically, before a bank holding company can acquire a securities affiliate: (1) the bank holding company's lead subsidiary insured depository institution must be well capitalized; (2) at least 80 percent of the aggregate total risk-weighted depository institution assets controlled by the bank holding company must be in depository institutions that are well-capitalized; (3) all subsidiary depository institutions controlled by the bank holding company must be well capitalized or adequately capitalized; and (4) the bank holding company itself must be adequately capitalized and must continue to be so immediately after the acquisition.

Alternatively, a bank holding company and its subsidiaries will be deemed to have met the legislation's capital requirements if all of its depository institutions are at least adequately capitalized after the acquisition of the securities affiliate and the holding company is well capitalized. Any bank holding company that chooses this latter option will be held liable for any FDIC losses, including any reasonably anticipated losses, associated with any of its depository institutions.

Furthermore, the securities affiliate must be separately capitalized. Consequently, in determining whether a bank holding company is adequately capitalized, the bank holding company cannot include the securities affiliate's assets and liabilities. In addition, certain deductions from the bank holding company's capital must be taken for equity investments in the securities affiliate as well as any extensions of credit to the securities affiliate.

If a bank holding company ceases to be in compliance with the legislation's capital requirements, then the securities affiliate must cease all securities underwriting and dealing activities. Exceptions are provided to allow underwriting of certain securities, including securities of registered mutual funds.

Collectively, these provisions are intended to ensure that any new securities activities permitted in the securities affiliate do not jeopardize the safety and soundness of affiliate depository institutions.

While the ABA supports the purposes sought to be served by these capital provisions and notes that H.R. 1062 follows the bank regulators capital adequacy requirements, these provisions are much stricter than any provisions required under GAAP and made applicable to other businesses, including unregulated non-bank financial services holding companies. Moreover, the ABA agrees that the requirement to cease underwriting and dealing when a bank holding company no longer satisfies the legislation's capital requirements should not apply to mutual funds. Mutual funds are in continuous underwriting and any requirement to cease underwriting would effectively cause the fund to cease operation, much to the detriment of that fund's investors. These same concerns are not presented with issues that only come to market on an infrequent basis.

FIREWALLS

The firewall provisions of H.R. 1062 are largely drawn from the current firewalls established by the FRB for Section 20 underwriting affiliates. These conditions were first articulated by the FRB in 1987. Since that time, the FRB has adjusted the firewalls to accommodate certain very specific circumstances as well as general market developments and to reflect the experience and comfort level attained by both the FRB and the industry in connection with bank affiliate underwritings.

As discussed above, the legislation would allow the FRB to exercise its discretion to adjust the firewalls as appropriate. That authority may be exercised if the FRB finds that its proposed action is consistent with the purposes of the Act, including the avoidance of any significant risk to the safety and soundness of the depository institution and the avoidance of conflicts of interest.

For example, one specific firewall would prohibit banks from issuing credit enhancements for securities being underwritten by the securities affiliate. Experience with this prohibition has revealed that safety and soundness concerns can be adequately addressed by permitting well-capitalized institutions, under certain specific circumstances, to issue credit enhancements. Consequently, H.R. 1062 would permit an exception for well-capitalized institutions. Moreover, any concerns about poten-

tial conflicts of interest between the well-capitalized bank and the securities affiliate have been addressed by requiring the transaction to be on an arm's length basis, *i.e.*, on terms and conditions substantially the same as those involving unaffiliated parties. Moreover, H.R. 1062 also would allow credit enhancement of bank eligible securities regardless of whether they were underwritten in the bank, a SIDD or a separate broker-dealer subsidiary or affiliate. The ABA supports these and other similar firewall exceptions as entirely appropriate.

INVESTMENT BANK HOLDING COMPANIES

H.R. 1062 would permit a new category of bank holding companies, known as investment bank holding companies ("IBHCs"). IBHCs will be allowed to acquire certain wholesale financial institutions or "WFIs". While a WFI will be defined as a bank and, thus, permitted to borrow at the FRB's discount window, it will not be allowed to accept insured deposits. WFI's will also be subject to higher capital requirements and transactions between a WFI and its affiliates will be subject to section 23A and 23B of the Federal Reserve Act. WFIs and their securities affiliates will not generally be subject to H.R. 1062's firewall provisions. Finally, under certain circumstances, IBHCs will be subject to a different supervisory structure than that applicable to bank holding companies.

The ABA supports the ability of bank holding companies with insured depository institutions to acquire a WFI. The ABA does not suggest that in acquiring a WFI, a bank holding company should be allowed to acquire certain firms not otherwise permitted to financial services holding companies.

Mr. STEARNS. Thank you, Mr. Jones.

Mr. Tassey.

STATEMENT OF JEFFREY TASSEY

Mr. TASSEY. Thank you, Mr. Chairman. My name is Jeff Tassey and I am presenting this testimony on behalf of the American Financial Services Association, AFSA. We appreciate this opportunity to express our views on H.R. 1062.

H.R. 1062 takes a constructive incremental step in loosening the barriers imposed by the Glass-Steagall Act between banking and securities activities. As we read the bill, the primary tier of benefits would flow to a relatively small number of larger wholesale banks and investment banks. These institutions would presumably enjoy greater economies of scale and a strengthened competitive position in global capital markets.

The Investment Bank Holding Company established in the bill, while not presently of direct interest to most AFSA members, provides a useful approach for dealing with deposit insurance concerns for certain activities, while providing some other benefits the present banking system confers upon its member banks. Where deposit insurance is not a factor, we see no reason to restrict affiliations. AFSA urges the exploration of what other kinds of uninsured institutions could be established that might meet various needs in our financial markets. We are currently reviewing a proposal for an uninsured, non-depository, market-funded lending institution that we hope to submit for consideration in the near future.

As H.R. 1062 stands, it places a number of limitations on the abilities of securities firms to own insured banks. Due to the fact that a substantial portion of the business of many securities firms involves activities such as insurance and merchant banking that are, with limited excepticns, proscribed under the bill. The solution to this is to broaden the financial nature tests contained in the bill to permit the financial services holding company to at least engage

in a full range of insurance activities, as well as enough commercial activities to cover merchant banking.

The affiliation issue is one of AFSA's primary concerns with H.R. 1062. We represent an extremely diverse group of lenders, primarily market funded, and accordingly subject to intense scrutiny and regulation by the markets. A great many of these entities have a wide range of functionally constrained affiliations with some type of federally insured institution. There has never been any evidence that any of these entities pose any systemic or deposit insurance risk as they go about their business of providing approximately 15 percent of all consumer credit.

At the very least, the true financial services holding company should also include insurance. It is difficult to argue that insurance is not financial in nature or incidental to such financial activities.

Beyond insurance, AFSA strongly supports the ability of commercial firms to own or otherwise affiliate with such a holding company. The prohibition on banking and commerce has always been shot through with exceptions. Thousands of individuals own banks who also own many and varied commercial interests, none of which are subject to the same holding company affiliation restrictions and oversight as banks owned by corporate entities. If it is harmful for banks and commercial entities owned in the corporate form to affiliate, then the same restrictions should apply to the thousands of wealthy individuals who freely mix banking and commercial enterprises.

The primary argument postulated against banking and commerce is that such a holding company form would result in large concentrations of economic resources. Such concentrations are far more likely to occur in small towns where, as described above, there is only one bank owned by an individual who also owns other major economic units, such as the local independent insurance agency, car dealer, feed store, et cetera.

Economic concentration, particularly in today's global market, is not just size, but sized in relation to the market in which the entity operates. A very large institution operating nationally and internationally is subject to competition at every size level, from the smallest independent bank to the largest Japanese bank.

In terms of risk to the bank and insurance fund from such a diversified structure, the experience with life insurance holding companies is instructive as discussed on page 8 of our written statement.

In addition to AFSA's affiliation concerns, the more general concern we have is that the bill does not do enough to bring market discipline to the insured portion of the industry, nor does it address the overriding issue of excessive deposit insurance. In the 1980's, numerous banks and thrifts continued to operate even though their market ratings were well below investment grade. In contrast, if the markets lose confidence in a market funded lender, it may no longer have the ability to fund its activities and grow. It must shrink and ultimately may be forced to close in short order.

Second, the market typically requires that the market funded lenders hold more capital relative to assets than banks. Appendix 5 of our written statement is a recently released chart showing that a representative sampling of finance companies had average

equity to assets almost double that of a representative sampling of banks.

As discussed in our written testimony, it is the sensitivity to financial condition of both the commercial parent and financial subsidiary, combined with the ability of the market to act quickly, without discretion, that makes market regulation so effective and gives lie to so many of the arguments against affiliations with insured institutions. In a modernized structure with separately capitalized affiliates, most of which would be market regulated, it is difficult to see the risk to the insured institution, especially if combined with a capital downstreaming mechanism.

In conclusion, AFSA strongly supports the modernization process, even though it is presently much more limited in scope than we feel is necessary. No financial modernization proposal of any magnitude has passed the House, primarily because of turf fights between various parts of the industry. One of the most intractable issues has involved the banks and the insurance agents as to who can sell insurance under what conditions.

Mr. STEARNS. Just, if you would summarize.

Mr. TASSEY. I just have another few lines.

Mr. STEARNS. Absolutely. Go ahead.

Mr. TASSEY. I apologize.

While this issue is not a specific concern to AFSA, our primary concern is the ability of insurance companies to affiliate with insured institutions. It is of great concern because of the impact it has had on the process.

As Mr. Bliley has just told us, the committee has worked assiduously on this issue and we would like to make a brief observation based on past an experience.

Achieving a compromise, even with more time, that both the banks and the agents will both endorse is highly unlikely and the best that can be hoped for is that a balanced approach can be crafted that takes away most of the plausible arguments on both sides and that the political will exists to force both sides to accept that compromise in committee and on the Floor of the House. We strongly support the efforts of the committee.

Thank you.

[The prepared statement of Jeffrey Tassey follows:]

PREPARED STATEMENT OF JEFFREY TASSEY, SENIOR VICE PRESIDENT, AMERICAN FINANCIAL SERVICES ASSOCIATION

The American Financial Services Association appreciates this opportunity to express our views on H.R. 1062, the "Financial Services Competitiveness Act of 1995."

The American Financial Services Association (AFSA) is the trade association for a wide variety of non-traditional, market-funded providers of financial services to consumers and small businesses. As adopted by our members, the mission of AFSA "is to assure a strong and healthy broad-based consumer lending services industry which is committed to (1) providing the public with a quality and cost effective service, (2) promoting a financial system that enhances competitiveness and (3) supporting the responsible delivery and use of credit and credit related products."

AFSA's members fit into four basic categories:

- Diversified Financial Services Companies—These are companies that offer a broad range of financial services and products to consumers nationwide. Many of these members are affiliated with banks or savings and loans.
- Automotive Finance Companies—These companies are frequently referred to as "captive finance companies." They provide financing for customers that purchase the manufacturer's products. In addition, many of the companies or their

parents have branched out into a range of other financial services, such as credit cards or mortgage lending.

- Consumer Finance Companies—The core business of this membership segment includes: unsecured personal loans, home equity loans, and sales financing (for retailers' credit customers). This segment includes companies of all sizes.
- Credit card issuers—This membership segment offers bank cards, charge cards, credit cards or private label cards. AFSA members include some of the largest credit card issuers in the U.S.

Some consumer finance companies are owned by, own, or are affiliated with depository institutions, such as savings & loans, consumer banks (limited-purpose banks), or credit card banks. These institutions are fully regulated institutions, subject to all of the laws and regulations applying to banking institutions, including the Community Reinvestment Act and the Home Mortgage Disclosure Act. They are regularly examined by state and federal banking authorities.

In addition, each of these consumer lenders must comply with federal regulations relating to consumer credit—the Equal Credit Opportunity Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, the Consumer Leasing Act, the Fair Credit Billing Act, the Fair Credit Reporting Act, and the Federal Trade Commission's Credit Practices Rule are among the most important.

Consumer lenders which are not depository institutions, are generally licensed and regulated by the state banking department or the department of corporations in every state in which they operate, often separately regulated for each product. They are subject to state laws governing the rates they can charge on consumer loans, as well as state consumer protection laws.

As the above demonstrates, AFSA members are important sources of credit to the American consumer, providing between 10 and 15 percent of all consumer credit. AFSA members are highly innovative and compete at all levels in the financial services markets. Our members have charged AFSA with promoting a free and open financial services market that rewards the highest level of competitiveness.

SUMMARY OF AFSA'S POSITION

H.R. 1062 takes a constructive first step in the process of making changes to our highly balkanized financial services structure, although its scope is primarily limited to the area of bank and securities activities and the removal of barriers between the two imposed by the Glass Steagall Act. AFSA would like to see H.R. 1062 take a more comprehensive approach to rationalizing and modernizing our financial laws, ideally the authorization of affiliations between insured institutions and insurance entities as well as firms engaged in other types of commerce. We feel that these affiliations can safely take place among separately capitalized affiliates in a functionally regulated holding company structure.

At a minimum, AFSA strongly feels that the "two way street" contained in H.R. 1062 should be widened as it relates to securities and insurance firms. As it stands, the bill provides a number of limitations on the abilities of securities firms to own insured banks, due to the fact that a substantial portion of the business of many securities firms involve activities, such as insurance and merchant banking, that are, with limited exceptions, proscribed under the bill. The solution to this is to broaden the "financial in nature" test contained in section 121 of the bill to permit the financial services holding company to at least engage in a full range of insurance activities.

In the committee's invitation to testify, comment was requested on a number of technical securities issues. These issues are by and large not of specific concern to AFSA members. We would only note that our members presently conduct their specific financial activities in separately capitalized affiliates, and that is unlikely to change. Additionally, we have always supported functional regulation.

H.R. 1062 contains an optional "Investment Bank Holding Company," a type of uninsured wholesale institution, which while not presently of direct interest to most AFSA members, provides a useful approach for dealing with deposit insurance concerns for certain activities while providing some benefits the present banking system confers upon its member banks. AFSA urges the committee to explore what other kinds of uninsured institutions could be established that might meet various needs in our financial markets. We are currently reviewing a proposal for an uninsured, non depository, market funded lending institution that we hope to submit for consideration in the near future.

AFSA strongly supports the modernization process, even though it is much more limited in scope than we feel is necessary. No financial modernization proposal of any magnitude has passed the house, primarily because of turf fights between various parts of the industry. One of the most intractable issues has involved the banks

and the insurance agents as to who can sell insurance under what conditions. While this issue is not of specific concern to AFSA—our primary concern is the ability of insurance companies to affiliate with insured institutions—it is of great concern because of its ability to stop the process. We know that the committee is working assiduously on this issue and would like to make an observation based on past experience.

Achieving a compromise that both the banks and the agents will endorse is highly unlikely. The best that can be hoped for is that a balanced approach can be crafted that takes away most of the plausible arguments on both sides and that the political will exists to force both sides to accept that compromise in committee and on the floor of the house. otherwise, this bill will meet the fate of its predecessors and that serves no public purpose. We strongly support the efforts of the committee to develop a legislative solution and urge you to move forward.

H.R. 1062 "THE FINANCIAL SERVICES COMPETITIVENESS ACT OF 1995"

H.R. 1062 constitutes a change of some magnitude in holding company activities and regulation. The bill establishes a "Financial Services Holding Company" ("holding company") and permits the holding company to have securities affiliates engaged in a full range of securities and investment advisory activities. In addition, the bill permits the establishment of an "Investment Bank Holding Company" that may control a "Wholesale Financial Institution," and a firm engaged in a full range of securities and investment advisory activities. The bill also amends Section 4(c)(8) of the Bank Holding Company Act to permit the holding company to engage in activities which are "financial in nature or incidental to such financial activities." With certain exceptions, this does not include insurance activities.

In addition to the above activities reforms, the bill also makes some reforms to the regulatory process. The bill basically replaces the current Federal Reserve application process with a notice process with reference to safety and soundness constraints.

COMMENTS ON H.R. 1062

The American Financial Services Association appreciates and acknowledges the reforms made by H.R. 1062. It is a step forward and we understand that a great many political and jurisdictional considerations were involved in the policy choices that were made. As we read the bill, the primary tier of benefits would flow to a limited number of larger wholesale banks and to a lesser extent, investment banks. These institutions would presumably enjoy greater economies of scale and a strengthened competitive position in global capital markets. To the extent that this lowers the overall cost of capital, it should benefit already competitive, efficient market funded and regulated lenders, such as those represented by AFSA, by lowering their cost of funding. Other than lowering funding costs, it does nothing to make highly regulated and inefficient insured institutions more efficient and competitive.

The bill would also benefit institutions without commercial and substantial insurance affiliations who wish to become a financial services holding company. While the bill retains the Federal Reserve as the holding company regulator, the bill's intent is to provide a notice procedure as opposed to the current application procedure so that these entities may function somewhat more like normal businesses. The bill takes steps in that direction although a number of issues remain. While H.R. 1062 changes the regulatory process, the culture of the regulator is another matter; the Federal Reserve is a bank regulator and has viewed any non-traditional affiliations or activities more critically. As one witness testified before the committee on banking, the Federal Reserve needs to become a "financial services" regulator, and that will be a difficult transition for them to make.

The Investment Bank Holding Company established in the bill, while not presently of direct interest to most AFSA members, provides a useful approach for dealing with deposit insurance concerns for certain activities while providing some other benefits the present banking system confers upon its member banks. Where deposit insurance is not a factor, there is no reason to restrict affiliations. AFSA would urge the committee to explore what other kinds of uninsured institutions could be established that might meet various needs in our financial markets. We are currently reviewing a proposal for an uninsured, non depository, market funded lending institution that we hope to submit for the subcommittee's consideration in the near future.

AFFILIATIONS—INSURANCE AND NONFINANCIAL COMMERCE

The affiliation issue is at the root of one of AFSA's primary concerns with H.R. 1062. As indicated at the beginning of the testimony, AFSA represents an extremely

diverse group of lenders, primarily market funded and accordingly subject to intense scrutiny and regulation by the markets. A great many of these entities have a wide range of affiliations with some type of federally insured institution. Virtually all of these affiliations have been in existence for some time with varying degrees of anti-competitive functional constraints imposed by federal law and regulation. There has never been any evidence that any of these entities pose any systemic or deposit insurance risk as they go about their business of providing approximately 15 percent of all consumer credit.

At the very least, a true financial services holding company should include insurance—it is difficult to argue that insurance is not "financial in nature or incidental to such financial activities."

Beyond insurance, AFSA strongly supports the ability of commercial firms to own or otherwise affiliate with such a holding company. The issue of mixing banking and non-financial commerce has become an overblown theological issue when it really is at most a competitive inequity susceptible of legislative solution. The prohibition on banking and commerce has always been shot through with exceptions—especially at the small bank level—and none of these exceptions—at least at the level of significant publicly owned corporations—have given rise to any problems, let alone problems that would justify the federal prohibition. Thousands of individuals own banks—large and small—who also own many and varied commercial interests, none of which are subject to the same holding company affiliation restrictions and oversight as banks owned by corporate entities. It is difficult to understand why individuals should not be subject to the same banking and commerce restrictions as corporate owners, if the proximity of banking and commerce truly is a mortal threat to the banking system. If it is harmful for bank and commercial entities owned in the commercial form to affiliate, *and AFSA does not think that it is,* then the same restrictions should apply to the thousands of wealthy individuals who freely mix banking and commercial enterprises.

The primary argument postulated against banking and commerce is that such a holding company form would result in large concentrations of economic resources, in addition to having the potential for conflicts of interest between the bank and the non-bank entities that would pose undue risk to the bank and the federal deposit insurance funds.

AFSA believes that this argument has little merit, especially in the context of the global marketplace in which our financial services industry now competes.

Concentrations of economic resources are far more likely to occur in small towns where, as described above there is only one bank owned by an individual who also owns other major economic units such as the local independent insurance agency, car dealer, feed store, etc. Economic concentration, particularly in today's global market, is not just size but *size in relation to the market in which the entity operates.* A very large institution, operating nationally and internationally, is subject to competition at every size level, from the smallest independent bank to the largest Japanese bank.

Size alone should not be an indicator of concentration and should not determine holding company activity restrictions. Size in a domestic market is a problem only if that market is protected from competition or if market forces are otherwise weak. The types of domestic financial institutions permitted by H.R. 1062 will probably, in general, be much larger than any heretofore able to exist. In today's global financial services market, larger institutions are a necessity. While AFSA feels that this H.R. 1062's limited approach will be beneficial to our international competitiveness, we don't feel that the benefits of modernization should stop at this point.

In terms of risk to the bank and insurance fund from such a diversified structure, the experience with life insurance holding companies is instructive. In its 1988 report, *Modernization of the Financial Services Industry: A Plan For Capital Mobility Within A Framework of Safe and Sound Banking,* the Committee on Government Operations of the U.S. House of Representatives found that:

> A close parallel exists between the temptations a financial services holding company would face to draw on the resources of its bank subsidiaries in a time of difficulty and the similar temptations that face the managements of existing life insurance holding companies under similar circumstances. Life insurance companies resemble banks in the sense that they are closely regulated for safety and soundness, and their obligations to policy beneficiaries are protected by a form of State-supervised insurance. There is thus the obvious danger that a holding company, one of whose other subsidiaries is having financial difficulties may try to obtain additional funding for the troubled affiliate from the resources of the insurance company.

> This potential threat to the resources of these insured institutions has not, however, prevented the formation of life insurance holding companies combining within the same corporation, major life insurers, major securities firms, major mutual fund organizations, and other substantial financial and nonfinancial operating companies.... To accommodate this movement toward holding company formations, a pattern of State regulation of the affairs of the life insurance companies and their interaffiliate dealings has been established that seeks to insulate the life insurers and without imposing substantive operating restraints on the affiliated companies or the parent holding company.
>
> ... The Committee finds, therefore, that the State regulatory experience with life insurance holding companies, in which the insurance companies are protected from abuse without destroying the apparent synergies and incentives for holding company affiliations, lends substantial support to the committee's conclusion that effective insulation of banks can be made fully compatible with the fundamental objectives of financial services holding companies. (H.R. REP. No. 100-324., 100th Congress, 1st Sess., 43-44, (1987)).

AFSA feels that the experience of the states with life insurance holding companies is instructive and urges the committee to take a close look at this model. we strongly urge the Committee to seriously explore the expansion of affiliations within a holding company structure.

THE PRESENT FINANCIAL SERVICES REGULATORY SYSTEM

AFSA's expertise is primarily in the area of consumer lending, but from that vantage point, we would like to make some general observations as to how our financial services markets have evolved to their present state.

Our present financial services system is strictly regulated as regards the banking component. Banking, at least in theory, is tightly compartmentalized from other types of financial and nonfinancial business. The objective of this intensely regulated structure is to control the risk exposure of individual banks so as to protect their safety and soundness, thereby, at least in theory, maximizing the stability of the whole system.

The stability of the system is also substantially predicated on government sponsored deposit insurance. which provides an additional reason for regulatory barriers and tight risk standards. The depression era Glass-Steagall [1] act and the Bank Holding Company Act are the two statutory components of the risk control structure. The ultimate consequence of these statutory barriers is that almost no corporations other than existing banks or bank holding companies are permitted to purchase a bank or start a new bank. Existing banks are therefore protected from competition with other business corporations. This barrier against corporate entry is designed to reduce specific risks by screening out potential competition.

This comfortable structure began to be rocked by revolutions in financial markets resulting in the bypassing of the banks traditional credit role through the use of securities and commercial paper markets to borrow directly from investors. Additionally, the securitization of assets [2] such as loans also worked to change the functional role of banks, which through Glass-Steagall were excluded from participation in these activities.

The Glass-Steagall and Bank Holding Company Act compartments have always had exceptions and the changes discussed above increased the erosion of the Glass-Steagall barriers. Additionally, a small number of grandfathered diversified lenders are not covered by Glass-Steagall and the Bank Holding Company Act although they suffer under significant growth limits and other restrictions imposed by the Competitive Equality Banking Act of 1987.[3] Some grandfathered foreign banks also conduct a wide range of activities. In other words, the securities, nonfinancial commerce and banking compartments have both been breached, but not in any organized or rational manner. Furthermore, the so-called diversifieds have breached the commercial compartment. Again, many of the grandfathered foreign banks also have commercial operations.

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[1] Please see appendix one for a summary of one scholar's analysis of the causes of the depression vis a vis banking and commerce and Glass Steagall.

[2] Please see appendix two for charts illustrating the role of "Pools" of securitized assets in consumer lending.

[3] Please see appendix three for a discussion of the Competitive Equality Banking Act.

The practical impact of this compartmentalization is to severely restrict capital mobility.[4]

The capital resources of financial corporations have two main components—financial capital and organizational capital. Financial capital is usually easily transferable. Overall, our financial markets work well in transferring financial capital from one area of business to another.

If this were the only form of capital of concern in the financial services industry, then we would not have a capital mobility problem.

However, there is also the less tangible but equally vital concept of organizational capital. There is no way to represent this "going concern" value on the balance sheets, but there is no doubt that this is a major factor in the value assigned to publicly held corporations in the equity markets.[5]

When an industry incurs a narrowing of the profit opportunities available to it, such that new capital could earn a better return elsewhere and profitability on existing capital investment is below average, then most businessmen and investors try to shift at least some of their capital into other, more profitable lines of business.

When the capital cannot be shifted, competition becomes more intense, profit declines and less successful firms suffer losses with the result that the value of capital invested in that industry is reduced. there is little doubt that Glass Steagall and the Bank Holding Company Act combined with our whole system of regulation constitute significant barriers to capital mobility and have greatly contributed to the problems in the banking industry over the past decade.

The best example of this concept had its beginning in the 1970's when the commercial paper market grew rapidly, attracting corporate customers whose borrowings had been a major source of stable earnings for the banks. The commercial paper market in turn was made possible by the advent of uninsured money market mutual funds. Banks could neither participate in the commercial paper market, nor could they offer money market mutual funds.

The result was that they were forced to replace safe corporate loans that paid a good return with much riskier loans that paid a higher return. We know how this worked out. In 1991 this committee was forced to both recapitalize the bank insurance fund and to impose even stricter safety and soundness regulations on insured institutions.

If our system had provided for an orderly exit[6] of organizational capital at that time, banks would have been able to follow their customers to the commercial paper market and at least some of the problems banking encountered would have been avoided. Capital is not a one way street—once it gets into a particular sector, it must also be able to exit in an orderly manner.

H.R. 1062 addresses to some extent the specific problem outlined above in terms of permitting banks to be involved in the underwriting of products such as commercial paper while also allowing to varying degrees, banks to be involved in securities activities.

The question is whether to stop at this point, or permit additional affiliations between insurance companies, commercial firms and banks. Neither bill addresses the overriding question of deposit insurance which is the primary reason financial modernization is a federal legislative issue to begin with.

The problem with stopping at this point is that the system remains compartmentalized; one of the compartments has been enlarged, but there are still legal and regulatory barriers to full capital mobility. no one envisioned or predicted the advent of the commercial paper market; who is to say that the next major advance in financial products will not come from the insurance industry or from a completely nonfinancial lender. it is virtually impossible to legislate ahead of the market. where there is federal regulation substituted for market discipline, serious distortions in economic behavior will occur.

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[4] *Modernization of the U.S. Financial Services Industry: A Plan for Capital Mobility within a Framework of Safe and Sound Banking,* H.R. REP. No. 100-324., 100th Congress, 1st Sess., 43-44, (1987)

[5] *Id.*

[6] For a discussion of an effective exit mechanism, please see appendix four regarding the commercial paper market's exit mechanism.

REGULATION OF MARKET FUNDED LENDERS THROUGH THE COMMERCIAL PAPER MARKETS

Fundamental Characteristics of Market Funded Lenders

A review of the commercial paper market[7] and the finance industry may help illustrate the point that it is necessary to remove all barriers to capital mobility and that these affiliations not only are not a systemic risk, but actually contribute to safety and soundness.

The fundamental difference between market funded lenders and banks is the nexus of their relationship with local communities. Banks' relationships with local communities emanates from their deposit base. Market funded lenders enter local communities through their lending activities, funded by the capital markets.

In the typical banking model, a bank generates funding for its lending activities from deposits gathered in by local offices. It then lends these funds locally or, if local demand is not sufficient or the bank elects to focus outside the community, the bank lends in other markets, buys securities, or places the funds in the federal funds markets (i.e., lends to other banks throughout the nation).

Clearly, there are exceptions to this pattern, especially among larger, wholesale oriented banks.[8] Nevertheless, in the context of consumer lending, this model gives a good picture of the funding and lending dynamics.

The model for the typical market funded consumer lender is, in a sense, opposite. These companies raise their funds in global capital markets by issuing commercial paper and medium and long term debt. To reduce their cost, their commercial paper is often backed by bank back-up lines of credit, the same way that non-financial corporations rely on bank back-up lines of credit to enhance their credit ratings; this is really the only way banks can participate in the commercial paper market.

As in the case of the banks, there are exceptions to this model, but again, it is a good representation of the funding and lending dynamics.

What these models show, very simply, is that banks generate funds locally, largely from consumers and small businesses, to lend inside or outside the local market, while market funded lenders raise funds worldwide to lend into local consumer and small business markets. This fundamental difference between the two groups is the basis for many of the institutional distinctions between them.

Market Oversight

The performance of publicly traded banks, thrifts, and market funded lenders is followed closely by the capital markets. Their debt securities are rated by the rating agencies such as Moody's, Standard and Poor, and Fitch. However, there is a key difference between depository institutions and market funded lenders. If the markets lose confidence in a bank or thrift, the institution can still operate by raising deposit funds. In the 1980's, numerous banks and thrifts continued to operate even though their market ratings were well below investment grade. In contrast, *if the markets lose confidence in a market funded lender, it may no longer have the ability to fund its activities and to grow—it must shrink and ultimately may be forced to close.*

Because the maturity of commercial paper is so short, 270 days or less, issuers usually expect to roll it over at maturity rather than pay it off. However, to obtain a higher rating for their debt by providing additional insurance that they have liquid funds available in the event that conditions change and they must repay their paper, the issuers obtain back-up lines of credit for a fee from banks, although this practice is decreasing. It is important to note that the actual risk of loss to banks is extremely low. Their role is to be ready to provide liquidity, but in most back-up arrangements they can restructure the debt to secure their interest to should the issuer face financial difficulties. Even that is unlikely, since only high grade corporations are accepted commercial paper issuers. In particular, the finance company issuers have high levels of capital which protect the banks against potential losses. Further, many finance company obligations are guaranteed by strong parent companies. Commercial paper defaults have been extremely rare, as have failures of finance companies.

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[7] Commercial paper is an important source of funding for market-funded lenders. Commercial paper is short-term, unsecured debt sold by corporations with good credit ratings. Commercial paper is generally issued to large investors. All types of corporations issue commercial paper, including manufacturers, transportation companies, banks, and finance companies.

[8] One exception to this model is funding by securitizing assets. In this process, the institution pools receivables and sells them as a security to investors, thereby raising new funds. This type of funding is becoming increasingly popular with all lenders, including banks. To the extent that this reduces the importance of deposit funding, it means that banks are becoming more like the market funded lenders, not vice versa.

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The Westinghouse Credit Corporation is a good example of how the market resolved a potential problem. As a result of large loan write offs in the early 1990s, Westinghouse Credit experienced large losses. The company lost its credit rating and could no longer issue commercial paper; the credit rating of the parent company was impaired and it was forced to downstream capital to the finance company. The company drew down its lines of credit at about 50 foreign and domestic banks. These lines were restructured into secured lines. The liquidation was orderly and quick without crisis. Throughout the process, the parent, Westinghouse Electric stood behind the debt of its subsidiary.

As the Westinghouse example illustrates, it is absolutely critical to market funded lenders that they be well regarded by the market. It is in that sense that the market regulates their financial viability and this regulation of safety and soundness is swift, with no excuses.

The Westinghouse example is one where the subsidiary impaired the parent and the subsidiary was forced to shrink and close. However, market discipline works in the opposite direction as well. There have been several instances where the manufacturing parent of the finance company encountered financial difficulty and received an impaired credit rating. Even though the subsidiary finance companies were doing extremely well, they were forced to shrink significantly. The Federal Reserve has been trying to implement a similar "source of strength" doctrine for banks and the bank holding company for some time. The market is considerably ahead of it, even with all of the bank regulatory improvements that have been made since 1989.

Not mentioned in the above discussion on commercial paper's impact on bank lending is the most interesting part—the fact that consumer and commercial finance companies are the largest issuers of commercial paper with over $392 billion outstanding as of year end 1993 and that these proceeds from the market are used to fund lending. Who are the finance companies, what kind of lending is being funded and why aren't banks doing it?

The modern finance industry consists of a varied group of market funded financial institutions. Ownership is especially diverse, including: industrial and other nonfinancial companies, banks, non bank financial companies as well as independent finance companies. Many companies engage in both commercial and consumer finance. In 1990 the combined assets of the twenty largest firms totaled $426 billion or 82 percent of the industry's overall assets. Of the top twenty companies, twelve do both commercial and consumer finance.

In virtually all cases, finance companies carry significantly heavier capital burdens and do not have deposit insurance.[9] In 1990, capital ratios for the top 20 companies ranged from a low of 8.4 percent to a high of 27.7 percent. Capitalization for finance companies is at least partially dependent upon asset quality and size.

Finance companies traditionally concentrate on loans secured by tangible assets and have the greatest success in niche markets where they are well established and have specialized expertise, whether it is in commercial aircraft leasing or second mortgage lending to consumers.

This is why finance companies are generally not in head to head competition with banks, but instead compete by offering services that substitute for bank credit in markets not served by banks. Banks are not prohibited from engaging in any of these types of lending but they choose not to do so, substantially in part because they are federally insured institutions with a regulatory environment that tries to protect the deposit insurance funds by tightly controlling risks, and hence controlling types of lending.

This is as true for an activity such as equipment leasing as it is for second mortgage loans to individuals. These specialized niche markets place a premium or specialized information and practical experience which place new lenders at a disadvantage short of acquiring a finance company engaged in a particular niche. For an insured institution it is particularly difficult to overcome this lack of knowledge and experience. Federal bank examiners will not tolerate the rate of losses and attendant demands on capital that it frequently takes to enter one of these niche markets. Additionally, once in the market, lenders are still exposed to higher risks than regulators of insured depository institutions would deem prudent, especially in light of congressional pressured in recent years.

To summarize the situation, on the one hand, the banks have lost a substantial amount of commercial lending to the commercial paper market while on the other hand, participants in the commercial paper market are using the proceeds that they obtain from the sale of commercial paper to fund lending that banks are not prohibited from doing, but choose not to do, largely because of their regulatory culture.

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[9] See appendix five for representative finance company levels vis a vis those of banks.

In other words, on one side there is a structural impediment to bank activities, while on the other side there is a cultural and regulatory impediment to such lending. Banks don't have to lend; they can simply invest their insured deposits in treasury bills and are even rewarded for doing so by risk based capital standards.

Finance companies have to lend; otherwise, they cannot provide the rate of return that the commercial markets require. A finance company that is not lending is forced to shrink, to increase its capital and to pay more for funds. Moreover, finance companies carry out this lending with a high degree of safety and soundness despite having affiliations with commercial firms and insurance companies.

AFSA believes that its members, who again are primarily market funded, and who have a wide range of affiliations, offer an excellent illustration of the effectiveness of market regulation for the commercial ownership of financial institutions. AFSA regrets that the debate on financial modernization has not yet focused on both the issue of how more market regulation can be injected into the federally insured part of the financial system, and on who should close weak or failing insured institutions—the markets or the regulators.

AFSA believes that the experience of financial institutions funded in the commercial paper market provides a blueprint for increased competition and availability of financial products. It also provides a rapid, highly effective discipline of unsound risk-taking combined with an exit mechanism for weak or failing institutions that only impacts shareholders and management without significant systemic risk.

FAILURE RESOLUTION

The fundamental difference between banks and market funded consumer lenders explains the dramatic difference in incidence and resolution of failures of the two groups of institutions. Banks are funded primarily through deposits. As the experience of the 1980s clearly illustrates, banks can continue to maintain and even increase insured deposits while the quality of their assets is severely deteriorating.

The S&L debacle gave an even clearer picture of how insured depository institutions can grow despite severe asset quality problems. At some point, the bank's liabilities may even exceed the true value of its assets. When this occurs, or hopefully somewhat sooner, the regulators must close or merge the bank. The regulators' goal is to protect the deposit insurance fund from losses. That requires that their primary focus be on ensuring the safety and soundness of the banks to avoid their failure and potential losses to the insurance fund. If the bank's assets are not sufficient to cover the insured deposits, the difference must be made by the FDIC's bank insurance fund. Insured depositors funds must be protected, by law.

In contrast, the failure of a market funded lender is borne solely by its shareholders and debt holders. Neither its customers, nor the government, nor the tax payers are directly affected.

Second, the market typically requires that the market funded lenders hold more capital relative to assets than banks. As of year end 1993, the medial ratio of equity to assets for bank holding companies with assets of $10 billion or above was 7.95%. The median for the largest 20 publicly held finance companies (ranked by total capital) in 1993 was 11.97%. Attached is a recently released chart showing that a representative sampling of finance companies had average equity to assets almost double that of a representative sampling of banks.[10]

Importance of the Corporate Parent

A finance company's credit rating depends not so much on its own capitalization as on the existence of a parent and the perceived capital strength of that parent. Some of the strongest parents are commercial or industrial firms. Financial ties to such parents often help raise a finance company's credit ratings and thus lower its borrowing costs, a benefit of ownership that is not institutionally available to commercial banks.

By assigning the credit ratings, the rating agencies in effect set capital adequacy guidelines for finance companies. In these guidelines, the agencies take important account of the parents' strength and the financial ties between parents and subsidiaries. When the parent is rated higher than the finance company, rating agencies look for mechanisms that protect the subsidiary in the event of parent stress.

These mechanisms may include attorney's letters and debt covenants limiting the capital a parent may take out of a subsidiary. On average, a subsidiary receives a somewhat higher rating than its parent because the financial ties are designed to enhance the finance company's rating rather than its parent's.

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[10] Please see appendix five.

IMPLICATIONS OF MARKET REGULATION FOR FINANCIAL MODERNIZATION

As is demonstrated by the above, it is the sensitivity to the financial condition of both the parent and financial subsidiary combined with the ability of the market to act quickly, without discretion, that makes market regulation so effective and gives lie to so many of the doomsday scenarios when an insured institution is thrown into the mix. In a financial services structure comprised of separately capitalized affiliates, most of whom are market regulated, it is difficult to see the risk to the insured institution, especially when combined with the bill's "capital bear down" provisions. The rating agencies and markets are going to be well aware of the liability of the holding company and its uninsured affiliates to the insured institution; this will be reflected in the capital ratios and debt ratings for the market funded firms in the holding company and the reaction of the market to any problems in any of the affiliates, particularly the insured affiliate as the market will know that the liability to the insured affiliate is virtually unlimited while the liability of the insured affiliate to the others is nonexistent.

The goal of any financial modernization should be to squeeze excess deposit insurance out of the system and to replace to the extent possible government regulation with the market discipline. To the extent that certain functions must be conducted in insured institutions, ownership of these institutions should not be restricted.

The other reason deposit insurance must be substantially addressed is because it has provided the nexus for a whole host of regulation that has nothing to do with safety and soundness, but instead is designed to fund a host of social programs. As budget funds for new programs are very scarce and almost no old programs are cut, many interest groups are searching for private income streams that can be nationalized for social purposes. Deposit insurance has provided the basis for all of these. It is important to take advantage of the opportunity the Committee has before it to reduce to the maximum extent this exposure.

CONCLUSION

AFSA would like to see the removal of all barriers to competition and the free flow of capital combined with intensive market regulation of financial services activities. It is important to take this opportunity to end the substitution of regulation for private capital in insured financial institutions and to remove excess deposit insurance from the system. Some limited form of deposit insurance is useful to protect certain vulnerable classes of individuals and for systemic reasons, but there is no question that there is too much deposit insurance today. Thank you again for this opportunity to express our views.

APPENDIX 1

Banking and Commerce, The Depression and Glass Steagall

I. INTRODUCTION

During any discussion of banking and commerce, there will undoubtedly be references to the Depression and the point will be made in various ways that those who don't learn from history are doomed to repeat it. This is undoubtedly true, but it is not clear what lessons we are supposed to have learned that would justify a continuation of the barriers separating banking and commerce as a policy response to the problems facing our banking industry and economy today.

The policies that many would leave in place were not a correct long term response to the events of the Depression, nor will they solve the problems facing our financial system today. A review of the events and mistaken assumptions of the period illustrates this point.

II. BANKS AND SECURITIES ACTIVITIES PRIOR TO THE CRASH

During World War I, the government issued huge quantities of Liberty Bonds and utilized banks to sell these war bonds to the public at war's end, the banks applied the experience gained in marketing these securities to other types of bonds. They were motivated to do this because of a sharp drop off in income from commercial loans. The modern corporations emerging during this period preferred to obtain their financing from retained earnings and stock issues as opposed to loans. This is very similar to the situation of modern banks in the late 1970's when corporations switched to the commercial paper market.

By 1930, 126 national banks provided full brokerage and investment banking services, with a greater number acting as brokers. Banks competed successfully as

the combination of related services they offered provided economies of scope that allowed lower prices. The vast majority of the securities they offered were investment grade securities carrying a rating by Moody's or a similar agency.

After World War I, the U.S. became a creditor nation and was the primary lender to Latin America, which was experiencing strong growth and demand for its products, making them particularly creditworthy. Analogies to the LDC loans of the 1970's can be made if desired.

By 1930, all of these investments, regardless of who sold them, looked awful on an ex poste facto basis. The magnitude of losses exceeded anything ever experienced.

III. THE ROLE OF BANKS IN THE STOCK MARKET CRASH OF 1929

Banks, in their efforts to follow their customers and remain the leading intermediaries between the public and corporations were both the newest entrants to these markets and the most visible of financial intermediaries. Accordingly, they received the bulk of the blame. Banks were blamed for (1) promoting unsound securities, (2) creating the stock market boom through offering an increased quantity of broker's loans and (3) securities affiliates were blamed for weakening the parent banks, allowing their failure during banking panics.

Taking these three accusations in order, claims that banks promoted unsound securities have never been corroborated with statistical or other evidence nor was any evidence offered that the vast majority of securities sold were anything but prudent investments at the time. Post Depression, after the world economies had collapsed, almost anything looked like an incredibly stupid investment, so this was an easy case to make.

The accusation that banks helped create the stock market boom by making excessive brokers loans is equally untenable. The stock market boom of the 1920's, just like the boom that lasted until 1987, and the present boom, was an autonomous event resulting from economic growth. In the corporate sector, banks and their securities affiliates, as well as the securities industry as a whole, responded to the demands of this growth, but in no way did they cause it.

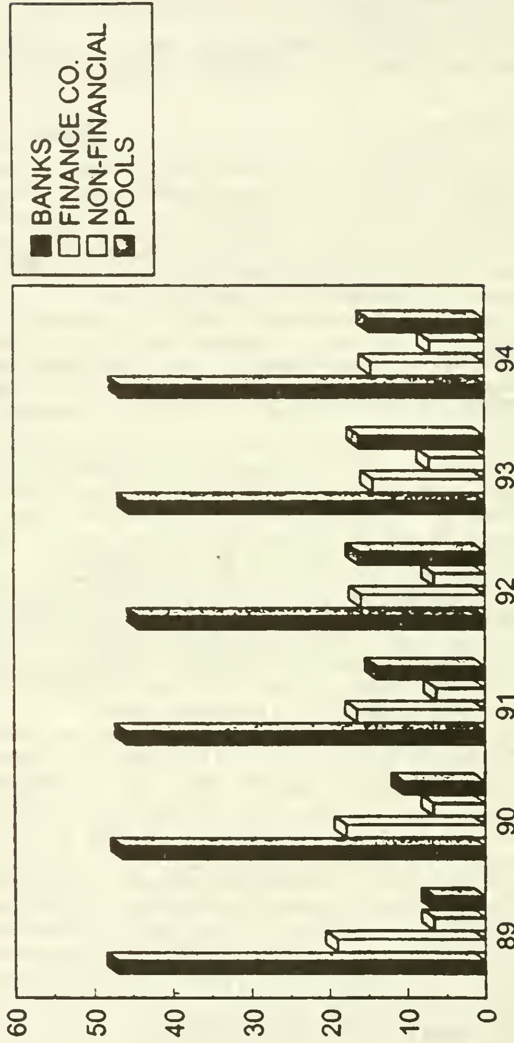
Finally, in terms of bank securities affiliates under the parent banks, subsequent studies have indicated that the size of securities operations for a bank had no effects on its liquidity or solvency, and that relatively few banks with affiliates failed as compared to those that did not have affiliates. Banks with affiliates during this time tended to be larger and better diversified. Commercial banking earnings tended to vary inversely with earnings from investment banking, so during this period, the affiliates may have actually had a stabilizing effect.

If banking and commerce didn't cause the depression, what did? As we know, periods of growth are followed by periods of correction of recession, which while unpleasant, are rarely fatal. As the twenties neared an end, the economy began going into a recession. The Federal Reserve, in what can only be described as an appalling error, adopted a monetary policy that allowed both a sudden and severe contraction in the money supply, which is frequently described as "failing to provide liquidity to the markets". This sharply reduced demand for foreign goods and brought about a collapse in stock prices. This brought about a chain reaction in the world economies which was worsened by equally erroneous tax and trade policies.

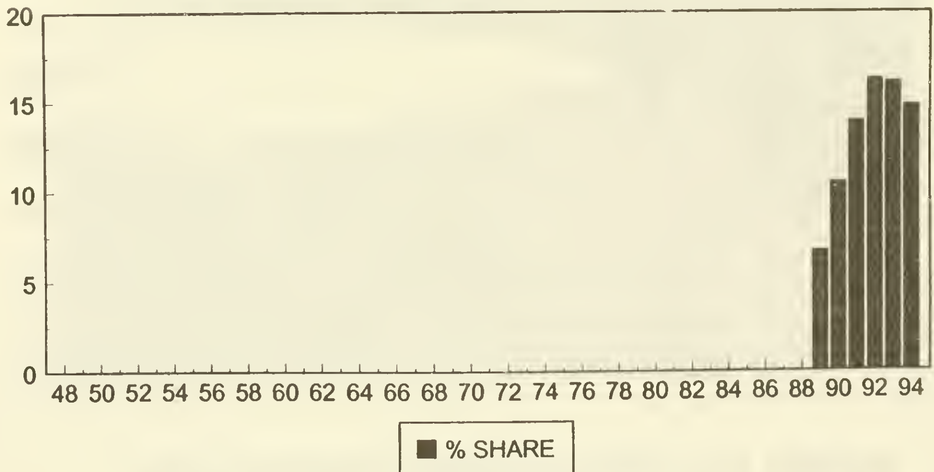
At this juncture, it is important to note that the federal reserve learned from history and did not repeat it. In October of 1987, when the market crashed, the Federal Reserve flooded the markets with liquidity and avoided turning the crash into a depression. Banks, substantially barred from the securities business, were no more responsible for the 1987 crash than they were in 1929. It was the monetary policy response that made the difference in either case.

[The above is summarized largely from the work of Dr. Eugene N. White of Rutgers University who has performed exhaustive research on this issue.]

APPENDIX 2

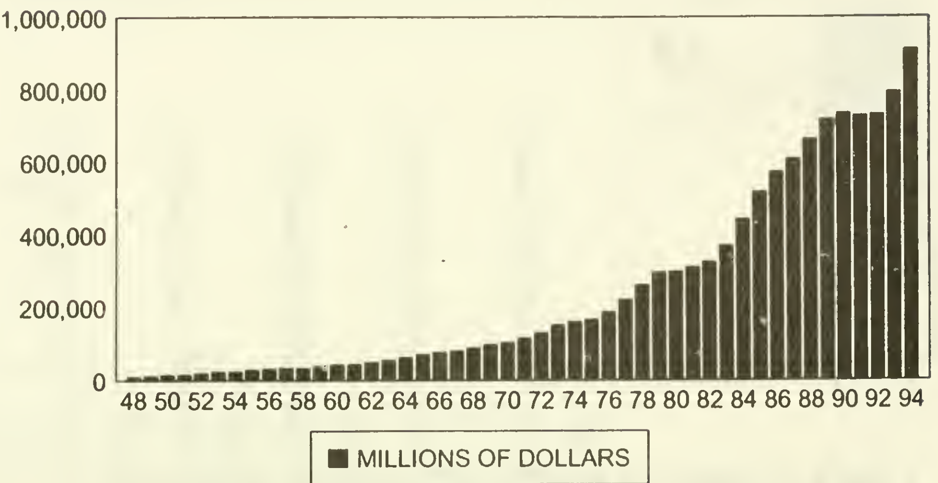


SHARE OF TOTAL INSTALLMENT CREDIT IN "POOLS" 1948-94.(NO DATA PRIOR TO 1989.)



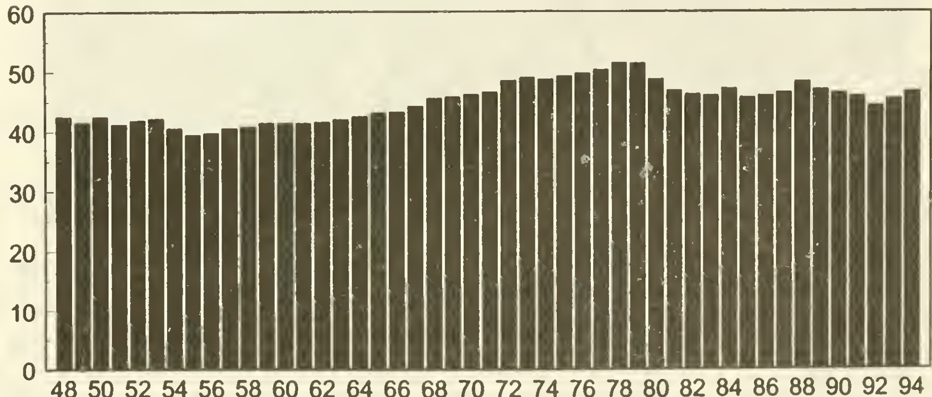
Source: Federal Reserve statistical release G-19 and Federal Reserve historical data

TOTAL CONSUMER INSTALLMENT CREDIT OUTSTANDING FOURTH QUARTER 1948-94.

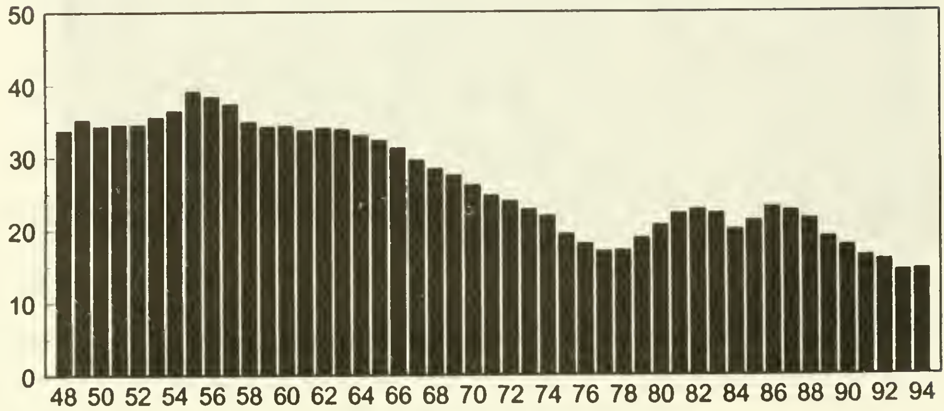


Source: Federal Reserve statistical release G-19 and Federal Reserve historical data

COMMERCIAL BANKS SHARE OF TOTAL INSTALLMENT CREDIT 1948-94.

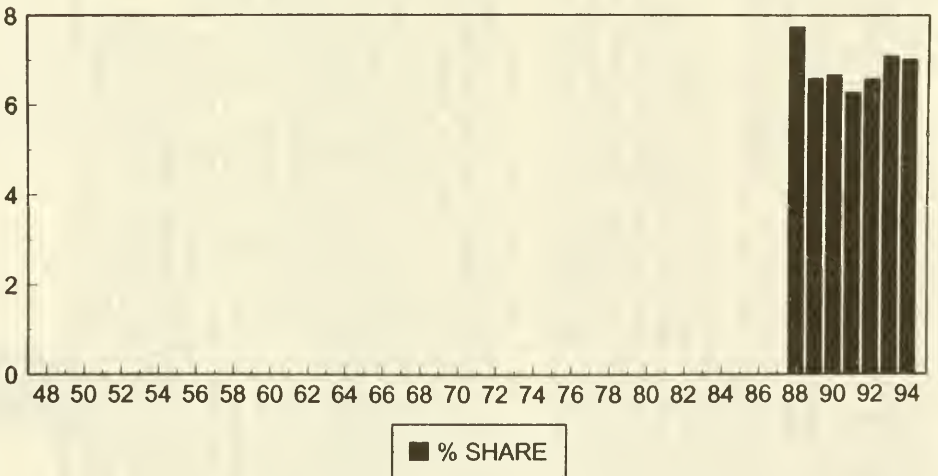


Source: Federal Reserve statistical release G-19 and Federal Reserve historical data



Source: Federal Reserve statistical release G-19 and Federal Reserve historical data

NON FINANCIAL BUSINESS SHARE OF TOTAL INSTALLMENT CREDIT 1948-94.(NO DATA PRIOR TO 1988.)



Source: Federal Reserve statistical release G-19 and Federal Reserve historical data

APPENDIX 3

The Competitive Equality Banking Act of 1987 (CEBA)

Limited-purpose "CEBA banks" are institutions whose ownership by entities that are not bank holding companies was grandfathered under CEBA, provided that the banks comply with a number of restrictions. These include: a restriction on engaging in both demand deposit taking and commercial lending, a limitation on crossmarketing with affiliates, a restriction on engaging in activities in which the bank was not engaged on March 5, 1987, a restriction against creating "daylight overdrafts" on behalf of affiliates, and a limitation on asset growth to 7% annually. These banks are, however, subject to the same capital requirements, supervision, community reinvestment obligations, consumer protection laws and other banking laws as full-service banks.

The CEBA restrictions were characterized as temporary, and Congress stated that they would be reconsidered as part of "comprehensive" banking legislation that addressed such issues as interstate banking, and the ability of full-service banks to engage in securities, insurance and real estate activities. The purpose of the restrictions, according to CEBA, was to permit Congress, rather than the regulators or the courts, to more clearly define how financial services providers were to be regulated, to encourage limited purpose banks to support this effort, and to maintain both the competitive and safety and soundness status quo pending consideration of such legislation.

Unfortunately, in the 8 years since CEBA's enactment, Congress has not enacted a "comprehensive" financial services law, and the restrictions on limited-purpose banks remain in place. Nevertheless, there have been many changes that make the retention of these restrictions, particularly the growth cap, unnecessary. These include: (1) a significant decline in the number of limited-purpose banks (from about 160 to 23), which reduces their competitive impact and facilitates regulators' ability to supervise them, (2) the enactment of important banking laws in 1989 and 1991 that enhance regulators' ability to insure that these (and other) banks are run in a safe and sound manner, including authority to freeze bank asset growth if capital levels decline, (3) the enactment in 1994 of interstate banking legislation which allows full service banks to compete geographically with limited-purpose banks and their owners, and (4) the approval by bank regulators, and the courts, of a growing list of securities, insurance and other financial services activities permissible for banks. These changes, occurring while limited-purpose CEBA banks have remained subject to onerous limitations on their growth, activities, and relationships with affiliates, address the concern expressed in 1987 about banks' ability to compete "on a more equal basis" with limited-purpose banks.

AFSA strongly believes that the asset growth limitation, as well as other CEBA restrictions, should be eliminated for *all* grandfathered CEBA limited purpose banks. The growth cap is a gratuitous and anticompetitive restraint on legitimate financial institutions. It is unheard of for any, free enterprise to be hobbled by such legislative restrictions.

APPENDIX 4

Moody's Investors Service
Global Credit Research

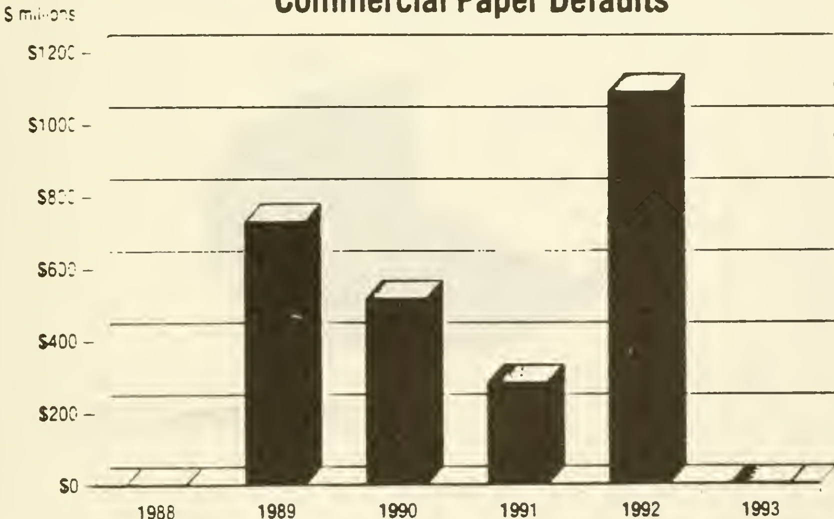
Commercial Paper Defaults 1970-1993

February 1994

Contacts (212) 553-1653
Jerome S. Fons
Karl Bergqwist

SUMMARY

This study brings previous Moody's studies of commercial paper (CP) defaults current through 1993. The studies were prompted in part by the dramatic increase in CP defaults beginning in 1989. From 1971, when Moody's began rating commercial paper, to 1989, CP defaults were extremely rare. Since 1989, 27 issuers have defaulted on $2.6 billion of rated and unrated publicly offered CP notes in the United States, the Euromarket, and other European domestic markets.



THE COMMERCIAL PAPER MARKET

Commercial paper is a senior level unsecured short-term note with a maturity usually ranging between one and 365 days. It is an important, flexible source of short-term financing for large corporations worldwide. CP is generally sold at a discount from par value and is placed directly by issuers or, more typically, placed indirectly through an intermediary in large denominations. Major purchasers of commercial paper include money market mutual funds, corporations, state and local governments, and commercial banks and their trust departments. Because of the large denominations and the sophistication of the institutional wholesale buyers, U.S. CP issuers are generally exempt from registration requirements. And while some trading in CP does take place in non-U.S. domestic markets, U.S. investors usually hold CP to maturity.

Commercial paper is a source of liquidity for issuers and a short-term store of value for investors. It represents a flexible, low-cost alternative to bank loans, especially for the largest and most creditworthy firms. Within parameters outlined in a CP program's prospectus, issuers are generally free to float new paper relatively quickly and cheaply. Investors, on the other hand, hold funds as CP in anticipation of near-term outlays. As a rule, investors do not consider their CP holdings as risk capital.

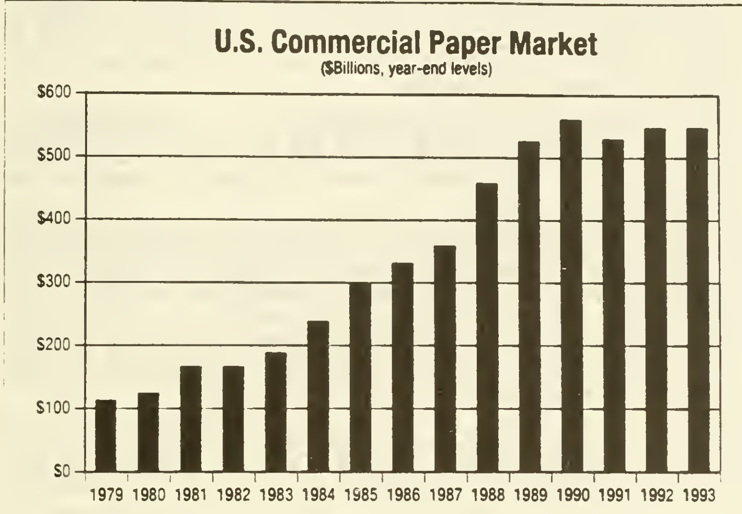
This report documents the default experience in the global CP markets since 1971, the year Moody's began rating these instruments. But background data, particularly that concerning issuers in non-U.S. markets, is often very scarce. Thus, the information presented here is, in many cases, incomplete.

The U.S. Commercial Paper Market

Having existed in one form or another for over two hundreds years, the U.S. commercial paper market is the largest such market in the world. It was virtually the only CP market in operation at the start of the 1960s and still accounts for roughly 60 percent of global CP outstanding.

According to U.S. Federal Reserve figures, the U.S. commercial paper market totaled $548 billion at the end of 1993. However, growth in this market, as seen in Figure 1, has been virtually flat since year-end 1989. Interestingly, the last few years have seen robust growth in the volume of domestic long-term public corporate debt. One possible explanation is that many long-term bond issuers took advantage of the decline in long-term interest rates by issuing more long-term debt than was required for expansion purposes. Flush with proceeds, these borrowers may have paid down part of their commercial paper outstandings. Following a large capital outlay, the intention may be to resume borrowing in the commercial paper market.

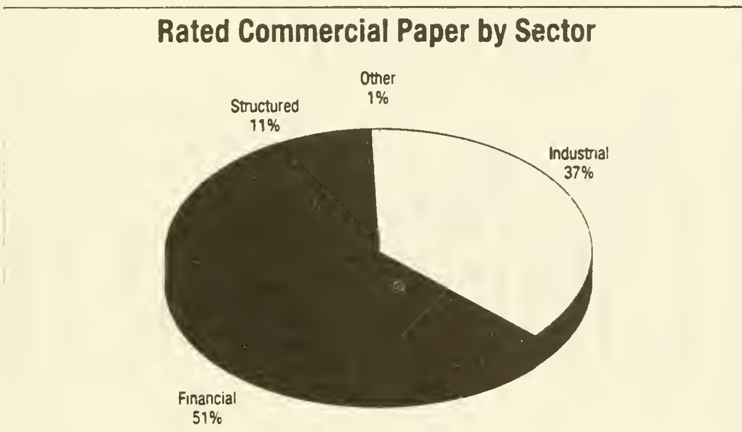
Figure 1



Finance companies remain the dominant issuer in the U.S. CP market, with $392 billion outstanding at year-end 1993, versus the $156 billion issued by nonfinancial entities. Over half of the finance company CP was placed by broker-dealers. Included in the U.S. CP total is $70 billion of paper issued by non-U.S. companies.

Based on Moody's rated population, as of September 30, 1993, financial issuers accounted for 51 percent of commercial paper outstanding (see Figure 2). Industrial issuers accounted for 37 percent of outstanding CP and another 11 percent was issued by structured finance entities.

Figure 2



THE U.S. CP MARKET'S "ORDERLY EXIT" MECHANISM

Since 1972, the U.S. CP market has been relatively default-free when compared to its long-term counterpart. One reason for the limited number of defaults has been the orderly exit from the market of troubled CP issuers before they could fail. This has worked because investors have been relatively unreceptive to lower-quality paper. This risk aversion is particularly true in the U.S. market and is developing in other CP markets.

Currently, a mere 0.8 percent of Moody's-rated CP carries a Prime-3 rating. Furthermore, very few U.S. CP investors will purchase unrated CP or CP rated Not Prime. In addition, some dealers decline to sell paper as an issuer's credit deteriorates. As a result, CP issuance often becomes uneconomical or impractical well in advance of a potential default, effectively forcing the company out of the market.

Listed in Figure 14 are examples of companies that defaulted on long-term debt after exiting the CP market. (In the case of Chrysler, the date on which federal legislation providing for loan guarantees was signed into law is treated as a default date.) Also listed here is the number of days before default the issuer received a Prime-3 rating, and the number of days before default that the issuer was downgraded to Not Prime or had its rating withdrawn (WR). The Not Prime rating or withdrawal of a rating can be taken as a rough indicator of the date at which the issuer had either exited the market or was about to exit the market as current outstandings matured. Accordingly, this sample of issuers exited the CP markets an average of 1,061 days or nearly three years before defaulting on their long-term debt.

Another way to consider the effect of the orderly exit process is to note the drop in outstanding paper once an issuer has been downgraded. Between 1972 and 1989, Moody's announced a total of 430 rating downgrades of CP issuers: 223 to Prime-2, 95 to Prime-3, and 112 to Not Prime. Figure 15 compares the average amount of CP (both U.S. and international) reported outstanding during the period from one to three months before a downgrade, compared with reported outstandings from three to six months after the downgrade. Downgrades to progressively lower rating categories appear to be associated with the removal of progressively larger volumes of issuers' CP from the markets, thereby reducing investors' exposure as default becomes more likely.

APPENDIX 5

Bank & Finance Company Capital Structure
for the period ending
September 20, 1994

Industry Averages	Debt/Equity*	Equity/Assets**	as a % of Total Capitalization			After-tax
			Short-Term[2]	Long-Term	Total Debt	ROE
Finance Companies[1]	6.04x	13.47%	33.95%	51.11%	85.06%	16.54%
			Deposits[3]	Borrowings[4]	Dep.+Borrow.	
Money Center Banks	11.83x	6.59%	57.97%	34.12%	92.09%	15.89%
Regional Banks	11.66x	7.84%	73.58%	18.41%	91.98%	16.10%
All Banks	11.68x	7.68%	71.49%	20.50%	92.00%	16.07%

Finance Companies	Mix	Debt/Equity	Equity/Assets	as a % of Total Capitalization		
				Short-Term[4]	Long-Term	Total Debt
1 American General Finance Corporation	Consumer	5.05x	15.18%	28.53%	54.95%	83.48%
2 Aristar, Inc.	Consumer	3.09x	22.82%	12.41%	63.14%	75.55%
3 Associates Corporation of N.A.	Diversified	7.05x	11.89%	38.86%	48.72%	87.58%
4 Avco Financial Services, Inc.	Consumer	5.96x	13.27%	33.11%	52.53%	85.64%
5 Beneficial Corporation	Consumer	7.46x	10.48%	30.79%	57.38%	88.18%
6 CIT Group Holdings, Inc.	Commercial	6.63x	11.45%	48.47%	38.43%	86.90%
7 Commercial Credit Company	Consumer	5.86x	12.10%	33.76%	51.66%	85.42%
8 FINOVA Capital Corporation	Commercial	5.44x	14.09%	31.52%	52.96%	84.47%
9 General Electric Capital Corporation[1]	Diversified	8.07x	8.47%	#N/A	#N/A	#N/A
10 Heller Financial, Inc.	Commercial	5.00x	15.04%	32.25%	51.09%	83.34%
11 Household International	Diversified	9.76x	7.02%	51.19%	39.51%	90.70%
12 Norwest Financial, Inc.	Consumer	5.98x	13.38%	28.21%	57.46%	85.67%
13 Transamerica Finance Group, Inc.	Diversified	5.17x	14.89%	38.33%	45.48%	83.80%

Source: SEC Filings

Finance Company Average[1]		6.04x	13.47%	33.95%	51.11%	85.06%

Footnotes:
(1) Averages do not include GECC, as only limited information is provided on a quarterly basis
(2) Finance company short term debt consists primarily of commercial paper
(3) Bank deposits consist of all deposits
(4) Borrowings consist of both short-term and long-term borrowings

* Total liabilities divided by total shareholders' equity — shows to what extent owners equity can cushion creditors' claims
** Equity ratio — measures the proportion of total assets financed by stockholders, as distinguished from creditors

Bank & Finance Company Capital Structure
for the period ending
September 30, 1994

Banks	Type	Debt/Equity	Equity/Assets	as a % of Total Capitalization		
				Deposits[3]	Borrowings[4]	Dep. + Borrow.
1. AmSouth Bancorporation	Regional	11.70x	7.82%	75.31%	16.82%	92.12%
2. Bank One Corporation	Regional	10.19x	8.81%	75.90%	15.16%	91.06%
3. Bancorp Hawaii, Inc.	Regional	11.51x	7.78%	56.92%	35.09%	92.01%
4. Bank of Boston Corporation	Regional	12.76x	7.03%	70.76%	21.98%	92.73%
5. Bank of New York Company	Money Center	10.30x	8.39%	71.85%	19.30%	91.15%
6. Bank South Corporation	Regional	10.23x	8.75%	69.73%	21.37%	91.10%
7. Bank America Corporation	Regional	9.54x	8.84%	76.54%	13.97%	90.51%
8. Bankers Trust New York Corp.	Money Center	15.74x	4.40%	28.17%	65.86%	94.03%
9. BanPonce Corporation	Regional	11.39x	7.95%	72.45%	19.48%	91.93%
10. Barnett Banks, Inc.	Regional	11.56x	7.86%	82.20%	9.83%	92.04%
11. BB&T Financial Corporation	Regional	11.17x	8.12%	74.42%	17.37%	91.79%
12. Boatmen's Bancshares, Inc.	Regional	11.67x	7.80%	73.24%	18.87%	92.11%
13. Central Fidelity Banks, Inc.	Regional	13.82x	6.64%	73.18%	20.07%	93.25%
14. Centura Banks, Inc.	Regional	11.76x	7.74%	84.17%	7.99%	92.16%
15. Chase Manhattan Corporation	Money Center	10.77x	7.21%	69.39%	22.11%	91.50%
16. Chemical Banking Corp.	Money Center	12.58x	6.38%	63.34%	29.29%	92.64%
17. Citicorp	Money Center	11.40x	6.70%	73.39%	18.54%	91.94%
18. Comerica Incorporated	Regional	12.20x	7.50%	64.53%	27.90%	92.43%
19. Compass Bancshares, Inc.	Regional	12.77x	6.94%	75.22%	17.52%	92.74%
20. CoreStates Financial Corp.	Regional	10.65x	8.14%	76.11%	15.31%	91.42%
21. Crestar Financial Corporation	Regional	11.74x	7.73%	77.22%	14.93%	92.15%
22. Fifth Third Bancorp	Regional	9.26x	9.53%	76.14%	14.11%	90.25%
23. First Bank System, Inc.	Regional	10.03x	8.81%	73.44%	17.50%	90.94%
24. First Chicago Corporation	Money Center	11.74x	6.91%	51.29%	40.86%	92.15%
25. First Empire State Corporation	Regional	13.16x	7.00%	72.12%	20.82%	92.94%
26. First Fidelity Bancorporation	Regional	10.64x	8.38%	82.30%	9.11%	91.41%
27. First Hawaiian, Inc.	Regional	10.17x	8.73%	72.02%	19.02%	91.05%

Source: SNL Securities
Prepared by Donaldson, Lufkin & Jenrette Securities Corporation

Bank & Finance Company Capital Structure
for the period ending
September 30, 1994

Banks	Type	Debt/Equity	Equity/Assets	as a % of Total Capitalization Deposits[1]	Borrowings[1]	Dep. + Borrow.
28. First Interstate Bancorp	Regional	14.01x	6.55%	90.21%	3.13%	93.34%
29. First of America Bank Corp.	Regional	14.57x	6.37%	83.81%	9.77%	93.58%
30. First Security Corporation	Regional	11.87x	7.64%	69.54%	22.70%	92.23%
31. First Tennessee National Corp.	Regional	12.41x	7.20%	75.29%	17.26%	92.54%
32. First Union Corporation	Regional	11.91x	7.57%	73.98%	18.27%	92.25%
33. Firstar Corporation	Regional	10.35x	8.66%	75.59%	15.60%	91.19%
34. Fleet Financial Group	Regional	12.22x	7.33%	73.76%	18.68%	92.44%
35. Huntington Bancshares Inc.	Regional	10.95x	8.25%	69.25%	22.38%	91.63%
36. Integra Financial Corp.	Regional	13.71x	6.71%	73.20%	20.01%	93.20%
37. J.P. Morgan & Co. Incorporated	Money Center	10.23x	6.29%	41.70%	49.40%	91.09%
38. KeyCorp	Regional	12.48x	7.29%	75.44%	17.14%	92.58%
39. Mellon Bank Corporation	Regional	7.75x	10.92%	72.34%	16.23%	88.57%
40. Meridian Bancorp, Inc.	Regional	10.82x	8.33%	77.69%	13.85%	91.54%
41. Midlantic Corporation	Regional	9.04x	9.84%	82.98%	7.06%	90.04%
42. National City Corporation	Regional	10.56x	8.49%	75.06%	16.30%	91.35%
43. NationsBank Corporation	Regional	14.58x	6.27%	57.99%	35.59%	93.58%
44. NBD Bancorp, Inc.	Regional	12.71x	7.14%	68.36%	24.35%	92.71%
45. Northern Trust Corporation	Regional	13.37x	6.75%	62.21%	30.83%	93.04%
46. Norwest Corporation	Regional	13.12x	6.76%	64.34%	28.58%	92.92%
47. Old Kent Financial Corporation	Regional	11.16x	8.13%	82.91%	8.87%	91.78%
48. PNC Bank Corp.	Regional	13.00x	6.95%	53.94%	38.91%	92.86%
49. Provident Bancorp, Inc.	Regional	13.44x	6.83%	71.23%	21.85%	93.08%
50. Regions Financial Corp	Regional	11.78x	7.73%	80.48%	11.69%	92.17%
51. Republic New York Corporation	Money Center	11.88x	6.48%	64.65%	27.58%	92.24%
52. Shawmut National Corporation	Regional	13.54x	6.79%	63.06%	30.06%	93.12%
53. Signet Banking Corporation	Regional	8.95x	9.81%	70.96%	18.99%	89.95%

Source: SNL Securities
Prepared by Donaldson, Lufkin & Jenrette Securities Corporation

Bank & Finance Company Capital Structure
for the period ending
September 30, 1994

Banks	Type	Debt/Equity	Equity/Assets	as a % of Total Capitalization		
				Deposits[1]	Borrowings[4]	Dep. + Borrow.
54. SouthTrust Corporation	Regional	13.82x	6.66%	73.18%	20.07%	93.25%
55. Star Banc Corp.	Regional	12.01x	7.62%	77.98%	14.33%	92.31%
56. Sun Trust Banks, Inc.	Regional	10.50x	8.47%	80.29%	11.01%	91.31%
57. Synovas Financial Corp.	Regional	10.62x	8.45%	85.58%	5.81%	91.39%
58. U.S. Bancorp	Regional	10.75x	8.25%	72.95%	18.54%	91.49%
59. Wachovia Corporation	Regional	10.51x	8.43%	60.13%	31.19%	91.31%
60. Wells Fargo & Company	Regional	11.71x	7.71%	78.23%	13.90%	92.13%

Source: SNL Securities
Prepared by Donaldson, Lufkin & Jenrette Securities Corporation

Bank Averages	Debt/Equity	Equity/Assets	Deposits	Borrowings	Dep. + Borrow.
Money Center Banks	11.83x	6.59%	57.97%	34.12%	92.09%
Regional Banks	11.66x	7.84%	73.58%	18.41%	91.98%
All Banks	11.68x	7.68%	71.49%	20.50%	92.00%

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ADDITIONAL INFORMATION AVAILABLE UPON REQUEST

Mr. STEARNS. Thank you, gentlemen.

I think what we are going to do is I am going to open up with questions and then we will go to the other side for some questions and we will see if some members come back. If not, we might take a 10-minute recess.

Let me start, question always sort of intrigues me. I have gone through the list of staff questions and sort of picked this one out, and this is for you, Mr. Jones. It is perhaps trying to present both sides here and try and get a hearing where we get your input.

To the extent that a separation of banking from insurance ever existed, you know, it is quickly changing here in the marketplace. Is there any reason why a broker-dealer with an insurance affiliate should not be able to buy a bank? And perhaps I think your answer would probably be more to the point, but I also would like the rest of the panelists to answer that too.

So, Mr. Jones, I will ask you that question.

Mr. JONES. Mr. Chairman, in fact today, many organizations who are broker-dealers own insurance affiliates and own insured banks. In our written testimony, which is on, I think, about page 5 or so, we have included a chart that I would call the members' attention to that shows very clearly the number of firms that cross those lines that you have just discussed.

So in fact today, insurance services are already being provided by broker-dealers who own insurance companies who own insured depository institutions. They offer a wide range of products, whether they be automobile loans, home mortgages, credit cards, a wide variety of financial services. So they have already made this transition.

Mr. STEARNS. But isn't it true that the bill says they must divest—the insurance company and securities company must divest themselves of insurance of banks?

Mr. JONES. Yes, that is true.

Mr. STEARNS. Doesn't that sort of tell a different story than what the bill actually proposes and what you are just saying?

Mr. JONES. Well, our position is simply that there ought to be open competition. If I go back to the example that I talked of before where in Red Wing, Minnesota, I am seeing $15 million of deposits flow out of my organization every year, I know that I have to have products and services that allow me to compete in that marketplace, to hold those funds in Red Wing, Minnesota, rather than shipping them off to New York City where they get deployed in some other way, other than trying to help the economy of our local area grow.

So the whole issue of banks owning insurance affiliates or insurance affiliates—or broker-dealers owning banks is not one that I can address because of my community banking experience.

Mr. STEARNS. Well, and I certainly understand your general point about—that the more products that you can sell, the more you can keep that bank money in the hometown.

Mr. JONES. That's correct.

Mr. STEARNS. But if I could, let me ask the other folks on the panel, Mr. Fink, what your comment would be.

Mr. FINK. Yes. The thrust of my testimony is securities firms should be able to own—have insurance affiliates and bank affili-

ates, and as I indicated, our survey shows 40 percent of the securities firms that are mutual fund companies today have an insurance affiliate. It is common for securities firms and insurance companies to be affiliating and I think the restrictions in the bill are wrong.

Mr. STEARNS. Okay.

Mr. Lackritz.

Mr. LACKRITZ. Yes, thank you, Mr. Chairman.

We completely agree with that, and in fact, I would go even further in the sense that not only do you have—the realities of the marketplace today are that these products and their financial products, they are banking products and services, they are securities products and services and mutual fund products and services, and they are insurance products and services.

The marketplace is clearly evolving and the lines of demarcation between and among these products is clearly being completely eliminated. It is, therefore, really important that players who want to be financial services providers have as wide an opportunity as they can to purchase an affiliate or work with other kinds of organizations and provide the mix of products and services that they want to, as long as they are all subject to functional regulation according to the activity that is there.

So that is the kind of model that we think is the more appropriate model for moving forward in the financial modernization, rather than creating a model with all these boxes where certain firms, certain companies have to divest certain kinds of things unless they reach a certain percent, and what you have here in essence would be a Banking Lawyer's Relief Act the way it is structured right now. So we think there is a simpler structure that works more effectively for everybody enrolled.

Mr. STEARNS. Hearing what you just said, obviously I would say that you endorse the banks selling securities too.

Mr. LACKRITZ. We have endorsed in a holding company structure that there be a separately capitalized securities affiliate, absolutely.

Mr. STEARNS. Okay. Mr. Tassey.

Mr. TASSEY. That is consistent with our position. We have always supported the fullest range of activities in a holding company structure with separately capitalized affiliates and functional regulation. There is a fair amount of experience with this type of structure in the life insurance holding company where many of the same problems that people are concerned about with insured institutions exist as well.

Mr. STEARNS. I am going to ask one short question.

I asked this to Mr. Levitt, the Chairman of the SEC, dealing with new security powers under the H.R. 1062, and this again would be for you, Mr. Jones, the ability to deal in municipal revenue bonds, shouldn't those activities take place at the SEC rather than the SID? I mean, your comments on that.

You might—you know, you have a chance now to put on record how you feel about this, and some members had some concern; I did. Frankly, I will give you a head's up. The SEC didn't seem to object to what we have in the bill, but I would be curious about your opinion.

Mr. JONES. Well, let me again address your question, Mr. Chairman, based on my experiences in a smaller community.

In Red Wing, Minnesota, a town of 15,000 people, our bank currently does quite a bit of business with the city of Red Wing. In terms of the municipality, we help them with cash management; we make loans and leases to them. We advise them on financial matters. They call us in from time to time. So it would seem to make an awful lot of sense that we would be able to continue that process, plus adding additional products that relate to municipal obligations.

The revenue bonds are an issue that we likely would not be underwriting in a smaller bank, but many banks in our association do see the need to do that and are already working with their municipalities much the same way that I have just described we do in Red Wing. So to hold them outside of the bank in a separately capitalized subsidiary seems to be an additional burden, an additional cost which may, in fact, make banks uncompetitive in regard to offering those kinds of services.

Mr. STEARNS. Thank you. My time has expired, so Ms. Eshoo from California has the next opportunity.

Ms. ESHOO. Thank you, Mr. Chairman. And thank you to the witnesses that have come to us to hopefully be instructive. We can learn from them and I always appreciate that. I always get an awful lot out of these hearings.

My question is directed to Mr. Jones. Mr. Jones, as you know, California voters passed a referendum in 1988 to permit banks the sale of insurance products. Would you comment, please, on that decision and what effects, as you have seen, the decision has had both on banking and insurance in California. And if you are suggesting that banking activities and insurance have helped California consumers, if you could give some examples of that.

Mr. JONES. Well, Congresswoman, I must tell you, I am from a small town in Minnesota.

Ms. ESHOO. Right.

Mr. JONES. So dealing with questions relative to the California experience is a little bit out of my jurisdiction. But I would tell you that banks being able to sell insurance products really becomes a very important part of the product line that we need to offer our consumers.

Let me take you back to about 1987 when our bank, as a national bank, was the only bank—only kind of financial institution in Minnesota that could not sell single premium, fixed-rate annuities. It is instructive. It is not exactly to your question, but the point——

Ms. ESHOO. Well, I asked the question of you because you are representing the ABA.

Mr. JONES. Yes.

Ms. ESHOO. And so perhaps you can get that information to us since you can't offer it today, but I think that that could be instructive to members as we are examining these areas.

It is also my understanding that H.R. 1317, as drafted, will not harm banks in California who already have the ability to sell insurance products. Can you explain how that bill would adversely affect banks in California? You may not be able to since you don't

know the California case or can't speak directly to it, given that the bill expressly permits current State law to be upheld.

Mr. JONES. I think the biggest problem that the ABA sees with H.R. 1317 is that it allows the State commissioners to define insurance. What we are mostly concerned about is not the issue——

Ms. ESHOO. But if they have already defined it, and you haven't had a problem with that—why would it become one?

Mr. JONES. Each State would have the ability to set their own definition of insurance, and what we are concerned about most of all is that banks will be discriminated against State by State based on providing insurance services.

Now, again, relative——

Ms. ESHOO. Do you think the State regulators favor insurance brokers over banks? Is that what you are saying?

Mr. JONES. I would say that there would be a very distinct possibility of that. Why shouldn't we not instead craft a law that takes discrimination out of the process and allows all competitors to compete on an equal footing?

Ms. ESHOO. But can you point to a case where that discrimination exists, though? That is the point that I don't—I am not picking up on. Perhaps you can offer some examples of that in some written testimony. I don't think you are prepared to do that today, but——

Mr. JONES. Examples I think are examples such as this: The fees may be higher for banks to get licenses and to enter the business than insurance agents. The waiting period for obtaining approval for a life insurer may be longer for bankers than it is for agents. Those are the kinds of things that throw up barriers to the banking industry, that do not put us on a level playing field.

Ms. ESHOO. And, let's see, I think I still have some more time to ask. Given the change in H.R. 1062, as reported, to permit banks to carry out securities transaction within the bank itself and not through a separate affiliate, can you comment on whether this provision would adequately protect consumers?

And I say this with some specificity with reference to the Barings Bank in England, which speaks for itself. When we say that, we all know what happened, so I don't need to go into details. How can we be sure that this wouldn't happen in—under the current structure of the bill?

Mr. JONES. Well, in the case—are you addressing the question to me?

Ms. ESHOO. Whomever would like to answer.

Mr. JONES. In the case of banks, really all underwriting would have to be done in a separate affiliate that would be SEC regulated.

On the issue of——

Ms. ESHOO. Who insures that.

Mr. JONES. Excuse me?

Ms. ESHOO. Who insures that?

Mr. JONES. The bill insures that.

Ms. ESHOO. I know. But who in terms of insurance? Is that underwritten or is it the Federal Government that needs to stand next to that, like an FDIC insured, so that we become—I wasn't asking Mr. Dingell the question. How would that work?

Mr. JONES. Is your question—I am a bit confused. Is your question——

Ms. ESHOO. You say it would be done through a separate affiliate.

Mr. JONES. Yes.

Ms. ESHOO. Just because it is a separate affiliate doesn't mean that this situation couldn't occur.

Mr. JONES. Well, if your question is relative to who insures that, such as who insures deposits of American depositors, there is no insurance to prevent insurance companies from going under. There are arrangements within States and between States that back up the insurance system, but in cases of insurance products, which I hear you asking about, today, America's banks, we believe, are way out in front in terms of disclosing insurance products that we are selling, talking to consumers about the fact that they are not FDIC insured, that they are not an obligation of the bank.

A recent survey done by the Profit Marketing Group shows banks coming out on top when measured against banks and insurance companies and securities firms in terms of disclosure to consumers, which I hear as the central point of your question.

Ms. ESHOO. And the protection of them, yes. Not just disclosure, but protection of them.

Thank you very much, Mr. Chairman. And if you would, Mr. Jones, get back to us in writing on the question that I had submitted to you. Thank you.

Mr. JONES. Yes, we will.

Ms. ESHOO. Thank you.

Mr. FIELDS. The gentlelady yields back the balance of her time. The gentleman from Pennsylvania, Mr. Klink.

Mr. KLINK. I thank the chairman for his courtesy.

Mr. Jones, we are not picking on you, but you have got to understand we have been talked to by people on the insurance side and the bank side. We are trying to sort through some of these things. I would just like to take a step back for a second from some of the intricacies of this bill.

As a new member of this committee who served on the Banking Committee during the last Congress, my question is really this: How can we as Members of this Congress be assured that, if H.R. 1062 is enacted as it is written, at some point we won't be called upon to bail out new, large, diversified banks that have experienced some substantial unexpected losses from their securities activity?

Mr. JONES. Well, Congressman, I think history proves, if we go back and look at the 1930's, that there were very few, if any, banks that failed in terms of their securities affiliates or their securities business. We believe that, quite to the contrary, a bank's ability to remain strong and vibrant and be less of a risk to the Federal deposit insurance system will be—their ability to remain strong will be enhanced by the fact that their earnings can be diversified through offering additional products, securities products, insurance products, a wide range of financial services.

Today, if we look at what has happened to banking's share of the traditional financial services market, it has reduced over the last 20 years. It has dropped from about 38 percent down to about 25

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percent during that period of time. We have to be allowed to provide additional products and services in order to be able to remain strong and vibrant and less of a problem to the FDIC's insurance fund.

Mr. KLINK. I understand what you are saying. They can diversify, and they have the opportunity of making more money, and all is well and good. But you can diversify and you can lose money. Indeed, there are a lot of people in the security business that lose money. Probably as many people make money as lose money. It is just a passing of dollars from one group to another. What if things don't end up good?

And I have to—look, I have to say this because you have to understand—I am sure you do. We are in politics, and, worse than that, we run for office every 2 years. And the people out there understand, people who elect me and elect everybody on both sides of the aisle, that over the last decade, decade and a half, that several thousand banks and thrifts failed. They know that.

And they know that the cost was about $200 billion. And they can quickly figure out that if we had that $200 billion back today, we could not only balance the budget this year but we would have a surplus. And we wouldn't have to cut their medicare, and we wouldn't have to cut back on school lunches, and we wouldn't have to cut back on education and job training and all these other programs that have a constituency out there.

When I go back to town meetings, they are going to say, look, Klink, what the heck are you doing? The banks have been running, they have been failing, and now you want to put them in the securities business? I mean, it is not just me and the rest of the members of this panel that you have to convince. It is the American public. And I am not sure that the argument you just gave me did that.

I will give you another bite at the apple. I am not picking at you.

Mr. JONES. I seem to be a very popular witness this morning. Let me——

Mr. KLINK. That is what happens when you sit in the bull's-eye.

Mr. JONES. Let me take another run at it. Because I think, first of all, relative to safety and soundness issues, the firewalls that are in place in H.R. 1062 go a long way to protecting the insured depository from problems of the securities affiliate. And when you speak to the issue of a $200 billion bailout of banks, I would quarrel with that a bit. It was a $200 billion, or more precisely, I think about a $150 billion bailout of the savings and loan industry and that insurance fund.

The bank insurance fund certainly did suffer some losses through the late 1980's and early 1990's, and the insurance fund of banks has been built up by the banking industry with no taxpayer expense. So I do feel that I need to make that point very clear.

Mr. KLINK. The premiums for the insurance of the banks are charged to whom? The depositors, I believe. I mean, where does the money come from to pay that insurance to the FDIC insurance?

Mr. JONES. Well, the money that banks pay into the insurance fund comes directly out of their earnings. It comes directly out of——

Mr. KLINK. And their earnings come from depositors. Depositors are taxpayers. That is my hope—we can't draw a line here and say that there is some mysterious group of people here who are not taxpayers. We are all citizens of the same country; so, ultimately, you are paying one way or you are paying another way. And my point to you is, your argument is not going to sell in Aliquippa, Pennsylvania. It is a problem that I have.

Mr. JONES. Well, the issue that you raise relative to who pays, we need to be instructed by the past. If we go back a few years and look at what happened to the S&L industry, they were not able to pass along the costs of increased premiums from their customers. They had to be bailed out by the American taxpayers. And that is the difference.

It tends to be a different subject than we are talking about today, but I hope that I have been responsive.

Mr. KLINK. You have been responsive.

I thank you, Mr. Chairman. Yield back what little time I don't have.

Mr. FIELDS. The Chair appreciates that.

The Chair will now recognize the gentlelady from Arkansas, Ms. Lincoln.

Mrs. LINCOLN. Thank you, Mr. Chairman.

We will give Mr. Jones a rest.

A couple quick questions to Mr. Lackritz and Mr. Fink. The security firms and the mutual funds have generally been extraordinarily resourceful in creating new products and services that respond to the needs of the marketplace the investors, and which facilitate some of the essential functions of capital formation that we look for.

What could you tell us would be the impact, if any, from 1062 on that—in terms of the development of innovative new products and services in the financial marketplace?

Mr. LACKRITZ. Well, I think the concern that we have with the regulatory structure that is currently in this bill is that it would ultimately stifle innovation and stifle some creativity and reduce the entrepreneurial risk-taking activities that are really at the core of the securities business.

And the reason for that, I think, is that the regulatory structure, as it is currently contained in this bill, creates a very—Rube Goldberg is about the best description I can give you of the different boxes that different kinds of firms have to go into, depending on their product mix, depending on how much of their capital goes into a particular line of business. And, therefore, there is not the functional regulation that has focused on investor protection and a clear, direct consistent line of regulation that ideally you would want to have in a financial regulatory structure.

With the consistent regulatory structure that permits firms to innovate, you wouldn't have to be concerned that if you created a new product, for example, it might move you into a different category of institution that, therefore, would have a different regulatory structure to comply with. But I think that is the chilling effect that I would be concerned about.

Mr. FINK. We are very concerned about having the Fed as the umbrella regulator because I think history in other countries shows

that a banking regulator's instinct is to stifle risk-taking and innovation. It is the opposite.

And Professor John Coffee of Columbia just wrote a recent article that I read that we cite in our testimony and said that had there been an umbrella banking regulator in the early 1970's. Probably that regulator would not have permitted the growth of money market mutual funds because they impose a competitive threat to the banking industry.

So I think that provision in this bill is a terrible thing, and I am very surprised that at a time when the country and the Congress is trying to get less government that there is a proposal for a single financial czar, in effect. And I have a lot of respect for the Fed, but I think it is the wrong way to go.

Mrs. LINCOLN. I don't want to exclude Mr. Jones. Would you like to comment on that?

Mr. JONES. From our point of view, we believe that the Federal Reserve is best able to judge changes in the economy and, therefore, make adjustments in regulation relative to this, and we are comfortable with the Federal Reserve being involved in the regulation.

Mrs. LINCOLN. I would also like to know what you think in terms of the testimony that was given on Tuesday by the OCC that suggested the legislation would spell potential disaster for small- and medium-sized companies, which is what I see most of in my district, in seeking capital for growth. Would any of you have a comment on that or does the ABA have a position on that?

Mr. JONES. Well, I don't know the full context in which the OCC made that comment, but small- to medium-sized businesses are typically shunned by Wall Street. They are not profitable for them to deal with. So to the extent that banks of all sizes are able to be involved in a broader range of services to serve those companies and able to attract capital for those companies, we would certainly support that.

Mrs. LINCOLN. Do any of you other gentlemen have a comment? It seems to me in recent years that they have worked with the SEC to make it less costly for small businesses, to become publicly held. Is that not correct?

Mr. LACKRITZ. There have been a number of initiatives to try and increase the access of capital for small businesses.

There was a legislative proposal in the last Congress to speed the development of the secondary market for small business loan securitization. In fact, the securities industry has been quite active in trying to securitize small business loans in order to provide more capital to small business owners and leverage—more extensively leverage.

And that is consistent with a lot of other innovations, whether it is money market funds, whether it is commercial paper, whether it is other innovations that the securities industry has brought into financial services. Those have all happened in part because of SEC-style regulation, rather than Federal Reserve Board regulation, and so I guess I would just go back to the point Mr. Fink raised before and emphasize that.

Mrs. LINCOLN. Thank you, Mr. Chairman. I yield back the balance of my time.

Mr. FIELDS. The Chair appreciates the gentlelady yielding back.

The Chair will recognize himself for just a few minutes, just to follow up, if I could.

Mr. Lackritz, Mr. Fink, let me ask you, is there perhaps a way to adjust this in a way that works? You know, certainly it is the hope of this committee to be cooperative with the Banking Committee and move a piece of legislation that does help, does recognize that the world has changed, recognizes the need to modernize.

Is it possible in a model, something that would be similar to taking the existing bank-eligible securities, leaving that as it is now, taking the SIDs as they have been proposed, combining those into one SID, functionally regulated by the Securities and Exchange Commission with the same or similar capital requirements that a separate affiliate would have?

Mr. FINK. I will leave—Mr. Lackritz is the SID expert.

I would simply say that you have been presented with a bill that is based on a model of bank regulation. You have A banks here with their own model, securities firms here with their model, and whoever put this bill together just grabbed model A and put it on the whole thing. I think there is room for compromise and accommodation.

I am not answering your SID question. I think this question of whether you need a czar regulator, there can be compromise, and our testimony tries to offer some.

Mr. FIELDS. If I could interrupt you just very quickly, because there is great sympathy for the testimony that you have given and even the response that you have just given to me, but there is also a recognition that there is a dynamic here and there is a strong belief that things should be functionally regulated, a sentiment of this subcommittee. And I guess what I am asking is, is there a way to perhaps make this work, to make this acceptable?

Mr. FINK. Yes. For example, if there is a feeling by the Fed or the Banking Committee that where there is a large bank involved, you need a parent—you need to regulate the holding company. You could have a compromise in this bill that said if a securities firm acquired a small bank that was less than X percent of the assets of the holding company, then there would not be Fed oversight. If it was a large bank that was a large—so that issue, I can imagine a number of compromises if that is what you are asking. There is a way to accommodate the two.

On the SID securities affiliate issue, I would really defer to Mr. Lackritz.

Mr. LACKRITZ. Thank you.

With respect to the SID and how to regulate the securities and how do you get functional regulation, I mean, there are three different problems here. One of the problems is that permitting banks to do any kind of securities activity in the bank without it being in either a separately capitalized affiliate or in a separately identifiable department creates an impossible situation from the standpoint of functional regulation. You can't get there from here.

If, on the other hand—we think the ideal solution is to require all securities activities to be conducted in a section 10 separately

capitalized affiliate. We think that makes the most sense, that is the clearest, that is the easiest to enforce. And from the SEC's standpoint, that would make the most sense.

If it turns out that, for whatever reason, that is not feasible, then, at a minimum, the SID has to be registered with the SEC, subject to capital requirements and the full panoply of SEC regulation. Otherwise, it is not workable.

And I defer to the SEC in terms of whether or not that kind of situation is even workable. We think the clearest solution and the cleanest solution is to put everything in a separately capitalized affiliate.

Mr. FIELDS. Again, that is feasible and makes sense; but, again, there is a different dynamic here.

Let me go back and focus for just a moment or have you focus on the capital requirements. Because, as I understand, the requirements by the Fed are different than the requirements—capital requirements required by the Securities and Exchange Commission. Is there a way to rationalize those or should it purely be the SEC capital requirements?

Mr. LACKRITZ. Our view is that functional regulation means just that, and that if someone is in the securities business they should be subject to the capital requirements of the SEC no differently than anybody else that is in the securities business.

With respect to the question of bank capital and with respect to the level of risk-based capital and that kind of thing that is contained when you get into the holding company structure and what should be counted, the most important issue, it seems to me, from the standpoint of the safety and soundness concerns of the Fed, coupled with the investor protection concerns of the securities regulators, is to make sure that you don't have a double counting of capital and that the broker-dealer capital is not viewed by the Fed as being part of any kind of holding company level capital.

Mr. FIELDS. Chair's time has expired.

The gentleman from Michigan, Mr. Dingell.

Mr. DINGELL. Mr. Chairman, thank you.

Gentlemen, if a bank were to engage in securities activities in a portion of the bank which would not be fully separated and not under SEC regulation, they would not then have to do the following things: one, to take series 6 and 7 exams or to participate in the continuing education requirements. Two, they would be exempt from SRO and SEC recordkeeping and inspection requirements. Three, they would be exempt from NASD investor protection rules. And, four, SEC and SRO rules to insure financial responsibilities, especially the SEC net capital rule, would not apply to them. Is that right?

Mr. LACKRITZ. That is correct.

Mr. DINGELL. That is correct. Now, Mr. Jones, why do you want banks to be exempt from those things?

Mr. JONES. Well, Mr. Dingell, currently——

Mr. DINGELL. I am sure there is a good reason.

Mr. JONES. Currently, as banks are providing securities brokerage activities for their customers——

Mr. DINGELL. They are exempt from those things?

Mr. JONES. We are, as an industry, requiring our people to take series 6 and series 7 licenses.

Mr. DINGELL. But why do you want banks to be exempt from these?

Mr. JONES. Because today——

Mr. DINGELL. You have a good reason. What is it? Give it to me in 25 words or less.

Mr. JONES. I will do my best. Today, the securities activities that are being handled in banks are being handled in the banks themselves, as opposed to in a separately capitalized subsidiary.

Mr. DINGELL. This would essentially continue that.

Mr. JONES. And we support the fact that it can be done in the bank as opposed to in a separately capitalized subsidiary without adding costs to the process.

Mr. DINGELL. Without adding—without affording any of these protections to the investors; isn't that right?

Mr. JONES. Well——

Mr. DINGELL. And what I am asking is, why do you want an exemption from these? There is a good reason, and I know you are going to tell it to me. What is it?

Mr. JONES. We as an industry have gone a long, long ways towards full disclosure.

Mr. DINGELL. Let me repeat the question because I want you to have it very clearly before you. You want an exemption from these. Why is it that you want to be exempt from these requirements?

Mr. JONES. Your question is, why are we——

Mr. DINGELL. Why do you want to be exempt from these requirements? Obviously, there is a superb reason. What is that reason?

Mr. JONES. Today, Mr. Dingell, we are—we are subject to many of the——

Mr. DINGELL. You are not subject to any one of these. You are subject to bank regulators' guidelines and such hit-and-miss requirements as they would impose upon you in connection with these kinds of activities, none of which are directed specifically at activities which are investor-oriented services. Now, why do you wish to be exempted from these?

Mr. JONES. My point, Mr. Dingell, is that we are really not. We are currently today acting with a third party carrier for securities products. We are subject to NASD rule. We are subject to——

Mr. DINGELL. Only to the degree that the bank regulator wants to apply them.

Mr. JONES. And the bank regulators apply them with great ferociousness.

Mr. DINGELL. Do you agree Mr. Lackritz? How about you, Mr. Fink? Do you agree with that?

Mr. LACKRITZ. I don't agree with that, no.

Mr. DINGELL. Do you agree with that Mr. Fink?

Mr. FINK. No, I do not.

Mr. DINGELL. Let's go through it. Why do you want to be out from under the SEC recordkeeping and inspection requirements and the SRO inspection and recordkeeping requirements?

Mr. JONES. Currently, banks are providing, through many third party carriers, securities brokerage activities, and we do keep very accurate records and comply with all of the SEC requirements.

Mr. DINGELL. You do?

Do you agree with that, Mr. Lackritz? Do you agree with that, Mr. Fink?

Mr. LACKRITZ. I don't know enough about all of the record-keeping requirements. My understanding is that they don't have the comparable requirements.

Mr. DINGELL. And they are not enforced in the same way——

Mr. LACKRITZ. That is correct.

Mr. DINGELL. [continuing] as they are through the SROs and through the SEC?

Mr. LACKRITZ. That is correct.

Mr. DINGELL. Mr. Fink.

Mr. FINK. I am not an expert in bank brokerage activities.

Mr. DINGELL. Nobody is because banks all have their own rules. This bank decides to do it one way and if the regulator says he wants to do it that way, that is fine.

Mr. FINK. This may not be responsive, Mr. Dingell, but my understanding is of mutual fund sales through banks, some 80 percent by volume are done by SEC registered brokers, subs of the banks. Factual answer.

Mr. DINGELL. Then why would Mr. Jones want the other 20 percent of those sales to be exempted? Can you tell us about that, Mr. Jones?

Mr. FINK. I am happy to say that is a question for Mr. Jones.

Mr. DINGELL. In fairness for the record, Mr. Jones, why do you want the other 20 percent of those good-hearted folk to be exempted?

Mr. JONES. Mr. Dingell, the 20 percent that Mr. Fink talks about is really not exempted.

Mr. DINGELL. They are not?

Mr. JONES. They are not.

Mr. DINGELL. They are or they are not? Are you going to tell me that they are covered in full the same way as if they were a broker-dealer or that they are not covered in the same way as if they were a broker-dealer?

Mr. JONES. Mr. Dingell, I think probably the best thing we could do for you is to summarize these points and how the banking industry is offering these products today for you.

Mr. DINGELL. See, Mr. Jones, you are dealing with a very peculiar guy. I am just a poor Polish lawyer. I am not a very sophisticated fella, and I don't understand these things unless I get the answer to the question in the way I ask it and the way I want to hear it.

So you have all these good-hearted bankers who are exempt, 20 percent of them. They are not members of NASD, they are not members of one of the exchanges, they are not part of any of the SROs, and they are not under SEC regulation. They are under bank regulation.

And why would 80 percent of the banks' sales of mutual funds be regulated and why should 20 percent not? Don't you want to have that 20 percent treated the same way so that all these bankers are playing on a fair and level and even playing field?

Mr. JONES. Mr. Dingell, we believe that, to every extent possible today, that banks are complying with SEC regulation and with all

of the regulations relative to the sale of mutual funds. I must tell you that, occasionally, banks in very small communities, very small communities, act as agent for their customers, but they make every disclosure in terms of not being an FDIC insured——

Mr. DINGELL. They are not required, however, to make those disclosures, are they? And so if they forget to make that disclosure, they are not subject to any discipline, are they?

Mr. JONES. Mr. Dingell, actually, they are required—they are required to make those disclosures, both bank regulators on the Federal level——

Mr. DINGELL. The 20 percent that are exempt?

Mr. JONES. The OCC and the FDIC have made it very clear that we must disclose on all fronts that these products are not FDIC insured.

Mr. DINGELL. Let's go to the next point. Why should banks not meet SEC capital requirements?

Mr. JONES. I presume, Mr. Dingell, you are addressing this to me.

Mr. DINGELL. I am, indeed. I know that you are expert on banks.

Mr. JONES. It is nice to be this popular.

There is a different—there is a different approach to capital requirements with securities' firms and banks. Banks have capital requirements based on credit risk. Securities firms have capital requirements based on liquidity risk. And to take the apples and oranges and put them together into one capital requirement does not seem to make sense.

Mr. DINGELL. Let's look at this for a second. You have got your bank that doesn't have to meet the liquidity requirements that are imposed on SEC-regulated entities. Then the failure to meet that becomes a responsibility of the general overall capital structure of the bank, does it not? So if I am a banker and I am not meeting the net capital requirements of the SEC, I am then responsible to my depositors or the people who do business with me out of the capital which is regulated by the bank regulators; isn't that right?

Mr. JONES. And that is the reason that H.R. 1062 requires firewalls to protect the deposit insurance.

Mr. DINGELL. Don't mention firewalls or you will confuse me. The answer to the question is yes, isn't it?

Mr. JONES. The answer to the question of whether——

Mr. DINGELL. The answer to my question is yes.

Mr. JONES. Could you please repeat it?

Mr. DINGELL. The question was, if a bank is not subject to the liquidity and net capital requirements imposed by the SEC, they then are responsible to their depositors or to their customers on the basis of the capital structure that is imposed upon them by their regulators; isn't that right?

Mr. JONES. Not if firewalls are in place to protect the bank.

Mr. DINGELL. Never mind the firewalls. Just answer the question.

Mr. JONES. In the bank, yes.

Mr. DINGELL. In the bank, yes. So that means, then, that the bank is responsible to its depositors if there is some sort of misfortune on these kinds of transactions on the basis of capital which

is essentially mixed into the government guarantee of liquidity of banks through the bank insurance structure; isn't that right?

Mr. JONES. Well, the people that are—excuse me.

Mr. DINGELL. Just yes or no. It would help us both because then I can go on. You remember the question?

Mr. JONES. Half no. Because, actually, the people that are at risk when bank capital is at risk are the shareholders of that organization.

Mr. DINGELL. I am sorry?

Mr. JONES. The shareholders of the bank are the ones that hold the capital, not the depositors.

Mr. DINGELL. But, in any event, it is the capital which then is at risk, and so the risk really comes around to be laid, ultimately, upon the government. If a bank is in this in a big way and the bank has some big loss, ultimately, they are playing with not only the capital of their investors, the money of their depositors, but they are also taking risks that can be expected to be met in a fair degree by the responsibility of the Federal Government on the Federal bank insurance fund; isn't that right?

Mr. JONES. No, I do not agree with that. I believe that banks——

Mr. DINGELL. Since you don't agree with that, what is there in this that guarantees that the Federal Government's FDIC is not at risk?

Mr. JONES. There is not a guarantee. However——

Mr. DINGELL. There is nothing. All right. Now you have comforted me. Let us proceed here.

Mr. JONES. Excuse me.

Mr. DINGELL. If securities are conducted in the bank's SID, why should the bank's SID be exempt from the SEC net capital requirements? There is obviously good reason. I want you to give it to me in 25 words or less.

Mr. JONES. I touched on it briefly before, Mr. Dingell.

Mr. DINGELL. Do it again, if you please.

Mr. JONES. And that is the issue that securities' firms are holding capital in order to protect them against liquidity risk. Banks are holding capital to protect themselves against credit risk. They are totally different concepts.

Mr. DINGELL. So you are telling me then that the bank SID has the bank's capital behind these activities. Is that what you are telling me?

Mr. JONES. No.

Mr. DINGELL. Well then, what is it that guarantees the liquidity of the bank's SID to meet the calls that might be placed through defalcation, misfortune, rascality, theft or whatever it might happen to be?

Mr. JONES. Under almost every circumstance the bank capital will be the same or greater because of the capital included in the SID.

Mr. DINGELL. How do you know that?

Mr. JONES. Our people are telling me——

Mr. DINGELL. You have got a very, very excellent coach sitting in the back. Give them my compliments.

Mr. FIELDS. The gentleman's time is almost expired.

Mr. DINGELL. Could I just get an answer?

Mr. JONES. Mr. Chairman, believe me. I have seen this red light on for a long time.

Mr. FIELDS. The question is, are you seeing red yet?

Mr. JONES. No, no, I wouldn't say that. But, Mr. Dingell, we have run numbers on capital calculations, and we would be happy to supply you with them. That would prove our point.

Mr. DINGELL. I would be delighted to get them, but you still haven't answered my question.

Mr. Lackritz, would you answer my question?

Mr. LACKRITZ. That is the problem with the structure, Mr. Dingell. The problem with the structure is that you don't have any capital requirement behind the SID; and, therefore, you don't have any capital that is backing up the obligation to protect investors or liquidity crisis or anything else; and, therefore, the capital of the bank would be at risk in that kind of situation, which would merely expand the safety net, expand risk to depositors and expand risk to the taxpayers.

Mr. DINGELL. Now, if you permit, Mr. Chairman, just one more question, because I know this is going to help me a lot. In this matter that we are discussing, we have an insurance program which has protected the people who leave their shares with the securities investment houses regulated by the SEC and the SROs. How would depositors be protected under the exemption which would be given to the in-bank SID? Would there be any protection for those shares or would there be none?

Mr. JONES. Mr. Dingell—Mr. Dingell, first of all, if you are talking about SPIC insurance——

Mr. DINGELL. Yes.

Mr. JONES. [continuing] it protects people from misappropriation, defalcation, fraud, those sorts of things.

Mr. DINGELL. That is correct.

Mr. JONES. It does not prevent someone from losing their money based on an inappropriate investment.

Mr. DINGELL. That is correct. It will surprise you, but I do know that.

Mr. JONES. And there is no retail SID embodied in this legislation, as I understand it.

Mr. DINGELL. There isn't? Well, it is fair to observe that any activity which a bank could persuade the Fed was a banking activity would fall into that category, would it not?

Let me hear from Mr. Lackritz. Mr. Lackritz, I want you to help both Mr. Jones and I. We desperately need it.

Mr. LACKRITZ. My understanding is that there is an option in this bill for a retail-oriented SID and that that is an option that is available to a bank that wishes to engage in these activities.

Mr. DINGELL. You say that there is or is not?

Mr. LACKRITZ. There is.

Mr. FIELDS. If the gentleman would yield. I think there may be additional questions that we may want to present to the panel, and the Chair wants to take one quick moment and ask Mr. Lackritz, if I could, because I asked just a moment ago if it is possible to rationalize the standard between—the capital standard between the Fed and the SEC, and you said it was not. And if I understood the testimony of Mr. Jones just a moment ago, he talked about the

Fed standard really being a standard based on illiquid assets and that is why you have that particular standard, and the standard that you have to live with is a standard based on liquidity.

And so, if I understood the testimony, it seems that he is almost arguing that if something is a security type—if it is functionally regulated by the SEC, it would seem that the standard should be an SEC capital standard. I mean——

Mr. LACKRITZ. That is right. That is exactly right. But all this discussion, I think, and the question of what is the basis for the capital requirements by the Fed or what is the basis for the capital requirements by the SEC and the fact that there may be two different purposes highlights the concerns, I think, that everybody has, the appropriate concerns about mixing these functions up, which leads back to the structure of this bill and why it is so important, we think, to create separately capitalized affiliates to conduct this business. That is the clearest and easiest way to provide for functional regulation.

Mr. FIELDS. Thank you very much.

The gentleman—another gentleman from Michigan, Mr. Stupak, has been waiting very patiently. Mr. Stupak.

Mr. STUPAK. Mr. Chairman, because I was at another committee meeting I did not have the benefit to hear this panel, so I don't think it would be appropriate for me to ask questions at this time.

Mr. FIELDS. The gentleman from Ohio, Mr. Gillmor.

Mr. GILLMOR. No questions.

Mr. FIELDS. The ranking minority member of the Telecommunications and Finance Committee, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Mr. Fink and Mr. Lackritz, if I may, in much of the testimony that has been submitted we see mention of the concept of a two-way street. Even though most of this bill is directed towards providing banks with new powers to conduct business in other fields, supporters of the bill refer to a two-way street to suggest that H.R. 1062 gives securities firms and investment companies a fair opportunity to get into the banking business.

My question to you is whether, in your judgment, the two-way street created in H.R. 1062 is fair and adequate. Your testimony suggests that securities firms may have to divest substantial and possibly highly successful lines of business if they want to be able to get into banking, while no similar hurdles exist for banks themselves. So it seems to me like it is a two-way street.

On the banking side, it is an eight-lane highway; and on the securities side, it is a one-lane, with potholes and a very expensive toll booth blocking the on-ramp. And I would like to get your views as to how close I have come to accurately describing that situation.

Mr. FINK. Well, if I can start—that is a heck of an analogy to try to beat so I won't try it. But it is—practically, it is no two-way street. Most of the large securities firms, mutual fund companies, have insurance affiliates or real estate affiliates or commercial affiliates. Forty percent, according to our survey of the mutual fund industry, has insurance affiliates. Fourteen percent are real estate affiliates.

They are all blocked from going into banking. Every one of the 12,000 or whatever banks in the country under this bill has a su-

perhighway to go into the securities business, and X percent—50 percent, 40 percent—of the security industry is barred unless it is going to give up longstanding affiliations. And I have never seen any of those affiliations ever cause a problem to a securities firm.

I would like to hear—if the premise of this legislation is that commercial banking and securities activities are so close they ought to be allowed to be merged and Glass-Steagall either was a mistake or is antiquated, if that is the thesis, then why, even though the securities industry has always had the affiliations and there are no problems, are you now saying to securities firms, you can't enter banking unless you give up those affiliations? It doesn't make any logical or historical sense.

I won't try to beat your analogy, but it is the Massachusetts Turnpike versus a dirt road on the Cape or something like that.

Mr. MARKEY. Let me ask—ditto marks there?

Okay, Mr. Lackritz. Let me ask you a different question, Mr. Lackritz, if I can, if you might help to clarify an issue that arose on Tuesday.

The Federal Reserve stated that H.R. 1062 gives no new securities powers directly to banks; it merely preserves those that banks already have. The new powers that are created by the bill, according to the Fed, are given only to separate affiliates of the bank, not directly to the bank itself. Implicit in this reading of the bill is that no new direct risks to taxpayers and the bank insurance fund has been created. Is that your understanding of the bill, Mr. Lackritz?

It has been suggested to me that this bill allows banks for the first time to underwrite and deal in virtually all types of municipal revenue bonds. Could you describe for us the significance of that decision?

And perhaps you might include in your response a description of the range of securities that are fairly characterized as municipal revenue bonds and the risks that accompany those types of investments.

Mr. LACKRITZ. Sure. I would be happy to.

First of all, if the testimony of the Federal Reserve was that there was no—there were no new securities powers given directly to the banks, I don't believe that is correct. It is clear in this bill that it clearly would make municipal revenue bonds bank-eligible securities and would make them eligible to be done inside a bank, not in a separately capitalized affiliate and not in a separately identifiable department of the bank. That creates—that is a broader power.

The other significant new power in here with respect to conducting securities activities in the bank is the power that the Federal Reserve Board would have, by its own authority, to define products that are close to bank—closely related to banking or financial activities that would be permitted to be done inside a bank. And the discretion that is given to the Fed to make these determinations would be such that, in fact, the Fed would be able on its own initiative to declare all kinds of products to be financial in nature or——

Mr. MARKEY. So it will create substantial new risk?

Mr. LACKRITZ. Absolutely. Absolutely.

Mr. MARKEY. Do you agree with that, Mr. Jones? It will create substantial new risk for the depositors?

Mr. JONES. Of municipal revenue bonds, is that your question?

Mr. MARKEY. When the bank is engaging in that type of activity, will it not put at risk the depositor and, ultimately, the taxpayer?

Mr. JONES. Well, I would take exception with it on one level because I believe that commercial banks have had, as one of their principles and longstanding products, the whole process of underwriting credit risk. We understand how to underwrite credit risk.

Mr. MARKEY. I understand that. But what happens if there is a big crash? Are only your shareholders going to be responsible or will depositors and taxpayers also be liable?

Mr. JONES. Is this back to the question of banks being capitalized and the capital not being included in the bank?

Mr. MARKEY. Yes. I know you know how to underwrite it, but do you know how to keep the market at 4,500 for eternity? Do you know how to do that?

Mr. JONES. I am sorry. I didn't hear that.

Mr. MARKEY. Do you know how to keep the stock market at 4,500 for eternity? I know you know how to write the document that will engage in the financial transaction, but I want to know if you can guarantee prosperous financial results for all of these products.

Mr. JONES. My response is that the banking industry has been handling municipal general obligation bonds for a long, long time. This is a very small departure from that, and I do not see any major risk.

Mr. MARKEY. Well, I think that we might just disagree as to the difference between plain vanilla and potentially nitroglycerin in terms of the handling of——

Mr. LACKRITZ. Could I just address that for a second, Mr. Markey? I think the data will show, if you look at the data and you look at the rate of default or failure with respect to—general obligation bonds are backed by the full faith and credit of the government. Revenue bonds are secured by a revenue stream that may come in and it may not come in.

I don't have the data in front of me, but I have seen data that shows that the rate of default among revenue bonds is significantly higher than the rate of default for general obligation bonds.

Mr. DINGELL. Will the gentleman yield?

Now, here is the way this would work. You have got a big market break. Before the big market break, let's say a good-hearted bank undertakes the responsibility of underwriting a major issue of revenue bonds. That means they, at that point, own the bond. They have the whole inventory. They make their money on the sale, from the fees and all that sort of stuff.

Now, the market breaks. The bond which they thought they could offer at, let's say, 102 or 103.5f or something like that, all of a sudden can only go on the market at 97. They have sold some of these bonds at 103 so they can't call them back. The bank is now responsible for the loss between 103 and a half and 97. And if the bonds go to 90, which they have done, they are then down something like 13.5 points. They have to keep that.

Now, the question again for Mr. Jones is, who is responsible for that loss? Mr. Jones, you want tc tell us who is responsible? Is it

the bank? Is it the shareholders? Is it the depositors? Or is it FDIC or all of the above fortunate people?

Mr. OXLEY [presiding]. The witness can respond, and then we will have to move to the next panel.

Mr. DINGELL. Can't Mr. Jones tell me?

Mr. OXLEY. Yes.

Mr. DINGELL. Mr. Yingling is sitting right behind him, and he has been briefing him very well as we have been going forward.

Mr. OXLEY. Mr. Jones may answer and then we have got to move on.

Mr. MARKEY. If Mr. Jones would just factor in inverse floaters as well. It is very important to me to tell me how you handle that.

Mr. JONES. Mr. Dingell and Mr. Markey, first of all, inverse floaters is not a topic that I am familiar with. I am not a securities lawyer and our bank does not deal in them, so I cannot be responsive to that question.

Mr. DINGELL. But other banks will.

Mr. MARKEY. We don't like you dealing in things that you don't know anything about in terms of your own testimony.

Mr. JONES. I am talking about my bank in Red Wing, Minnesota, and where I come from.

Mr. DINGELL. It strikes me that we probably ought to protect you against this peril, your bank, and the thought is that maybe we just ought to protect other banks and bankers and other investors and the taxpayers from this kind of a risk.

Mr. OXLEY. The gentleman's time has expired.

We appreciate the witnesses and their testimony, and this panel is dismissed.

We would like to welcome our third panel and final panel.

Mr. GILLMOR. Mr. Chairman, may I be recognized out of order for about 30 seconds?

Mr. OXLEY. Yes, be glad to recognize the gentleman from Ohio, Mr. Gillmor.

Mr. GILLMOR. Mr. Chairman, I just want to be recognized out of order very briefly to note that the panel has a long-time friend of mine and friend of yours who I have known since he has served in the Governor's Office of Ohio and was the Chairman of the Industrial Commission of Ohio and is now an outstanding insurance executive in this country. So I would like to joining in welcoming a Ohioan, Craig Zimpher.

Mr. OXLEY. I appreciate that. I am sure he does as well.

We will introduce our panelists and then begin: Mr. Drew Pfirrman is our first witness, Senior Vice President and Counsel for Fleet Financial Group. Our second witness, Samuel Baptista, President of Financial Services Council; the aforementioned Craig Zimpher, Vice President of Government Relations with Nationwide Insurance based in the Buckeye State; and, finally, Steven Foster, Commissioner of Insurance for the Commonwealth of Virginia. Welcome to all of you.

STATEMENTS OF DREW PFIRRMAN, SENIOR VICE PRESIDENT AND COUNSEL, FLEET FINANCIAL GROUP; SAMUEL BAPTISTA, PRESIDENT, FINANCIAL SERVICE COUNCIL; CRAIG ZIMPHER, VICE PRESIDENT OF GOVERNMENT RELATIONS, NATIONWIDE INSURANCE ENTERPRISE; AND STEVEN T. FOSTER, COMMISSIONER OF INSURANCE, COMMONWEALTH OF VIRGINIA

Mr. OXLEY. And, Mr. Pfirrman, you may begin.

Mr. PFIRRMAN. Thank you. Chairman and members of the subcommittee, I am Drew Pfirrman, Senior Vice President and Counsel of Fleet Financial Group. I appreciate the opportunity to testify today on behalf of Fleet in support of H.R. 1062 and urge you to report this legislation favorably because enactment of Glass-Steagall reform legislation will continue the fine work started last year by the 103rd Congress to modernize the Nation's financial system by enacting nationwide banking and branching legislation.

In enacting H.R. 1062, we urge the committee to reject amendments dealing with bank insurance issues, such as H.R. 1317, which are anticompetitive and undermine the development of an efficient financial sector that is competitive, both domestically and overseas.

We were interested to hear Chairman Bliley's opening remarks that this issue of permitting affiliation between banks and securities firms with insurance companies is not accomplishable at this time. We at Fleet feel that, at some point, a compromise that allows affiliation in a balanced way, that expands consumer choice, must be accomplished; and we stand ready to participate in that process.

There were three essential elements that we—in any compromise on bank insurance activities. Number one, Federal preemption. We feel that State anti-affiliation affiliation, statutes which prevent otherwise legitimate affiliations between banks and insurance companies, must be preempted by Federal law. Without such preemption, the Nation will be balkanized into a patchwork of States which do and do not permit affiliations, thus undermining the goals of the Glass-Steagall reform legislation, H.R. 1062, and the interstate banking and branching bill enacted last year, to modernize the financial services system.

The second element would be nondiscrimination. If States are authorized to define and regulate bank insurance products, these rules and regulations should be designed so that insurance companies, brokers or agents affiliated with banks are not unfairly discriminated against. A strong, nondiscrimination requirement must be imposed to insure that the basic right to affiliate is not undermined.

Third, we feel that grandfathered rights are essential. If national banks are prohibited from offering products and services currently permissible—currently permissible bank insurance products should be grandfathered, and national banks should be given parity with State banks in those States that permit their banks to engage in insurance activities.

If these three critical elements are in place, we believe that a workable bank insurance compromise can be put on the table that should generate support from a bipartisan majority in the Con-

gress, the Clinton administration, the Federal regulators, from the banking industry and, hopefully, from enlightened elements of the insurance industry.

Most importantly, a good compromise will preserve the legitimate and appropriate State regulatory authority over bank insurance activities, greatly reduce expensive protracted and wasteful litigation and will be of great benefit to consumers who will enjoy more choices and flexibility in buying insurance products and related financial services.

Thank you.

[The prepared statement of Drew Pfirrman follows:]

PREPARED STATEMENT OF DREW J. PFIRRMAN ON BEHALF OF FLEET FINANCIAL GROUP

INTRODUCTION

Good afternoon Chairman Fields, Chairman Oxley and Members of the Subcommittees. I am Drew Pfirrman, Senior Vice President and Counsel at Fleet Financial Group, which is a $48 billion diversified financial services holding company with banks throughout the Northeast and approximately 1,200 other offices nationwide offering a variety of financial services products.[1] On behalf of Fleet, I would like to thank you for the opportunity to appear before your combined Subcommittees today to urge you to act favorably on H.R 1062 with a good, strong and fair bank insurance provision.

Fleet strongly supports H.R. 1062, the Glass-Steagall reform legislation reported by the House Banking Committee several weeks ago and referred to your Committee. Enactment of Glass-Steagall reform will continue the fine work completed last year by the 103d Congress in enacting interstate banking and branching legislation, and is the second step toward full modernization of our financial services sector. We urge your Committee to report H.R. 1062 favorably, and that you add provisions to this legislation permitting the affiliation of banks and securities firms with insurance companies in a reasonable and balanced way thus further expanding consumer choices in the financial services area.

Dealing with insurance is an important step in the process of modernizing the nation's financial services industry. However, in Fleet's view there is a right way to do this, and a wrong way. The wrong way would be to enact H.R. 1317, the "Insurance States' and Consumers' Rights Clarification and Fair Competition Act". As the American Bankers Association testified before the Commerce, Trade and Hazardous Materials Subcommittee on May 22, and reiterated in its testimony today, H.R. 1317 essentially gives state insurance commissioners carte blanche powers to expand their oversight of banks and impose anti-competitive state laws and regulations that discriminate against insurance agents simply because they are affiliated with banks. This is not in the best interests of consumers since it would stifle not stimulate competition.

On the other hand, the right way to deal with bank insurance issues would be to formulate a new balanced approach which protects the dual banking system and the national bank charter, while at the same time recognizing an appropriate role for the states to play in the regulation of bank insurance activities. We commend Chairman Bliley and his staff for attempting this and taking on the tough and perhaps thankless job of trying to bring together two industries that have been at odds for too long to build a compromise that will work.

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[1] Fleet is headquartered in Providence, Rhode Island and has banks in Connecticut, Maine, Massachusetts, New Hampshire, New York and Rhode Island. It also has a large mortgage company headquartered in Columbia, South Carolina and approximately 1,200 offices nationwide engaged in commercial and consumer banking, mortgage banking, consumer finance, asset-based lending, equipment leasing, investment management, and student loan processing. Once Fleet's proposed merger with Shawmut National Corporation is cleared through the regulatory process, the merged organization will be one of the country's top 10 bank holding companies with over $82 billion in assets.

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ELEMENTS OF BANK INSURANCE COMPROMISE

Based on my work in the trenches on the legal and regulatory aspects of the bank insurance issues at both the federal and state level, I would identify the following three elements of an acceptable and workable compromise:

- Federal preemption of state anti-affiliation statutes, which prevent otherwise legitimate affiliations between banks and bank holding companies, and insurance companies and agencies.
- Strong non-discrimination legislation, if states are authorized to define and regulate bank insurance products.
- Grandfathering of currently permissible insurance activities offered by national banks.

1. Preemption of State Anti-Affiliation Laws

It is critical that existing state anti-affiliation statutes be preempted by federal legislation. Anything less than this would result in a balkanization of the United States into a hodge-podge of individual states, some who do and some who do not permit affiliations between banks, securities firm and insurance companies. This clearly would be a step backward and runs counter to the purpose of H.R. 1062 and Congresses' overall intent to modernize our financial services system. It is simply not good public policy, and if not dealt with, could make the new bank-securities structures created in H.R. 1062 unworkable and will undermine the nationwide banking and branching legislation enacted last year. In addition, pushing insurance issues aside would be sure to trigger a whole new round of prolonged and expensive litigation over basic policy issues that Congress has an obligation to resolve.

There are some who argue that this is a "states rights" issue and that there should be no preemption of state authority on bank insurance issues because of the need to protect consumer rights and avoid unfair tying and coercion by banks. This ignores the importance of having a free flow of interstate commerce, a right historically guaranteed by the Constitution through the "interstate commerce clause", to help achieve the goals of financial services modernization—that artificial barriers to competition should be broken down in favor of providing as much flexibility as possible to deal with the realities of the market place and provide consumers with a broader and more flexible range of low-cost financial services products, while protecting them through appropriate, non-discriminatory state regulatory action.

More importantly, the "states rights" and "consumer protection" arguments are not borne out in practice. It is my experience that a prohibition on banks and the affiliates of the new Financial Services Holding Company (FSHC) from offering insurance products actually harms consumers. For example, the state of New York permits affiliations between banks and insurance companies and consumers have benefitted from this through better products and services. Conversely, several states in the Northeast, including Connecticut, Massachusetts, Maine, New Hampshire and Rhode Island, have restrictive rules prohibiting such affiliations. This has led to the development of a convoluted and inefficient system that limits competition and harms consumers, while protecting the current monopoly on the sale of insurance.

The practical impact of tins is that unlike a consumer in Hartford, Connecticut, a consumer in Buffalo, New York, has the ability and convenience to choose whether to buy insurance products from a local bank, or going to an independent agent, and this competition keeps costs down and generates more innovative and flexible insurance products and services. Another interesting fact is that while Massachusetts and Connecticut generally have more restrictive laws than New York regarding bank insurance activities, all three states permit special institutions called savings banks to offer life insurance products to their customers. In the more than 100 years that this has been allowed, we know of no cases of alleged consumer abuse such as tying or coercion. Consumers have clearly benefitted from this through greater convenience and lower prices.

A 1995 study by the Financial Institutions Insurance Association (FIIA) pointed out that due to the inefficiencies inherent in the current insurance distribution system approximately 40 percent of all Americans have *no* life insurance coverage, and what is available is mostly targeted for the affluent (those with incomes over $75,000). The FIIA study, backed up by statistics from insurance and other industry sources,[2] points out that the number of independent insurance agents is shrinking on a yearly basis. As the agent pool contracts, it is making less and less contact with middle market consumers and is focusing on the more affluent segment of the

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[2] Including: Life Insurance Marketing and Research Association 1993 Report and 1994 Banks In Insurance Fact Book (Association of Banks-In-Insurance).

market. Further, according to the American Council of Life Insurance's (ACLI) "Map", study shows that 69 percent of Americans do not have a personal insurance agent.

This leaves a large gap that the banks can and should be allowed to fill. Allowing banks to sell a range of insurance products would benefit consumers through greater access to insurance, provide increased competition and thus lower prices. Fleet itself would be well-positioned to help with this because of its strong ties and service to middle income consumers.

Another interesting fact brought out by the FRA study is that permitting banks to sell insurance products does not necessarily mean that independent agents would lose business or be put out of business. In fact, since there is a vast undeserved market for insurance, it is not a zero-sum game and hundreds of thousands of new jobs could be created nationwide. This is particularly important for states in the Northeast that have been faced with a slow economy and defense industry cutbacks in recent years.

The question facing Congress, and especially your Committee, is whether to preserve an outdated, inefficient and expensive distribution system, or to free our financial services industry to be truly competitive in the domestic and international markets by allowing it to offer an ever expanding range of financial products and services.

2. Non-Discrimatory State Regulation

Preemption of state anti-affiliations statutes does not mean states give up the right to protect consumers. For instance, it would make sense to allow states to license and otherwise regulate, on a non-discriminatory and reasonable basis, the insurance activities of companies affiliated with banks or the new FSHC entities created by H.R. 1062, since the sale of insurance would remain essentially a state regulated function. If state licensing and other regulations are applied in a non-discriminatory manner so that independent insurance providers are treated the same way as those that are affiliated with banks or FSHCS, the opportunity for the banking industry to make its products available free from unfair restraints would be preserved, along with legitimate state interests in protecting their citizens from potentially abusive practices.

As Mr. Bob Fulwider testified before Chairman Oxley's Subcommittee on May 22 on behalf of the Independent Insurance Agents of America "[e]very entity that engages in the underwriting and sale of insurance must comply with applicable state insurance regulation." We agree. Although I do not claim to speak for the banking industry, for Fleet non-discriminatory regulation of bank insurance activities by state authorities is an acceptable trade-off for preemption of state anti-affiliation statutes.

Based on our experiences in the Northeast, which has some of the most restrictive bank insurance laws in the country, a strong non-discrimination provision is essential because states often use discriminatory legislative and regulatory devices to reinforce or expand their antiaffiliation schemes. For example, in addition to prohibiting affiliations between banks and insurance companies, Rhode Island law prohibits the sale of insurance products on bank premises, whether retail or back office, and prohibits the sharing of customer information including name fists, between banks and insurance agencies.

In acting to assure that states do not engage in discriminatory practices in their oversight of national bank insurance activities, it is extremely important that if some discretion is given to states to deal with cross-marketing between insurance affiliates and banks during the transition period after state anti-affiliation laws are repealed, that this be done on a very narrow and limited basis.

Further, if state regulators are to be given the power to define what constitutes insurance and license and regulate those products, it is critical that the federal bank regulators and the banks themselves be given the right to challenge state actions in this area in the federal courts. Otherwise, there would be no real check on unfair actions by state insurance authorities or legislators directed at national banks, which are chartered by the federal government.

3. Grandfather Currently Permissible Bank Insurance Activities and Provide Parity With State Banks

The third element of a compromise on bank insurance activities should provide that if the Office of The Comptroller of the Currency (OCC) is to be prohibited from authorizing new insurance products for national banks, currently permissible activities, including the sale of annuities, should be explicitly grandfathered and national banks should be given parity to offer bank insurance products to the same extent state chartered banks are authorized to do so. The grandfather and parity provi-

sions should be an iron-clad guarantee that protects national banks against inappropriate direct or indirect interference from state regulators or legislators.

CONCLUSION

It is Fleet's view that if these three critical broad elements are put in place—preemption of state anti-affiliation statutes, non-discriminatory state regulation and grandfathering currently permissible bank insurance activities—a workable bank insurance compromise can be put on the table that should generate general support from the banking industry, and hopefully, enlightened elements of the insurance industry. It should also win support from those in other segments of the financial services industry that want an effective and strong financial services sector put in place in this country without further delay. Most importantly, it should enjoy support from consumers, who would benefit greatly from more competition and flexibility in buying insurance products and services. Fleet looks forward to working with the Members of this Committee, other Members of the House and Senate, and other interested parties to try and put this in place.

I thank the Chairmen and Members of these Subcommittees for allowing me to testify today and look forward to answering any questions you might have.

Mr. OXLEY. Thank you.

Mr. Baptista.

STATEMENT OF SAMUEL BAPTISTA

Mr. BAPTISTA. Thank you, Mr. Chairman. I appreciate the opportunity to present the views of the Financial Services Council on the need for the financial reform generally and offer specific comments on H.R. 1062.

The Council's diverse membership, which includes bank holding companies, thrifts, insurance companies, securities firms and diversified financial service companies, is committed to modernizing our financial regulatory structure in a manner that will permit any well-managed, well-capitalized company, regardless of its corporate structure, to enter or exit any sector of the financial services industry anywhere in the world.

We believe that it is important for legislation to move through the House this year. The ability of the American financial service providers to continue to be innovative and competitive in a market rapidly changing through new applications of technology and telecommunications is constrained by antiquated laws and regulations that present barriers to affiliation.

The legislation pending before this committee, H.R. 1062, does begin the process of building a more fully integrated financial services model by amending the Glass-Steagall Act to allow banks to more broadly affiliate with an investment banking firm and allow some, but not all, investment banking firms to affiliate with banks.

In addition, replacing the Bank Holding Company Act's closely related banking test with one that is financial in nature will allow banking organizations to participate in a broader range of activities impermissible today.

Unfortunately, after taking this positive step toward recognizing that financial services is broader than just banking, H.R. 1062 specifically excludes a critical component of the financial services industry, namely, insurance. As a result, many securities firms would be unable to acquire or affiliate with a commercial bank due to the retention of such specific activities restrictions, and insurance companies are completely left out of the modernization process.

It is disappointing that the Banking Committee's product does not recognize the extent to which financial services has become one

market. It is disappointing to learn this morning of Chairman Bliley's intent not to continue to press forward on the issue of affiliation.

I realize that this issue raises thorny issues and ignites turf battles between the banking and insurance sectors on questions of how and by whom insurance products may be sold. It will take strong leadership to devise an equitable solution, but I cannot impress upon you enough the importance of doing so.

In many respects, today's financial services industry can be viewed as a three-legged stool: banking, securities and insurance. Without all three legs on solid ground, the stool tilts off balance or, worse, collapses. If it is to succeed, financial modernization must take into account all three sectors and move them forward together.

Proposals that do not recognize the need for reciprocal market access for all participants within the financial services industry eventually collapse due to their inherent competitive imbalance. It simply makes no sense to exclude insurance from being financial in nature when the market clearly dictates that it is.

Thus, under the Banking Committee's construct, the Federal Reserve Board could determine that Microsoft was a financial concern but would be precluded from making the same determination for companies like Travelers, Aetna, AIG, New York Life, Prudential, Providian, USAA, Kemper, et cetera. These are not just insurance companies. They are the very essence of a financial services holding company. To foreclose their inclusion within a new statutory framework for financial services is counterintuitive to the realities in the marketplace.

Thus, the Council recommends that, at a very minimum, this committee act to amend H.R. 1062 by expressly providing that all forms of insurance are deemed financial in nature, permit mutual and reciprocal insurance companies which may not by law form upstream holding companies to themselves become financial service holding companies and permit insurance affiliates of a financial services holding company to continue to invest their reserves and unearned premiums in accordance with State law.

Additionally, H.R. 1062 gives far too much latitude to the Federal Reserve. We are particularly concerned about the plenary grant of regulatory authority to the Fed essentially making them the sole arbiter of how our new financial system evolves.

Further, by building on the existing Bank Holding Company Act framework, functional regulation is thwarted and existing restricting holding company regulation is perpetuated. To the extent that any umbrella oversight is needed, we believe that such authority would be more properly vested with a committee similar to the National Financial Services Oversight Committee, as contemplated under the legislation introduced by Senator D'Amato and Representative Baker. This approach would more appropriately complement and coordinate the notion of functional regulation.

In summary, today's marketplace no longer recognizes a unique role for a commercial bank, investment bank or insurance company. It recognizes the role of a financial intermediary. As a result, we no longer have the luxury of dealing with reform one industry segment at a time. The limitations placed on affiliations by the

Glass-Steagall Act and the Bank Holding Company Act must be dealt with in tandem if we are to have a workable, fair and equitable framework for the delivery of financial services.

Thank you.

[The prepared statement of Samuel Baptista follows:]

PREPARED STATEMENT OF SAMUEL J. BAPTISTA, PRESIDENT, FINANCIAL SERVICES COUNCIL

Mr. Chairman and Members of the Committee, I am Samuel J. Baptista, President of the Financial Services Council ("Council").

The Council is a unique coalition representing companies from literally every sector of the U.S. financial services industry. It was formed in April of 1987 in response to the very real need for an inter-industry focus on issues involving the structure of our nation's financial system. Our sole purpose is to promote the development of an open and competitive financial services industry—one that ensures the safety and soundness of the nation's financial system while increasing the availability of financial products and services at fair and reasonable prices; and one that enhances the competitive posture of the U.S. financial sector in an ever more complex global marketplace. Council members seek to modernize our financial regulatory structure so that any well managed, well capitalized company, regardless of its corporate structure, would be permitted to enter or exit any sector of the financial services industry anywhere in the world. The Council's diverse membership, which includes banks, thrifts, insurance, securities, finance, and diversified companies, is committed to comprehensive, pro-competitive financial services reform in keeping with these general principles.

I am pleased to have an opportunity to present the Council's views on the issue of financial services reform generally, and specifically on what we see are necessary changes to H.R. 1062, the Financial Services Competitiveness Act of 1995, as reported from the Banking Committee.

There can be little debate over the fact that modernization of our financial laws is long overdue. The issues surrounding the modernization debate are not new. The Congress, through its deliberations on this issue over the past decade, has amassed a comprehensive record of the need for modernization and the pros and cons of competing legal frameworks for the financial services industry. The Council wishes to commend the Commerce Committee for its work on this legislation, and particularly for the importance you place on creating an equitable structure for the entire financial services industry. We believe it is imperative for this legislation to move through the House this year and not get bogged down in the usual turf wars that have defeated modernization efforts in the past.

Our current financial regulatory structure was put in place in a very different time. In the wake of the stock market collapse of 1929, the sections of the Banking Act of 1933 known as Glass-Steagall were enacted in an era of deep distrust of our financial sector. As a result, today's financial system is heavily regulated and the banking system is protected by numerous safeguards enacted over the years. The most recent of these safeguards, the FDIC Improvement Act of 1991, significantly raised the capital requirements for banks, provided extensive new supervisory authority for bank and thrift regulators, and instituted a prompt regulatory action system that mandates early intervention into troubled institutions in order to protect the insurance fund.

Furthermore, the current regulatory structure was put in place when the range of services available to the consumer, as well as the number of potential providers, was limited. Financial services largely were obtained locally, more often than not from a neighborhood banker or insurance agent with whom the consumer was personally acquainted.

Today's marketplace involves millions of investors and consumers who are not hesitant to obtain services from a variety of providers, some locally, and some located in distant states. Today's increasingly sophisticated consumers can obtain an ever-growing range of services that were not available when the legal framework was constructed—services like mutual funds, money market accounts, credit cards, individual retirement accounts, and home equity loans. Financial services providers use a wide range of risk-management techniques that were not available when the legal framework was constructed, like derivatives, futures, options, and global syndications. While the legal structure was set up to compartmentalize financial services products and providers, the marketplace, driven by consumer demand and risk-management technology, is blurring those distinctions and in many instances making them irrelevant. Services that were once available only from specific providers

can now be obtained from many sources. For example, a consumer can obtain a personal loan through a bank, a finance company, a securities firm, or a credit card issued by a diversified company. Consumers can open a bank savings account or save through a mutual fund or an insurance annuity. And, in many respects, money market accounts increasingly are becoming replacements for the more traditional bank checking account.

On the provider side, the economics and risks inherent in a loan syndication do not differ essentially from the economics of a securities underwriting. And except for the differences imposed by law or regulation, it is difficult to identify substantive differences between a guaranteed investment contract provided by an insurance company and a bank investment contract provided by a bank.

While outdated, the financial services laws are nevertheless porous enough to allow the competitors of banking organizations to effectively penetrate markets which had historically been the province of banking,and to allow banks to penetrate markets reserved for other providers. Nonbank financial firms entered the banking business using legal loopholes and special provisions of law to buy or establish credit card banks, industrial loan corporations, other limited purpose banks, and thrifts. Banks entered the securities and insurance sectors using laborious, time consuming and cumbersome regulatory procedures. But though financial services companies are diversifying to the extent legally possible, none can truly compete effectively because each has limitations on its ability to provide the full menu of financial services demanded by their customers.

To allow the free market to work, financial services laws must be revised in ways that reflect the changes in consumer and business demands and their savings and investment preferences. Likewise, it is imperative that this new structure also reflect the blurring of distinctions between financial services products, the emergence of new financial services products and communications and computer technology by which these products are made available. The marketplace has so outpaced the regulatory framework that, for the most part, the legislation we are discussing today is hardly innovative. The repeal of affiliation restrictions between insured banks and investment banks by no means captures the breadth of evolution of the financial marketplace. As you look to legislative remedies, the Council would like to offer several guiding principles:

- The revised structure should remove anti-competitive barriers to affiliation that favor any industry segment and thereby limit the product offerings, marketing approaches and competition which would otherwise benefit consumers.
- The new structure should open all financial business to companies—financial and commercial—that meet tests of financial soundness and prudent operation—in order to promote new investments and capital.
- Regulation of separate affiliates under a holding company umbrella should be conducted along functional lines.
- In keeping with functional regulation, holding company supervision should be minimal, residual in nature, and then related only to specific goals of public policy.

The legislation pending before this Committee, H.R. 1062, does take a necessary step in modernizing our financial laws. H.R. 1062 would allow banks to more broadly affiliate with an investment banking firm while allowing some investment banking firms to affiliate with banks. However, as discussed, affiliations between banking and securities organizations is only part of the financial modernization equation. It is disappointing that the Banking Committee's product does not recognize that financial services have become one market, and seeks instead to continue to single out only parts of the financial services industry for special treatment.

As this Committee contemplates improvements to H.R. 1062, it is important to bear in mind that the new framework must work for all sectors of the financial services industry. In many respects I view today's financial services industry as a three-legged stool—banking, securities, and insurance. Without all three legs on solid ground, the stool tilts off-balance, or worse, collapses. If it is to succeed, financial modernization must take into account all three sectors, and move them forward together. Proposals that do not recognize the need for reciprocal market access for all participants within the financial services industry eventually collapse due to their inherent competitive imbalance.

The Council would have preferred that legislation be based on the framework proposed in H.R. 814, introduced by Mr. Baker, a companion bill to S. 337, introduced by Senate Banking Committee Chairman D'Amato. These proposals incorporate the Council's primary principle—that the financial services industry be open to all competitors who meet the tests of financial soundness and prudent operation. They

would set in place a new legal framework that works equitably for the entire financial services industry.

In this regard, I applaud the efforts of this Committee to bring insurance back into this debate. I realize that it raises thorny issues and ignites turf battles between the banking and insurance sectors on questions of how and by whom insurance products may be sold. It will take strong leadership to keep all parties at the table and devise an equitable solution. But I also cannot impress upon you enough the importance of doing so.

H.R. 1062

Briefly, H.R. 1062 would repeal the anti-affiliation restrictions of Section 20 of the Glass-Steagall Act to permit a financial services holding company to control a bank and a securities affiliate. The securities affiliate may engage in underwriting and dealing in any security, can sponsor investment companies and distribute shares of those companies. Investment banking firms that fit within the narrow definition of financial services contained within H.R. 1062 would be able to become financial service holding companies and, thus, control an insured bank. The bill also creates a parallel structure for financial services companies that do not accept insured deposits or deposits under $100,000. These companies would be able to establish an investment bank holding company to own both a noninsured wholesale bank and a securities firm, and participate in a slightly wider range of services.

H.R. 1062 does begin the process of allowing a more fully integrated financial services model by replacing the Bank Holding Company Act's "closely related to banking" test for permissible activities with a "financial in nature" test. We are encouraged that prior to mark-up the Banking Committee did expand the definition of "financial in nature" to include a broader range of activities than permissible today. The definition was expanded by requiring the Federal Reserve to take into account changes and reasonably expected future changes in the marketplace and in technology, as well as activities approved for U.S. banks overseas. This should allow the new financial services holding companies to engage in a wider variety of activities. However, after taking this positive step toward recognizing that financial services is broader than banking, the bill then specifically excludes certain financial services from the definition, namely insurance.

A quick review of the current affiliations of major securities firms in the U.S. highlights the competitive problems that result from this approach. Although repeal of selected Glass-Steagall proscriptions and the new financial in nature test as provided by H.R. 1062 would allow bank affiliates to engage in securities activities, many securities firms would be unable to acquire or affiliate with a commercial bank due to the retention of specific activities restrictions contained in Section 4 of the Bank Holding Company Act. Thus companies like Kemper, American Express, USAA, Prudential and Travelers, to mention only a few, would not qualify to become this new financial services holding company because of affiliations with insurance underwriters or affiliation with entities engaged in activities that may not be determined "financial in nature."

The fact that only limited insurance activities could be included within the new holding company framework while most other insurance activities are excluded will invariably lead to more unproductive, costly litigation as interested parties attempt to enter new fields or protect existing turf. It simply makes no sense to exclude insurance from being "financial in nature" when the market clearly dictates that it is. Under the H.R. 1062 construct the Federal Reserve Board could for instance determine that Microsoft was a financial concern but would be precluded to make the same determination for Travelers, Aetna, AIG, New York Life, Prudential, Providian, USAA, Kemper, etc. These are not just insurance companies, they are, in the eyes of the marketplace, the very essence of a financial services holding company. To foreclose their inclusion within a new statutory framework for financial services holding companies is counterintuitive to the realities of the marketplace. And the fact that many securities firms have either significant insurance or commercial affiliations makes the proposal unworkable for part of the investment banking industry it was supposed to include. As a result, the bill falls far short of the very modernization it purports to accomplish.

Second, H.R. 1062 gives too much latitude to the Federal Reserve. The Federal Reserve, as the premier bank regulator, has a history of extreme caution and timidity toward expanding the range of financial activities allowable for a bank holding company. We sense the same bank orientation will preside over the new financial services holding company. The Council is also concerned about the plenary grant of regulatory authority to the Federal Reserve, essentially making one regulator the sole arbiter of how our new financial services system evolves.

Further, by building on the existing Bank Holding Company Act framework, functional regulation is thwarted and existing restrictive holding company regulation is perpetuated. Though H.R. 1062 sets a category of institutions that will be eligible for less direct-Federal Reserve supervision, most financial services holding companies will be subject to direct Federal Reserve regulation. Rather than concentrating on supervision of the insured depository institution, regulatory attention will likely be focused on the activities of the holding company and other nonbanking activities. Effective oversight of prudential activities and bank safety and soundness is more appropriately directed by looking first and foremost at the activities and operations of the insured depository and secondarily at the activities of its affiliates. Thus, the Council believes that regulation should be focused from the bank outward versus the top down regulatory model that exists today with the Bank Holding Company Act and would continue to exist under the new Financial Services Holding Company Act contemplated by H.R. 1062.

To the extent that any umbrella oversight is needed, we believe that such authority would be more properly vested with a committee similar to the National Financial Services oversight Committee comprised of the various federal functional regulators as contemplated under the D'Amato/Baker bill and the Treasury proposal. This would both complement and coordinate the notion of functional regulation. While H.R. 1062 does include an advisory committee, called the Banking and Financial Services Advisory Committee (BFSAC), comprised of the Chairs of the Federal Reserve, FDIC, SEC, CFTC, the Comptroller of the Currency, and the Secretary of the Treasury, the bill would be improved by enhancing the role of this Committee from strictly advisory. The Committee should be empowered to make binding policy decisions regarding the "financial in nature" definition and prudent regulation.

BANKING AND COMMERCE

While I fully realize that allowing commercial firms to own insured banks is not on the table at this stage of the debate, I would be remiss if I did not mention one of the cornerstones of the Council's philosophy. As stated earlier we believe that any well managed, well capitalized company, regardless of its corporate structure should be able to enter or exit any sector of the financial services industry anywhere in the world. Therefore, we support all forms of affiliations, including those between banking and commerce. It simply makes no sense to place limitations on such affiliations as long as they satisfy prudential regulations.

H.R. 1062 recognizes that financial firms are engaged in commercial activities. But instead of building a regulatory framework to accommodate this, the bill seeks to limit which firms can continue what percentage of non-financial activities for what period of time by building in baskets for "non-conforming" activities and transition periods to divest of certain businesses. It is a convoluted construct that simply ignores the reality of the market.

Affiliations between commercial firms and banks is neither a radical nor new concept in our country. Banking and commerce have been mixed in the U.S. since our country's birth. Today, commercial firms can own limited purpose banks or full-service thrifts. Those that do, do so because they have chosen to diversify into financial services and the affiliation allows them to more fully serve their customers.

In a 1987 study, the FDIC noted that "there has never been a complete separation of finance and commerce in the history of American banking." The law has always permitted individuals to own controlling interests in both a bank and a commercial firm, and throughout American history individuals have simultaneously owned and in many cases managed both a bank and a commercial firm. Thus, an individual on Main Street can own the only bank in town as well as the only insurance agency, real estate agency, car dealer, and hardware store. Yet, publicly traded companies may be prohibited from having such affiliations simply because of their corporate structure. Surely, if restrictions on affiliations with commercial banks are appropriate for publicly traded companies subject to the rigors of market regulation by our nation's rating agencies they should apply to individuals whose activities and financial conditions are subject to far less scrutiny.

Summary

Today, the marketplace no longer recognizes a special role for a commercial bank, investment bank, or insurance company. It recognizes the role of a financial intermediary. As a result, we no longer have the luxury of dealing with reform one industry segment at a time. The limitations placed on affiliations by the Glass-Steagall Act and the Bank Holding Company Act must be dealt with in tandem to create a workable, fair, and equitable definition of financial services. Then, and only

then, can a framework be developed that works not only for banking organizations but for the financial services industry as a whole.

Although all financial services have the same common elements, law and tradition have treated banks as if they were special. Monies depositors place with their depository institutions are insured by a federal agency. Depository institutions also have access to federal agencies for their funding needs in times of trouble. These advantages justify federal regulation. But regulations restricting the ownership and affiliations of depository institutions are counterproductive and thwart the goal of ensuring safety and soundness.

The benefits of competition—the market constraints on prices, the incentives for efficiency and innovation, and the dispersion of economic power are widely recognized. The taxpayers—your constituents our members customers would benefit from a comprehensive financial services holding company structure. The safety and soundness of the entire financial system would be strengthened; there would be open and fair competition in the domestic financial services marketplace; and American suppliers of financial services would become more competitive worldwide. A more efficient and stable financial system will be better able to serve the needs of individual consumers, businesses, and governments in the U.S. and around the world. Only through comprehensive financial modernization can we achieve these vital public policy goals.

Mr. FIELDS [presiding]. Mr. Zimpher.

STATEMENT OF CRAIG ZIMPHER

Mr. ZIMPHER. Thank you, Mr. Chairman. In absentia, let me also thank Congressman Gillmor for those very kind comments.

Mr. Chairman, my statement has been submitted and for the sake of brevity, knowing you have a full crunch of business today, as other members do, I will try to be brief and summarize my comments. But I would begin by adding to Congressman Markey's analogy.

We happen to believe, speaking of streets and highways, Mr. Chairman, that to expand opportunities for insurance product development, distribution and delivery to consumers outside of well-established State regulatory mechanisms wouldn't be a two-way street, it wouldn't be a one-way street, it wouldn't be the Massachusetts turnpike. It would be a cul-de-sac, and it is a cul-de-sac we happen to think many insurance consumers around the country could ultimately be unwittingly and unnecessarily trapped in.

Our concern, Mr. Chairman, and you heard many of these comments this morning in the first panel that you chaired about preemption of State regulation, stems from a series of Comptroller of the Currency opinions and rulings over a period of time which have unilaterally expanded insurance authority for national banks. Several examples of those opinions and rulings are outlined on page 2 of my statement which has been submitted.

Members of the committee, Mr. Chairman, absent any clear expression of legislative intent or congressional intent, certainly at a minimum as that provided in H.R. 1317, these rulings could very likely serve as a basis for future and continued erosion of State insurance regulation.

We happen to believe, based on behalf of Nationwide and NAMIC, who I am testifying on behalf of today, that State regulation serves a very effective purpose, particularly in two areas: first, in financial regulation; and, second, in what I will term market conduct or consumer protection regulation.

In the financial realm, Mr. Chairman and members of the committee, insurance companies are exposed to risk-based capital requirements. All of our reserving requirements are specified in State

regulatory statutes and rules. Reserving requirements are predicated upon the nature of the risk of the particular claim or the kind of insurance that may be involved.

And, second, the majority of States across the country, Mr. Chairman, require prior approval of all insurance rates. That is, that before any premium increase may be affected in a majority of those States, we must file, prior to any commissioner's approval, for complete review and oftentimes extensive hearings on our rate requests.

And third, State regulatory systems provide guarantee funds. Assessments against insurance companies fund those funds and exist—they exist to protect consumers in the event of insolvencies on behalf of insurance companies.

Second, in the area of market conduct examinations or market conduct regulations, what I would refer to as policyholder protection regulations, every phase of our business and every phase of an agent's business is required to be reviewed either annually or triennially. Those reviews and examinations and audits by insurance commissioners include such things as our adherence to renewal or cancellation laws in the States, fair claims practices and settlement procedures to assure that we are filing and using proper rates and rating territories in the States, whether it is for auto, homeowners, any line of insurance, Mr. Chairman.

We happen to think that these rules have been effective. They have been modified. They have been worked on through 50 years of trial and error and experience. They exist, Mr. Chairman, to protect the long-term financial promise that is, in essence, an insurance contract.

I would just conclude my testimony there, Mr. Chairman. Thank you.

[The prepared statement of Craig Zimpher follows:]

PREPARED STATEMENT OF W. CRAIG ZIMPHER, VICE PRESIDENT OF GOVERNMENT RELATIONS, NATIONWIDE INSURANCE ENTERPRISE ON BEHALF OF THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. Chairman and members of the Committee, my name is Craig Zimpher. I am Vice President of Government Relations for the Nationwide Insurance Enterprise, headquartered in Columbus, Ohio. The Nationwide Enterprise is a group of core insurance companies, ranging in product lines from Personal Auto and Homeowners to large commercial cases. Our products include a significant national exposure as well in the life insurance, annuity and health insurance areas. Our companies are licensed to engage in the business of insurance in all 50 states. In addition, Nationwide operates an affiliate insurance operation, NECURA Insurance Company in Germany and other parts of Europe. I appear before you today on behalf of Nationwide, and, or specifically at the request and on behalf of the National Association of Mutual Insurance Companies (NAMIC). NAMIC is a national trade association representing over 1,200 property and casualty insurance companies. Its membership ranges in size from small county mutuals to industry giants and consist of several types of companies including mutuals, stocks, reciprocals, reinsurers, and surplus lines carriers.

You have heard, and will hear additional commentary on the issue of banks, and their proposal to engage in the business of insurance. This issue is significant and has vast public policy ramifications as it affects the financial security of millions of Americans.

NAMIC believes, Mr. Chairman, that to expand banking powers into the insurance business, absent of state regulation of such practices, as currently provided in all 50 state jurisdictions of this country, would be misguided, misdirected, and terribly short-sighted public policy on behalf of the millions of insurance consumers across this country. I can assure you that if Nationwide were to acquire a depository

institution we would expect to manage it under the appropriate set of rules and regulations designed for that business... we also believe insurance should be managed under its set of rules.

We believe, due to decades of business regulation by the states, as mandated by Congress in the 1940's through the McCarran-Ferguson Act, that the existing system of insurance regulation at the state level works effectively and efficiently for both those regulated and those protected, the consumers. To exempt or preempt the banking insurance from such regulation would disrupt and distort the insurance marketplace across the country.

Mr. Chairman, H.R. 1062 is not "insurance neutral." Unless safeguards and provisions of state regulation, as encompassed in H.R. 1317, are incorporated in any final legislation, NAMIC and its members must oppose current legislative proposals. Our concern about bank preemption from insurance regulation results from a series of rules and opinions issued by the Comptroller of the Currency. These rules have unilaterally expanded insurance authority of national banks. For example, these rules have:

- Interpreted existing statutory authority of small town banks to sell insurance in rural areas in a way that permits money center banks with branches in small towns to sell insurance nationally.
- Concluded that municipal bond guarantee insurance could be issued by national banks as "standby letters of credit."
- Concluded that mortgage completion insurance could be issued by national banks as "debt cancellation contracts."
- Pronounced that annuities are not insurance and can therefore be sold by national banks without limitation.
- Pronounced that annuities can be underwritten by national banks as "deposit obligations," there by forcing the FDIC to extend federal deposit insurance coverage to this form of insurance.

In sum, these rules, absent any other clear expression of Congressional intent, may very well serve as the foundation for future and drastically expanded erosion of state insurance regulation and consumer protection.

Mr. Chairman, should banks engage in any phase of the insurance businesses, we strongly believe that such engagement should be conducted on a two-way street. It should be conducted on a level playing field. To preempt state regulation or exempt the banking industry from state regulation of insurance is not a two-way street...it is not even a one-way street...it would be nothing more than a cul de sac...into which insurance consumers would be trapped in every corner of this country.

Mr. Chairman, state regulation has, essentially, a two-fold purpose. First, it is designed to protect and assure equity of consumer treatment by insurance providers. Second, it is designed to protect consumers, and their long term financial needs, through the financial regulation and oversight of insurance companies.

During the last several years, significant strides and progress have been made in standardizing financial reporting and monitoring requirements. Minimum standards of insurance company capitalization, or surplus maintenance, to assure individual company solvency have been promulgated and are in place. These capitalization requirements differentiate among insurance product lines and the associated degrees of risks involved therein. Included in these standards are specific reserving requirements for various types of claims with which companies must comply. If banks were to be preempted or exempt from state insurance regulation, such as the one I just noted, such reserving or other solvency provisions of state law would not be applicable to banks, therefore allowing much greater capital or "surplus" flexibility and liquidity for them, creating an extremely unfair and disadvantageous situation. To assure that insurance rates are not unfair, excessive, or inadequate, the majority of insurance regulators across the country require prior approval of any insurance rates before they are implemented. In other words, Mr. Chairman, before any premium increases may be effective in a state, regardless of whether the premiums are related to automobile insurance, homeowners insurance, workers compensation or any other line of insurance, rate proposals are closely scrutinized and evaluated by insurance regulators. So long as the prior approval requirements are in effect, why shouldn't all potential providers of insurance products be subject to the same rate regulation? Exemption from such rate regulation would, it is so obviously clear, create a vastly unfair and unlevel competitive environment in a particular state.

Second, Mr. Chairman, through various "market conduct" regulations the various insurance departments of this country have promulgated a series of requirements and regulations designed to provide adequate and equitable protection of insurance policyholders. Market conduct laws and regulations apply to insurance practices and operations ranging from insurance nonrenewals and cancellations to reviews of

agent conduct and activities claims handling and processing procedures to assure compliance with unfair claims practices provisions, and individual company underwriting practices, to assure that appropriate rates are being charged for various lines of insurance. Such state regulation ensures that insurance products are being offered in a way so as not to create discrimination, so that fair and prompt claims handling practices are being adhered to, and to assure than honest marketing and sales practices are engaged in. The fact, Mr. Chairman, is that these series of regulations, in their totality, effectively serve to protect the consumers and assure the long term financial viability of those offering customers insurance products.

Mr. Chairman, one additional feature unique to the state regulatory scheme has been the development and successful operation of state guaranty funds. These funds, including both property and casualty and life insurance products, are in place in the various states and are funded through assessments of existing insurance companies. They are designed to protect and assure long term protection of policyholders whose insurance companies may have become insolvent. Any companies or business interest involved in the insurance business should and must be subject to participation in such guaranty funds.

Language in the current draft of H.R. 1062 would permit subsidiaries of a financial service holding company to disclose to affiliates customer information as long as the customer is given the opportunity to object to having the information communicated. If the financial services holding company is permitted to own an insurance agency, and bank affiliates can release information concerning its customers current insurance carriers, insurance premiums, insurance coverage, renewal date, income, location of risk, etc., to the insurance affiliate, this amounts to a taking for profit of the insurer's proprietary information by a third party beneficiary. While it is one thing to allow banks the right to market insurance to ALL their bank customers, it is quite another issue to allow banks to target customers from information in their mortgage files in order to "cherry-pick" the best risks. For example, the insurance affiliate of the bank could contact the customer just prior to policy renewal, be able to offer a lower premium, know more about the policyholder's current coverage than the policyholder may know, and be in a position to make a sale without the current agent or company even knowing what happened. For customers whose insurance premium is held in escrow there would be nothing to prohibit the insurance agent to lead into the sales call with "how would you like to reduce your mortgage payment?" This would not appear to be prohibited under the tying restrictions applicable in the bill, yet would be an unfair sales practice.

The banks are arguing that any state limitations on specific marketing activities of bank insurance affiliates would be unfair discrimination. First of all, this is untrue. There are many examples of laws which affect insurance companies differently because of the corporate structure and those laws are generally not found to be discriminatory. However, we think if it is appropriate as a matter of federal banking law to prohibit improper use of customer information. This would avoid insurance regulators becoming involved in the issue and unnecessary litigation in the states on the basis of any anti-discrimination language in the statute.

Mr. Chairman, America does not need a dual system of regulation for insurance products. A steady and sound regulatory system has been in place for decades. State regulation of insurance is getting the job done effectively and efficiently. To exempt from state regulation insurance products offered by banks would be unsound and counter-productive to modernizing financial services delivery in this country and protecting consumers of insurance products. We should clearly and vigorously echo a comment made by a previous witness before the Committee... and that is that the Commerce Committee's consideration of H.R. 1317 cannot be separated from the ongoing discussions and eventual consideration of financial institution reform. Certainly, at a minimum, one way to assure competitive equality and parity would be to attach H.R. 1317 to H.R. 1062... such an action would at least begin to level the playing field.

In conclusion, NAMIC is not in a position to support any proposal which contemplates affiliations within the same corporate structure between banks and insurers. However NAMIC has taken the position that there are a few critical elements which at a minimum would have to be incorporated in any affiliation proposal in order to receive even initial consideration by NAMIC member companies: 1. All insurance activities would have to be conducted by an entity or entities separate from any depository institution; 2. All such insurance affiliates would have to be subject to all the requirements of the appropriate state insurance regulatory authority; 3. Any structure permitting such affiliations would have to be supplemented by a grant of reciprocal authority that would permit both stock and mutual insurance companies to engage in the business of banking and other activities in which depository institutions are permitted to engage.

Mr. OXLEY. Thank you.
And our final witness is Steven Foster from the State of Virginia.

STATEMENT OF STEVEN FOSTER

Mr. FOSTER. Thank you, Mr. Chairman.

Good afternoon. My name is Steven T. Foster. I am the Insurance Commissioner for the Commonwealth of Virginia. I am also the former President of the National Association of Insurance Commissioners, and I am here today to represent the NAIC before these two subcommittees.

First of all, Chairman Oxley, I would like to thank you for the opportunity to be here today on behalf of the NAIC, and I also wanted to express my particular appreciation to Chairman Bliley and Congressman Dingell and the other supporters of H.R. 1317. I do not have many comments to make today about H.R. 1062, but you should know that the members of the NAIC have formally endorsed Chairman Bliley's bill, H.R. 1317, in our recently completed summer national meeting convened this week in St. Louis.

As State insurance regulators, we believe adamantly that the States, and not Federal bureaucrats, who are responsible for overseeing banks or the security industry, but instead the States should regulate the business of insurance, including the insurance marketplace and those entities and those individuals in the sale and underwriting of insurance.

The NAIC members have not taken a position on H.R. 1062, but our members do believe strongly in the idea of functional regulation in the sense that State insurance regulators—and, again, not Federal banking regulators—should regulate and oversee the business of insurance, regardless of the type of entity or individual engaged in those same activities. All who sell or underwrite insurance or solicit the sale of insurance should conform to the same laws and regulations.

If the Committee on Commerce is to amend H.R. 1062, this committee must do exactly what Chairman Bliley said when he introduced H.R. 1317, and I quote: "The traditional role of the States in insurance regulation must be protected," and, also, "the committee should reaffirm the rights of the States to oversee the sale, underwriting and solicitation of all insurance products, including those sold by national banks."

All insurance activities by banks should be approved by State insurance regulators who should have explicit authority over insurance activity in the respective States. Anyone who engages in insurance business, whether insurance sales or underwriting, should and must adhere to the same State insurance laws and regulations. In other words, a level playing field is important for all of those who engage in the business of insurance.

Though the Comptroller of the Currency and other Federal banking regulators may disagree, I think the Committee on Commerce and the 104th Congress should and must add the language of H.R. 1317 to H.R. 1062. Such an amendment would serve to clarify and reinforce the fact that the McCarran-Ferguson Act of 1945 entrusts the States and not Federal regulatory authorities with the jurisdiction and authority to regulate the insurance business in this country.

Whatever action the Committee on Commerce takes regarding the affiliation of banks and securities, it is important to insure that the appropriate regulators, in this case State insurance regulators, retain jurisdiction over the business of insurance.

As Virginia's Commissioner of Insurance, my most important responsibility is to protect our consumers and the policyholders of those companies licensed in Virginia. I attempt to do so by requiring all of those who sell insurance or otherwise engage in the business of insurance to comply with all of Virginia's licensing laws and our consumer protection laws and regulations.

In Virginia, we happen to have a permissive environment. Our laws do not distinguish between national banks and State-chartered banks, and our statutes do not prevent banks from selling insurance. But I hope you will all remember that it is the States and not the OCC or other Federal banking regulators that are responsible for protecting insurance consumers and policyholders, and it is our duty to make sure the insurance industry remains financially sound for all Americans.

These are the most important functions of my office. The other respective State insurance departments, and not Federal bank regulators, share in these same priorities.

I would like to thank you for this chance to testify, and I would be happy to answer any questions, Mr. Chairman, you and the others may have. Thank you.

[The prepared statement of Steven Foster follows:]

PREPARED STATEMENT OF STEVEN T. FOSTER, COMMISSIONER OF INSURANCE, COMMONWEALTH OF VIRGINIA ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Good day, Chairman Bliley; Chairman Fields; Chairman Oxley; members of the Subcommittee on Telecommunications and Finance; and members of the Subcommittee on Commerce, Trade, and Hazardous Materials. My name is Steven T. Foster. I am the Commissioner of Insurance for the Commonwealth of Virginia. I am also a former President of the National Association of Insurance Commissioners (NAIC). I served as president in 1993 and I remain active in the NAIC, our nation's oldest association of state officials. The members of the NAIC are the chief insurance regulatory officials from the 50 states, the District of Columbia, American Samoa, Guam, Puerto Rico, and the Virgin Islands.

Perhaps I should start by describing the unique regulatory structure in the Commonwealth of Virginia. We have a three-member State Corporation Commission (SCC) that has been vested with regulatory authority over many Virginia businesses and economic interests. These interests are as varied as the SCC's powers, which are delineated by our state constitution and state law. No other state has charged one agency with such a broad array of regulatory responsibility. The SCC is organized as a fourth branch of government with its own legislative, administrative, and judicial powers. Appeal of decisions by the SCC can only be made to the Virginia Supreme Court. The SCC's jurisdiction now includes insurance, securities, state-chartered financial institutions such as banks, and public utilities. I regulate the business of insurance as the Commissioner of Insurance responsible for the Bureau of Insurance (BOI). I serve at the pleasure of the SCC. The SCC also includes a Bureau of Financial Institutions, which regulates state-chartered financial institutions—banks, savings and loans, credit unions, etc.—and examines these institutions to assure financial soundness; oversees consumer finance companies; and issues licenses to mortgage lenders and brokers, money order sellers, and debt counseling services.

I will talk about H.R. 1062, the "Financial Services Competitiveness Act of 1995", Representative Leach's legislation to remove many of the restrictions imposed by the Glass-Steagall Act of 1933 on affiliations between banks and securities firms. But, first, you should know that the NAIC has formally endorsed Chairman Bliley's bill, H.R. 1317, the "Insurance State's and Consumer's Rights Clarification and Fair Competition Act of 1995", or equivalent language in another, appropriate legislative

vehicle. This past Sunday, while meeting in St. Louis as part of the NAIC's Summer National Meeting, the full membership of the NAIC discussed the merits of H.R. 1317.

We believe that state insurance regulators, not federal bureaucrats responsible for overseeing banks or the securities industry, should regulate the business of insurance, including the insurance marketplace, and those entities and individuals involved in the business of insurance to the extent of their involvement in the business of insurance. The NAIC members have not taken a formal position on H.R. 1062, but I would suggest that our members believe in the concept of "functional regulation" of financial services. I realize that this term is subject to differing interpretations, but I do not doubt that my colleagues believe that state insurance regulators, not federal banking regulators, should regulate and oversee the business of insurance, regardless of the type of entity engaged in insurance activities such as sales or underwriting.

Some of the members who serve on the Committee on Commerce are advocates of creating a federal regulatory agency to oversee the business of insurance. In reality, the fact remains that over the years state-based regulation of the business of insurance has worked. As an insurance regulator, I applaud the efforts of many in this committee to help improve upon what state insurance regulators have been doing. In particular, I want to thank Chairman Bliley, who introduced H.R. 1317. During the NAIC meeting in St. Louis, many of my colleagues expressed appreciation for the motivation behind Chairman Bliley's proposal. While I realize that the Committee on Commerce may consider alternatives other than H.R. 1317 as amendments to H.R. 1062, I must state at the outset that it is absolutely essential for consumer protection that all who sell or underwrite insurance or solicit the sale of insurance should conform to the same laws, regulations, and rules.

If the Committee on Commerce were to agree to allow affiliations between banks and securities firms, this committee must do exactly what Chairman Bliley said when he introduced H.R. 1317—"The traditional role of the states in insurance regulation must be protected"—and reaffirm the right of state insurance regulators to oversee the sale, underwriting, and sales solicitation of all insurance policies, including those sold by national banks. All insurance related activities by banks should be approved by state insurance regulators who should have explicit authority over insurance activity in the states. Anyone who engages in the business of insurance—whether insurance sales or underwriting—must adhere to state insurance laws and regulations. A "level playing field" is important for all who engage in the business of insurance. Though the Office of the Comptroller of the Currency (OCC) and other federal banking regulators may disagree, I think the Committee on Commerce and the 104th Congress must add the language of H.R. 1317 to H.R. 1062. Such an amendment would serve to clarify and reinforce the point that the McCarran-Ferguson Act of 1945 entrusts the states, not federal bureaucrats, with the jurisdiction and authority to regulate the business of insurance.

To organize my remarks on H.R. 1062 and possible changes to this legislation by this committee, I would like to refer to the eight-point "Glass-Steagall Framework for Discussion" developed by your committee aides. I must admit, however, that I do not know if this committee is still using this framework. Also, I have not actually seen the legislative language, other than H.R. 1317, under consideration as a possible amendment to H.R. 1062. While the NAIC members were meeting in St. Louis, I was prevented from following the ever-changing status of negotiations on amendments to H.R. 1062.

First, my understanding is that the Committee on Commerce is considering language that might preempt all state anti-affiliation laws. Under this proposal, federal law would expressly permit affiliations among insurance companies, banks, and securities firms. In the Commonwealth of Virginia, our statutes do not prevent banks from selling insurance, but we do require that banks or their affiliates hold a license as an insurance agency. What this means for a bank is that such a company's articles of incorporation must expressly authorize the bank to engage in the business of insurance. Further, our laws do not distinguish between national banks and state-chartered banks. We require the employees of banks to obtain licenses as insurance agents if they are going to solicit insurance. If a bank, through its employees, is going to solicit or receive a commission, then the bank or its affiliate must be licensed. The individuals engaged in selling insurance must also be licensed. Banks in Virginia are in the business of insurance to earn commissions, so therefore, these institutions must obtain agency licenses. By the way, this is not an expensive or burdensome process. A one-time fee of $15 is required for an agency license. There is no requirement for a bank to have a separate physical location or create a separate entity.

We already have a "permissive" environment in Virginia, but if one were interested in establishing a national two-way street—allowing affiliations between banks, securities firms, and insurance companies—a number of states would find their anti-affiliation laws preempted. I do have serious concerns about who will protect the interests of insurance policyholders and consumers, especially without the protections afforded by H.R. 1317. Unless all who engage in the business of insurance play by the same rules, not only will insurance agents be at a competitive disadvantage, but the insurance-buying public could also lose.

Second, the Committee on Commerce is considering a specific, federal definition of "insurance." This has been implicitly and explicitly the domain of the states. In Virginia, we have separate definitions for each line of insurance authority. How is it unfair if states define insurance as long as all entities engaging in the business of insurance must abide by the same definition? We define "insurance transaction," "insurance business," and "business of insurance" to "include solicitation, negotiations preliminary to execution, execution of an insurance contract, and the transaction of matters subsequent to execution of the contract and arising out of it." Va. Code Ann. §38.2-100. For purposes of our Unfair Trade Practices statute, an "insurance policy" or "insurance contract": "includes annuities and any group or individual contract, certificate, or evidence of coverage, including, but not limited to, those issued by a health services plan, health maintenance organization, legal organization, legal services plan, or dental or optometric services plan... issued, proposed for issuance, or intended for issuance, by any person." Va. Code Ann. K38.2-501.

When my colleague, Jim Long, the Commissioner of Insurance for North Carolina, testified before the Subcommittee on Commerce, Trade, and Hazardous Materials on May 22, 1995 during a hearing on H.R. 1317, he told you North Carolina's definition. Commissioner Long added that while the states may have 50 different definitions of "insurance," there are a number of similarities. Under H.R. 1317, states would define "insurance." As the McCarran-Ferguson Act leaves regulation of the business of insurance to the states, there is no federal definition. States have been, and should remain, free to define "insurance." Contrary to the claims made by the banks, there tends to be great uniformity among the states. Furthermore, everyone purporting to engage in the business of insurance must abide by these state definitions.

The framework definition may include an identification of certain products specifically considered to be insurance and certain products that would not be treated as insurance. My understanding of the framework is that state insurance regulators would be permitted to issue further definitions, but the Federal Reserve Board and the OCC would have direct standing to file a lawsuit challenging a state product classification. In Virginia, the BOI is one agency within the SCC. I do not have unilateral authority to define a product as I see fit. Any effort at defining a product would have to be done by regulation adopted by the SCC or by statute.

Third, under the proposed framework, state insurance regulators would retain the right to regulate all sales of insurance. Anyone involved in the sale, underwriting, or solicitation for sale of insurance in a state must qualify under that state's laws and comply with all of that state's insurance regulatory requirements. It is for just such a reason that the members of the NAIC endorsed Chairman Bliley's bill, H.R. 1317. In the Commonwealth of Virginia, we require all entities and all individuals that engage in the business of insurance to have the appropriate licenses and to meet all of the requirements of our insurance laws. Those who deal in insurance products should be licensed no matter for whom they work. Only companies approved to do business in a state should be engaged in the business of insurance and only licensed agents should be selling insurance products. Everyone who holds an insurance agent's license in Virginia has to go through the same process for obtaining and holding a valid insurance license. In short, everyone who sells insurance in Virginia must meet the requirements of our law. I will tell you if there were an exemption from state licensing laws for national banks, this would be extremely unfair to insurance agents and would prevent us from offering the same level of consumer protection covering all insurance transactions.

Fourth, under the proposed framework, the OCC may authorize national banks to sell insurance on the same basis as state banks authorized to sell insurance in states. On this point, I should note that Virginia does not discriminate between national banks and state banks. Therefore, we are dismayed when we hear that the OCC has issued instructions to national banks essentially stating that such entities can disregard state insurance laws and regulations. Remember, the McCarran-Ferguson Act of 1945 manifested Congress' decision that the states, not federal bureaucrats, should regulate the business of insurance. The business of insurance is not a power incidental to the business of banking. The proposed framework indicated that where states prohibit the sales of insurance (other than fixed annuities, credit

life, etc.) for all banks, national banks would not be allowed to sell insurance. Again, I note that under Virginia law, national banks and state-chartered banks have essentially the same rights to qualify as insurance agencies.

Fifth, the language of the proposed framework would permit the OCC to continue to allow national banks to sell fixed annuities. States may not prohibit such sales within a bank, although they may continue to regulate annuities as insurance with "appropriate consumer protections." States will be permitted to delineate the areas in a bank where annuities and other exempted products could be sold, so long as such regulation does not intentionally or effectively prohibit such sales. Banks would also be allowed to continue to sell a list of products including credit life. My suspicion is that this is consistent with the Supreme Court's decision in *NationsBank of North Carolina v. Variable Annuity Life Ins. Co. (VALIC)* and *Ludwig v. VALIC*. Clearly, the Supreme Court deferred broadly to the Comptroller's view of "incidental" bank powers for national banks. Further, in addressing the National Bank Act, the Court rejected the position that annuities are an "insurance," rather than an "investment," product, but the *VALIC* Court said nothing about the ability of states to regulate bank sales of annuities because this question was not addressed. As Commissioner Long has told the Subcommittee on Commerce, Trade, and Hazardous Materials, the NAIC filed an *amicus curiae* brief when both the United States Court of Appeals for the Fifth Circuit and then the Supreme Court heard *VALIC*. On those occasions, the NAIC contended that annuities are insurance products, with insurance characteristics, subject to state insurance regulation, and should not be sold by national banks in towns with more than 5,000 residents. While the Supreme Court specified that the *VALIC* decision was applicable to the sale, not the underwriting, of annuities, the Court did not address the role of state insurance departments in licensing bank employees as insurance agents; requiring consumer disclosure that annuities are not insured by the Federal Deposit Insurance Corporation (FDIC); or charging premium taxes on bank-sold annuities. The Supreme Court also did not address the issues of whether national bank sales of insurance are restricted to towns with fewer than 5,000 residents or whether banks could potentially sell other insurance products.

In holding that annuities are not an insurance product, the Supreme Court left unanswered a number of questions. It is appropriate that Congress attempt to fill this void, not the OCC, as the Committee on Commerce is contemplating in the framework. Nevertheless, I would still have concerns with the suggestion made by some that banks do not have to use insurance companies to write annuity policies. Do banks have the authority to underwrite annuities? I do not think *VALIC* changed anything as far as state regulation: In Virginia, the BOI still treats annuities as a line of insurance. I would argue that the framework is unclear as to whether banks could underwrite annuities. As with the underwriting of traditional insurance products, I am not sure that many banks would want to assume the risk of writing annuities. My belief is that most banks would prefer to let insurance companies continue to assume the risk, while the banks receive commissions for marketing the products.

Sixth, the proposed framework would limit the sale of insurance by banks or branches of banks to towns of fewer than 5,000 people and "contiguous rural areas." There would be an exemption for more permissive states, as is the case in Virginia. I wanted to note that in 1991, Virginia repealed its own town-of-5,000 restriction on bank sales of insurance.

Seventh, under the proposed framework, federal law would bar any "cross-marketing" (using bank customer lists to sell insurance) by banks for two years. After that, existing customers must be given the opportunity to opt out of any cross-marketing arrangements, while new customers must decide to be included. States may adopt their own cross-marketing standards or prohibitions. Such state statutes will preempt the federal standard, but states cannot discriminate in favor of state banks. Further, states may not adopt "arbitrary" standards or those "which by intention or result seriously impair the viability of an affiliation." Similar names and logos would be permitted.

In his earlier testimony, Commissioner Long discussed his concerns with "tying." Many of us have had our own experiences with credit life insurance sold by banks. All of us know that there are problems with the tying of products, but typically we do not get many consumer complaints because most consumers do not understand there is anything about which to complain. Unfortunately, many consumers do not realize that they are under no obligation to purchase insurance products from the same bank in which they are obtaining a mortgage or other loan. Further, in order to make a loan, especially a mortgage transaction, banks require fairly extensive information about customers. In short, a bank may have access to a customer's total financial profile—his or her assets, obligations, etc.—information that a non-bank-

affiliated insurance agent would love to have. As you can well imagine, most consumers are extremely reluctant to divulge such information. I can see how banks' access to such information might provide an extremely unfair competitive advantage, especially when dealing with higher-income consumers who are seeking estate planning or more comprehensive financial investments. There is no level playing field when banks have unencumbered access to consumers' financial information. At the very least, the provisions of H.R. 1317 requiring compliance with state insurance law are essential. How does one establish a level playing field if banks have access to such information, but non-bank insurance agents do not?

Finally, the proposed framework includes a provision that national banks could not refer a customer inquiring about or applying for a loan to an insurance affiliate or subsidiary unless the customer specifically requested such information. A national bank making a referral to any insurance company, broker, or agent must include the disclosure of any affiliations. Further, the national bank must provide a warning that such products are not insured by the institution, bank, or the FDIC. If consumer protection is to remain a priority, I believe full notice and disclosure, at a minimum, are reasonable requirements.

As the Commissioner of Insurance for the Commonwealth of Virginia, I place no responsibility as high as that of requiring all who sell insurance or otherwise engage in the business of insurance to comply with Virginia's insurance licensing and other consumer protection laws and regulations. I would be remiss if I do not commend Chairman Bliley and the other cosponsors of H.R. 1317 for their work to ensure the protection of insurance consumers and policyholders. In addition, I want to acknowledge the effort of the members and staff of the Committee on Commerce who have worked to ensure strong and effective regulation of the business of insurance by the states. I hope during your consideration of H.R. 1062 that you will all remember that it is the state insurance departments, and not the OCC and other federal banking regulators, who are responsible for protecting insurance consumers and policyholders and assuring the financial stability of the insurance industry. These are the most important functions of the Bureau of Insurance in Virginia. The other insurance departments, not federal banking regulators, share these priorities.

Thank you for this opportunity to testify. I would be pleased to answer your questions.

Mr. OXLEY. Thank you, Mr. Foster.

And let me follow up on your comment that Virginia allows for the sale of insurance by banks. It is my understanding that was a recent bill passed by the Virginia legislature.

Mr. FOSTER. In 1991, at the request of the Virginia Bankers Association and others, our laws were amended to take down whatever barriers there may have been prior to that time. Even before that time, we had several—I think four national chartered banks were able to sell in Virginia because they were grandfathered in as to certain Federal banking restrictions. We did have at that time, though, the 5,000 population statute. That was repealed in 1991, along with any other restrictions as to banks selling or underwriting insurance.

Mr. OXLEY. You had the same statute as the original Federal statute, the 5,000 people—population exemption, you mean?

Mr. FOSTER. We did have that statute until 1991. That is correct.

Mr. OXLEY. That was repealed?

Mr. FOSTER. Yes, sir.

Mr. OXLEY. That was part of the legislation that expanded the bank powers?

Mr. FOSTER. That is correct.

Mr. OXLEY. What has been the experience of the business of insurance in Virginia since that time, and particularly the effects on consumer safety and competition among the agents?

Mr. FOSTER. Prior to that time, 1991—and since that time, frankly, I have made no distinction as to the corporate entity or individuals selling insurance. Prior to 1991, we had bank affiliates, both

as entities and individuals employed by the bank, licensed like every other insurance agent. That was not changed in 1991. The legislature simply allowed more banks to avail themselves of that same opportunity.

I worked for the Virginia State Corporation Commission, which has been around for 92 years and regulates both banks and insurance, and I think insurance regulation is appropriate to all of those who sell or solicit the sale of insurance.

I work very closely with my bank counterpart, and I don't get in his way, and he doesn't get in my way, but we have never drawn a distinction, at least in my mind, as to why it should matter as to who owns the entity or who pays the individuals selling insurance. We have the same license fee for all. There is no preference or discrimination, to use the term used earlier, against those who work for a bank or a bank affiliate versus those who work for an independent insurance agency.

Mr. OXLEY. So you are, essentially, a functional regulator?

Mr. FOSTER. That is correct.

Mr. OXLEY. Mr. Zimpher, regarding State insurance regulation, is State financial regulation of insurance companies designed to reflect the particular nature and risks of insurance products?

Mr. ZIMPHER. Yes, Mr. Chairman, it is. I should probably let Commissioner Foster speak to much more detail about that than I, but yes. Yes, those reserving requirements are—reflect and predicated the nature of the risk in a particular claim category.

Mr. OXLEY. And can you tell us a little bit about the experience in Ohio in that regard?

Mr. ZIMPHER. Well, I think we have had a good experience in Ohio. As you know, Mr. Chairman, from your legislative days and being perhaps a little closer at that point in time to insurance regulation or insurance issues, I think regulation in Ohio has been very effective. I think we have had a—frankly, I cannot recall—need to be corrected—the last insolvency we have really experienced in Ohio. I think particularly under the new NAIC's risk-based capital requirements we are seeing very, very adequate reserves established, and they are being monitored vigorously. We go through annual examinations in our offices in Columbus by the Insurance Commission—Insurance Commission staff from all over the country.

Mr. OXLEY. Mr. Baptista, what is the effect of anti-affiliation laws on your members, and what would the advantages be of preempting such laws?

Mr. BAPTISTA. The anti-affiliation laws, frankly, would prohibit the—a nationwide financial service provider to be able to follow its customers throughout the country. Unfortunately, the anti-affiliation preemption has gotten very much caught up in the turf fight between the banking industry and the insurance agents, particularly on how and by whom insurance products might be sold.

We think, at a minimum, to create some type of equity here, we need to at least address the question of affiliation between the construct of the Bank Holding Company Act. This committee could at least provide the authority for a bank and an insurance company to affiliate under a financial services holding company structure without getting into the anti-affiliation preemption. And that would

allow, at least in those States that choose to permit banks to sell insurance, to have the reciprocal market access so that insurance companies would also have the ability to be in the banking business in those States.

Mr. OXLEY. Let me ask you, Mr. Pfirrman, isn't the maintenance of anti-affiliation laws a States' rights issue?

Mr. PFIRRMAN. It is a States' right issue, but it is a States' right issue I think that is appropriate for Congress to address.

Mr. OXLEY. Why is that?

Mr. PFIRRMAN. Well, when you are looking at a States' right issue, you want to first determine whether there is a Federal interest, whether it would be appropriate to—for the Federal Government to preempt. And because of the commerce clause, I think that there is a legitimate Federal interest here.

Then you look——

Mr. OXLEY. You think the burden of proof is on those who would wish to preempt State laws?

Mr. PFIRRMAN. The burden of proof is on those who wish—yes, I think that might be the case. But I think when you look at what the State interest that you are trying to protect here is, I think that the States have a legitimate interest in protecting or regulating how insurance is sold within their State.

I think that the anti-affiliation laws weren't enacted to—I think the legislative history on New England, particularly in Connecticut, is clear on this point. They weren't enacted to protect consumers. They were enacted—insurance consumers. They were enacted to protect insurance agents' monopolies, and I don't think that that is an interest that outweighs the destruction of commerce that they present.

Mr. OXLEY. So you don't have any problem with the Virginia situation as described by Mr. Foster? That is, the functional regulation of products regardless of who happens to own the entity?

Mr. PFIRRMAN. No, we don't.

Mr. OXLEY. Thank you. My time is expired.

The gentlelady from California, Ms. Eshoo.

Ms. ESHOO. Thank you, Mr. Chairman.

My question is directed to Mr. Foster, and thank you for—all of you—for being here today.

Given Virginia's laws which permit banks to sell insurance products, as well as your support of States' rights and H.R. 1317, is there any possibility in your mind that that legislation will reverse laws in Virginia which give banks this freedom?

Mr. FOSTER. That is not how I have read—H.R. 1317 you are referring to?

Ms. ESHOO. Yes.

Mr. FOSTER. It simply leaves as a States' right issue—and Virginia, through its public policymaking process, our legislature, heard the arguments on both sides; and they were quite strident on both sides. In the end, those who were—who were suggesting there should not be any barriers won the day. And I think it is appropriate that Virginia ought to make that call for Virginia residents and those who purchase insurance.

And, 3 to 4 years later, we have not seen any complaints, frankly, that there is any kind of inappropriate behavior on the part of

those who are licensed as insurance agents. They have passed all the requisite examinations, but they happen to work for a bank or a bank affiliate. And so I would—as I read the bill, it would not undo those things we have done, but we would like to maintain the sovereignty of each State looking at that situation and making its own determination.

Ms. ESHOO. I appreciate your response. I think that it in many ways mirrors the California experience, but the individual that was on the panel previous to you that represented the banks nationally couldn't really speak to it. So I appreciate what you have said, and I will yield back the balance of my time, Mr. Chairman. Thank you.

Mr. GILLMOR [presiding]. Thank you very much. I will use my time for questions now.

And if I might direct a question to Mr. Zimpher pertaining to your company—and I do understand your argument and some of the other members of the panel for State regulation of insurance, but assume that at some point in the future that your company either attempted to or wanted to acquire a bank. How would you anticipate that that acquisition ought to be regulated?

Mr. ZIMPHER. Mr. Chairman, under the appropriate rules in place governing acquisition of banks, as you may know, under the Bank Holding Act, a mutual insurance company, which Nationwide is, and our subsidiary also is, we are prohibited from acquiring a national bank, national depository institution.

But if the laws were changed to permit those affiliations, whether through a financial holding company or whatever structure, I suspect we would fully intend to both acquire and to operate that institution under the pertinent rules that govern. If that means that we adhere to the Federal Reserve, FDIC or Comptroller of the Currency rules and regulations, that is what we would do.

Mr. GILLMOR. Let me ask Mr. Foster, one of the fears that have been expressed by banks, if we end up with legislation that in essence gives the State insurance commissioners the power to regulate and define what insurance products are for banks, one of the concerns that has been expressed is—I am sure this would not happen in Virginia under the relationship and the way that you are operating—but that they go very far in defining what most people would consider a bank product as insurance and thereby try to claim regulatory authority.

I mean, how would you deal with that situation?

Mr. FOSTER. First of all, I don't believe there is any basis for that argument that some may be making. Insurance regulators are quite accustomed, for example, to recognizing that insurance companies can and may sell noninsurance products. Many of those products are not under our jurisdiction because there is no transfer of risk, there is no guarantee fund coverage and, under given States' laws, there is no requirement those policies be approved.

I have seen no indication in my State nor have I heard from other States where commissioners just unilaterally declare bank products to be insurance products. My State as the example, I can't declare anything unilaterally. If I want to make such a move to suggest that a banking product would come under my jurisdiction, you would have to go to the legislature where there is plenty of opportunity for due process and to be heard. Or I go, in my case, to

the Virginia State Corporation Commission and they must hold a hearing and give notice, and they can only adopt regulations if there is first statutory basis for such a regulation to be adopted.

I have been surprised to hear that suggestion by some that insurance regulators would simply deem a lot of bank products to be insurance products so as to extend our jurisdiction. It does not happen as far as I know. It certainly has not happened in my State.

Mr. GILLMOR. But if it were, you know, I think over a period of time when you have 50 commissioners, you know, if you have 50 bishops, somebody is going to do the wrong thing and it is possible you could have a rogue. I take it in your case, basically the Corporation Commission is the referee. So I guess really my question was, what kind of referee do you think you ought to have?

Mr. FOSTER. Well, Virginia is not one State but many States have to go to a conference of legislators to have regulations heard and to get approval. So in most every State, if in fact not in all States, commissioners just cannot laterally adopt regulations or just suggest for purposes of filing jurisdictional products that you would have to file certain bank products.

I mean, most States' statutes, although there is great uniformity, they are very specific as to what it takes to be an insurance product. And we make those determinations, frankly, every week. We are looking at new product development and to what extent, currently, insurance companies are selling or have been selling products which are noninsurance products.

If we deem them not to meet the test of being insurance, they are not filed with my office. In fact, I have told some insurance companies not to file them because many insurers will suggest, well, we may—we filed this with the State. And that could suggest to some consumers that it has been reviewed by the State or meets State standards.

Many companies will call those sort of informational purpose filings, they are filed with the State just for informational purposes. We discourage those and in fact don't accept them. I just think there are enough safeguards built into every State's regulatory adoption scheme where commissioners can't do. If they do attempt to do it, there are appeal processes in place in every State where a bank or group of banks could say, we think the commission has gone—the commissioner has gone beyond his statutory authority, we want to overturn his determination.

Mr. GILLMOR. Thank you. Let me direct a question just to the panel in general and anybody who wants to comment. One of the concerns that a lot of people in the insurance industry have expressed have been the decisions of the Comptroller of the Currency to basically expand national bank powers.

If the Commerce Committee were to pass an amendment to H.R. 1062 preventing the Comptroller of the Currency from further expanding national bank powers, what impact would that have on your views toward H.R. 1062? Mr. Zimpher?

Mr. ZIMPHER. May I jump off here. That is certainly a step in the right direction, Mr. Chairman. That is a step.

The next step would be we would be much more comfortable in terms of adopting an appropriate framework, in setting the appropriate parameters for discussions if the committee were to adopt

H.R. 1317. We would certainly find that to be a much more preferable resolution. But your question implies certainly in the right direction.

Mr. BAPTISTA. If I may, I think if the committee were to act just unilaterally on the Comptroller moratorium without addressing in some way the affiliation question—and I am not talking about preempting State law here, I am talking about the definition of what is financial in nature to include insurance—we would oppose that amendment, and I think that would probably diminish the chances of this bill being passed by the House because it is at least my understanding—I don't want to speak for the banking industry but the banking industry would then oppose the bill. These issues have to be dealt with in a way that gives everybody equal access or it is just not going to work.

Mr. GILLMOR. That is one-to-one, so I—Mr. Foster?

Mr. FOSTER. Mr. Chairman, you used the term "referee" earlier. I think if anyone needs a referee, it is the Comptroller of the Currency because, from our standpoint, unilaterally, and just deeming insurance products to be banking products. And I think it is safe to say that States as insurance regulators can make the determination better. We look at those contracts all the time, and so certainly as one commissioner, and I think I can probably speak for most, we would support the reigning in of that kind of authority.

Mr. GILLMOR. Thank you.

Mr. Pfirrman?

Mr. PFIRRMAN. I believe we would be opposed to that. We believe that the Comptroller's actions have been consistent with Federal law and necessary to keep pace with the changing financial services environment and also necessary to help the American banks keep pace with their competitors abroad.

Mr. GILLMOR. Thank you very much.

The gentleman from New York, Mr. Frisa. No questions.

The gentleman from Idaho, Mr. Crapo.

Mr. CRAPO. Are you almost done with this panel?

Mr. GILLMOR. Yes, sir, unless you filibuster.

Mr. CRAPO. No, I won't ask any questions.

Mr. GILLMOR. There being no further questions, the Chair would like to express the appreciation of the committee for your help on this issue. Thank you.

[Whereupon, at 2:17 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows.]

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June 30, 1995

The Honorable Jack Fields
Chairman
Subcommittee on Telecommunication and Finance

and

The Honorable Michael G. Oxley
Chairman
Subcommittee on Commerce, Trade
and Hazardous Materials
House Commerce Committee
2125 Rayburn House Office Building
Washington, D.C. 20515

Re: Financial Modernization Hearings; June 8, 1995

Dear Chairmen:

During the recent hearings on financial modernization, Representative Dingell raised certain issues with Mr. Scott Jones, who was testifying on behalf of the American Bankers Association ("ABA"). Mr. Jones indicated that the ABA would respond for the record to these issues.

The attached documents are responsive to these issues and I would respectfully request that they be added to the record of the hearing.

Sincerely,

Sarah A. Miller

Sarah A. Miller

Attachment

SIDDs
(Separately Identifiable Departments or Divisions)

With financial modernization, there is, increasingly, a convergence between securities and banking products making it extremely difficult to determine when a banking product ends and a security product begins. In addition, certain securities activities are recognized as being so integral to banking that it makes very little practical sense to separate these activities from banking activities. In recognition of these facts, the Financial Services Competitiveness Act of 1995, H.R. 1062, would permit banks, under certain circumstances, to conduct securities activities in separately identifiable departments or divisions of the bank ("SIDDs").

SIDDs, GENERALLY

Under H.R. 1062, SIDDs would operate in accordance with functional regulation concepts. Specifically, securities activities conducted in a SIDD would be regulated by the Securities and Exchange Commission ("SEC") by requiring the SIDD itself to be registered as a broker-dealer under the Securities Exchange Act ("Exchange Act") and be subject to all applicable provisions of the Exchange Act.

One important exception is made by H.R. 1062 to the functional regulation concept. Specifically, so long as a bank with a SIDD is adequately capitalized under the federal banking laws, the SIDD would not have to comply with the SEC's net capital rule. This provision was added in recognition of the fact that the SEC's net capital rule would effectively preclude banks from registering as broker-dealers. Unlike bank capital requirements which focus on credit risk, broker-dealer net capital rules focus on liquidity risk and would, if made applicable to banks, require disproportionately high levels of capital for illiquid instruments like bank loans.

H.R. 1062 permits only certain securities activities under certain very specific circumstances to be conducted in a SIDD. Basically, a SIDD could be established under three situations:

- If a banking organization has established a securities underwriting affiliate (a bank holding company subsidiary) eligible to underwrite all types of securities including corporate debt and equity and mutual funds, then asset-backed securities backed by residential mortgages, consumer receivables and consumer leases may be conducted through a registered SIDD.

- If a banking organization has established a securities underwriting affiliate eligible to underwrite all types of securities including corporate debt and equity and mutual funds, private placement activities could also be conducted in a SIDD.

- Regardless of whether a securities underwriting affiliate is established, any activity that is later determined by the SEC to be a security activity may, under approval of the Federal Reserve Board, be conducted in a SIDD.

H.R. 1062 does not mandate that these activities be conducted through a SIDD. Banking organizations would be free to conduct these activities through registered SIDDs, registered bank broker-dealer subsidiaries or registered bank holding company broker-dealer subsidiaries. Unlike SIDDs, stand-alone bank brokerage units would be subject to the SEC's net capital rule.

Underwriting of corporate debt and equity and mutual fund shares could not, under any circumstances, be conducted through SIDD; these activities must be conducted in an SEC regulated bank holding company subsidiary. Nor, as discussed below, could bank retail securities activities.[1]

H.R. 1062 does not authorize the creation of any other SIDDs for capital markets activities.[2] H.R. 1062 does, however, add to the activities that could be conducted in SIDDs previously established for municipal securities activities.

MUNICIPAL SECURITY SIDDs

Banks are permitted, under Glass-Steagall, to underwrite and deal in general obligation bonds of any political subdivision or state. In 1975, the Congress authorized the creation of the Municipal Securities Rulemaking Board ("MSRB"). The MSRB was charged with adopting rules applicable to municipal securities dealers. Municipal securities dealers were defined to include banks that conduct their municipal securities activities through a "separately identifiable department or division". Enforcement of those rules was, however, left to the bank regulators and the SEC for bank municipal securities dealers, while enforcement of the rules for non-bank dealers fell to the self-regulatory organizations ("SRO") and the SEC. Thus, the Congress itself, over twenty years ago, first recognized the merits of allowing banks to conduct certain securities activities through SIDDs.

H.R. 1062 would add to the activities that could be conducted through the municipal securities SIDD. Recognizing the important roles banks serve with respect to their state and local government customers, H.R. 1062 would permit bank securities dealers to underwrite municipal revenue bonds in the existing SIDD. Municipal revenue bond underwriting by banks would give state and local governments better access to the capital markets and increased liquidity which, in turn, results in lower borrowing costs (yield as well as underwriting costs) inuring to the benefit of state and local governments and their taxpayer constituents.[3]

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[1] It should be noted that certain permissible securities activities could continue to be conducted in the bank without triggering, under any circumstance, the requirement to establish a SIDD. These permissible securities activities include underwriting and dealing in U.S. government and agency securities, commercial paper, and other similar securities.

[2] H.R. 1062 does provide that a SIDD may be established for those banks that provide investment advisory services to registered mutual funds. This investment advisory SIDD would be required to register with the SEC as an adviser under the Investment Advisers Act of 1940. SEC registration would subject this SIDD to regulation and examination by the SEC.

[3] It should be noted that the SEC is on record in support of banks underwriting municipal revenue bonds pursuant to the existing municipal securities regulatory system. See, Testimony of Arthur Levitt, Chairman of the SEC, before the Subcommittee on Telecommunications and Finance and the Subcommittee on Commerce, Trade and Hazardous Materials of the Committee of Commerce, U.S. House of Representatives, June 6, 1995.

RETAIL SIDDs

H.R. 1062 does not provide for the creation of any other SIDDs, including a SIDD dedicated to retail securities sales by banks. In fact, H.R. 1062 would strip away the current blanket exemption from broker-dealer registration for banks under the Exchange Act. Under H.R. 1062, banks, engaging in retail securities sales activities, would either have to register with the SEC as brokerage firms or spin the brokerage activity out of the bank and into a separate bank or bank holding company subsidiary.[4]

Certain exemptions to the requirement to register are provided by the legislation, including those situations where a bank employs a third-party networking firm which is already a registered broker-dealer and subject to all appropriate rules and regulations of the SROs and the SEC or where the bank engages in only a small or de minimis amount of transactions for its customers. In this latter situation, the bank regulators and the industry itself, have adopted guidelines for the retail sales of securities. In many instances, these guidelines are comparable to the rules and regulations of the National Association of Securities Dealers.

None of these broker-dealer exemptions provide for the creation of a SIDD, i.e., a separately identifiable department or division subject to SRO and SEC rules and regulations with enforcement of those rules vested in either the SRO, the SEC or the bank regulators.

CONCLUSION

H.R. 1062 recognizes the important benefits to be gained by consumers, investors and the financial services industry, itself, if banks and securities firms are allowed to affiliate. H.R. 1062 also recognizes that because the legislation is not being written on a clean slate, appropriate steps must be taken to accommodate the growth and development of both the banking and brokerage franchises. SIDDs are such an accommodation. SIDDs comport with functional regulation theory by allowing the SEC jurisdiction over bank securities activities. At the same time, SIDDs allow business synergies developed over time between banking and security business lines to continue by permitting the security activity in question to be conducted in the bank.

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[4] Obviously, to the extent, a bank sought to sell private placement, asset-backed or municipal securities to the retail market, it could do so through the established SIDD. Any SIDD that sold securities to the retail public would be subject to investor protection rules established by the SEC, the SROs and the federal banking regulators.

A Comparison Of Broker-Dealer and Bank Capital Rules

Comparing bank capital requirements to broker-dealer net capital rules is like comparing apples to oranges. Bank capital rules are designed to protect depositors and promote financial stability by assigning capital to credit and other risks posed by financial transactions. Broker-dealer capital rules seek to protect broker-dealer customers against the risk of broker insolvency and assign capital according to liquidity risk.

Nevertheless, when a bank determines to establish a broker-dealer firm, that brokerage unit, whether housed in a bank subsidiary or a bank holding company subsidiary, must comply with all applicable rules and regulations of the Securities and Exchange Commission ("SEC"), the National Association of Securities Dealers ("NASD") and the Municipal Securities Rulemaking Board ("MSRB"), including the SEC's net capital rule, Rule 15c3-1. If a bank were to establish a brokerage subsidiary, that subsidiary would be subject to NASD and SEC enforcement of those rules.

Rule 15c3-1 requires broker-dealer firms to maintain a minimum capital requirement of anywhere between $5,000 and $250,000 depending on the type of activity being conducted in the firm. Thus, for example, if a securities firm did not hold customer funds or securities and engaged in riskless principal type activities, then the firm need only hold $5,000 in net capital. On the other hand, if a brokerage firm carried customer accounts and received and held customer funds and securities, it would be required to hold $250,000 in net capital. Underwriting of securities would not add to this minimum or floor capital requirement.

Net capital is computed by first adding up liquid assets and deducting liabilities and, thereafter, deducting a certain percentage or haircut against each specific security asset class to allow for market fluctuations. Haircuts are determined according to the type of security and its maturity.

To determine if the floor dollar amount should be raised, a brokerage firm must also total its aggregate indebtedness. Aggregate indebtedness is basically monies owed by the brokerage firm. Secured liabilities are excluded from the aggregate indebtedness standard. The total aggregate indebtedness ratio must not exceed 1500 percent of net capital (which is a leverage ratio of about 15). If a brokerage firm is in its first year of operation aggregate indebtedness must not exceed 800 percent of net capital. To satisfy the net capital rule, the brokerage firm must hold either the floor dollar amount or the aggregate indebtedness ratio, whichever is higher.

Bank capital rules, on the other hand, categorize banks according to whether they are well-capitalized, adequately capitalized, undercapitalized and so on. The ability to engage in various activities is very often conditioned (by statute as well as by bank regulator) on a bank satisfying the requirements for the well- or adequately-capitalized category. Thus, well capitalized institutions may operate at a minimum leverage ratio of 10, adequately capitalized may operate at a minimum of 12½ and under capitalized at a leverage ratio of 15. In order to determine in which category a bank should be placed, three capital ratios must be evaluated.[1]

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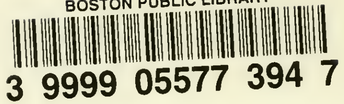
[1] These three ratios are: the total risk-based capital ratio which measures total capital to risk-weighted assets; Tier 1 risk-based capital ratio which measures Tier 1 capital to risk-weighted assets, and leverage ratio which measures Tier 1 capital to total average assets.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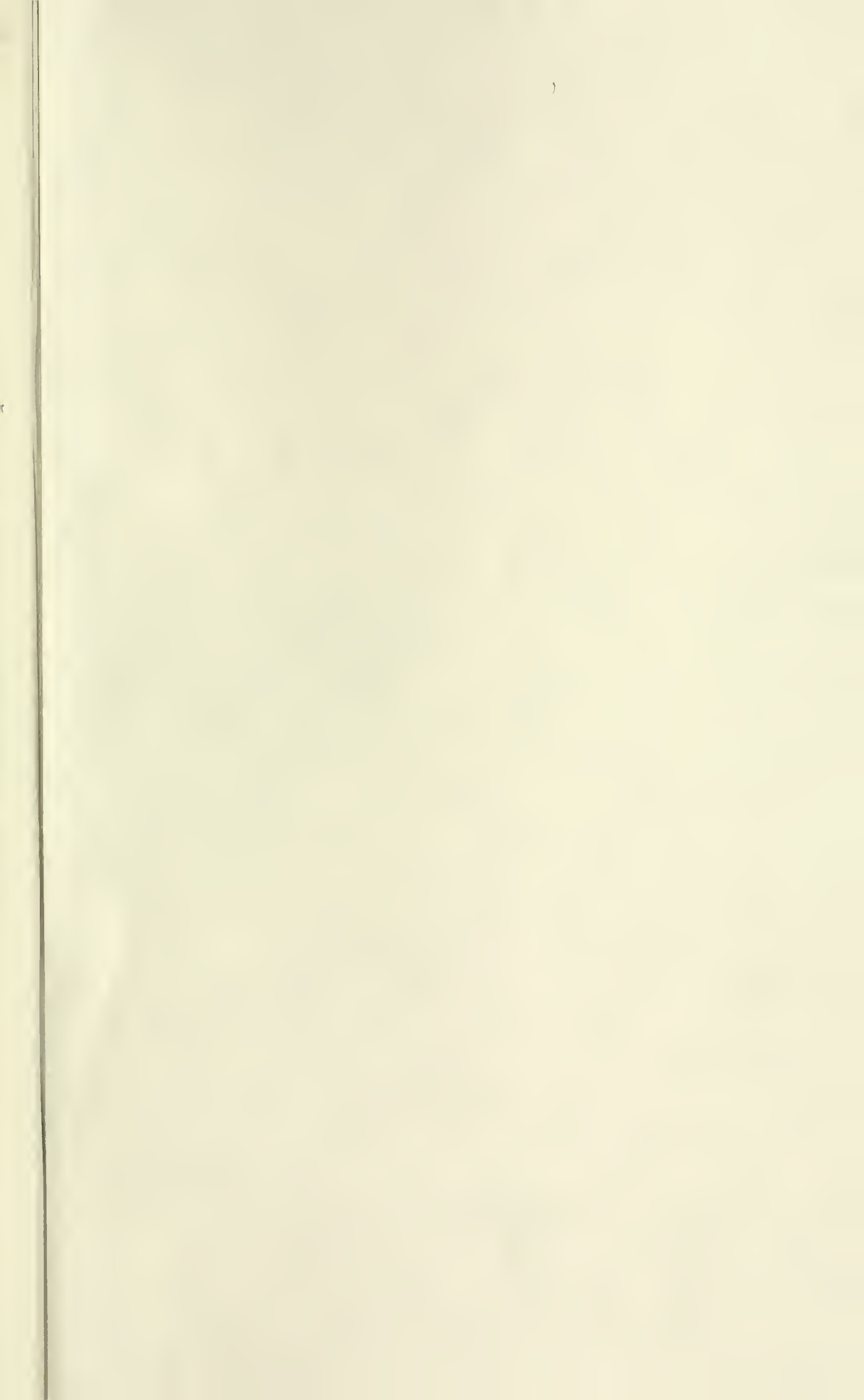
Capital set aside by a parent bank to establish a broker-dealer subsidiary would be considered to be an asset of the bank for purposes of the bank capital rules as well as GAAP and, thus, would be included in the bank's capital. If the broker-dealer were a bank holding company subsidiary, the capital required under the Net Capital Rule for the bank holding company subsidiary would not be included in the bank's capital. Rather, it would be consolidated with the financials prepared by the holding company parent.

CONCLUSION

Clearly, under the Net Capital Rule, bank broker-dealer subsidiaries are required to hold at least as much capital as non-bank affiliated broker-dealers. In fact, bank capital requirements may require even higher capital to be held by the banking organization and its subsidiaries. Consequently, no competitive advantage with respect to regulatory capital requirements exists for bank broker-dealer subsidiaries.



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