

Community Investments Vol. 11, Issue 2 The Great Debate - What will become of financial modernization?

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It appears that the financial services, insurance, and securities industries may finally see some resolution on the myriad of issues that comprise what has come to be known as "financial modernization." There are a number of issues yet to be resolved, including possible ramifications for the CRA. In the article that follows, we'll explore some of those issues and explain some of the key legislative provisions. We'd like to thank Win Hambley for his insight, and for taking the time to provide the Fed's perspective on financial modernization.

What is financial modernization about?

The central idea behind financial modernization is to permit broad affiliations between banks, securities firms, insurance companies, and other "financial" businesses. Such legislation would facilitate the creation of "financial supermarkets" offering "one-stop financial shopping" to consumers. Modernization involves significant changes to the Glass-Steagall and Bank Holding Company Acts, two laws that currently prevent such broad affiliations.

Allowing and encouraging the formation of financial conglomerates raises questions as to how they will be supervised and regulated in the public interest. Thus, modernization also calls for a blend of "functional regulation"

of the individual businesses - for example, banks regulated by banking regulators and securities firms by the SEC and "umbrella supervision" of the consolidated entities by the Federal Reserve.

Why is modernization important?

The public would benefit from the greater convenience of the one-stop shopping concept. In addition, the legislation would promote competition, economic efficiency, and innovation. This would lower the cost, and improve the variety and availability of financial products. For financial institutions, modernization would eliminate artificial and outdated restraints on product offerings, allowing them to compete more effectively in response to changing market demands.

Where does modernization stand now?

The Senate and House have each passed separate modernization bills - S.900 and H.R.10, respectively. The Senate approved S.900, a purely Republican bill that the President has threatened to veto, on a party line vote of 54-44 on May 6, 1999. In contrast, the House approved H.R. 10, a bipartisan bill supported by the President, by a vote of 343-86 on July 1.

What issues remain to be resolved?

The two bills differ sharply on CRA, operating subsidiaries, privacy issues, and the transferability of existing unitary thrifts to commercial owners. CRA continues to be highly controversial, and there are major CRA differences between the House- and Senate-passed bills.

The House bill (H.R. 10) requires all depository institution subsidiaries of financial holding companies to both have and maintain at least "satisfactory" CRA ratings in order to engage in the new financial activities authorized by the bill. Comparable provisions apply to national banks with subsidiaries engaging in new financial activities. In addition, CRA would apply to newly-authorized "wholesale financial institutions." CRA provisions would not,

however, apply to insurance or securities firms that become subsidiaries of either banks or financial holding companies.

The Senate bill (S.900) contains none of these provisions. It would: a) exempt small and rural banks entirely from CRA, b) create a "rebuttable presumption" that banks with at least a "satisfactory" CRA rating have complied with CRA, and therefore could not have applications turned down on CRA grounds, and c) require full disclosure of all CRA agreements between banks and community groups.

A second issue to be resolved concerns the permissible new activities of national bank subsidiaries, or "op subs." The House bill would allow certain principal activities, notably securities underwriting and merchant banking, to be conducted in an op sub structure. In contrast, the Senate bill would permit small banks not in holding companies to engage in most new principal activities through direct subsidiaries. Larger banks and banks in holding companies would have to conduct new principal activities exclusively through a holding-company affiliate.

In addition, differing provisions on unitary thrift holding companies leave unresolved the contentious "banking and commerce" issue. H.R.10 leaves the "unitary thrift loophole" open: it would stop the creation of new unitary thrifts with "commercial" connections, but would also permit more than 500 existing unitary thrifts to be transferred to commercial owners. The Senate bill, in contrast, would both stop the creation of new "commercial" unitaries and prevent the transfer of existing unitaries to commercial firms.

The House provisions on financial and medical privacy, disclosure, and the sharing of customer financial information with non-affiliates and third parties go well beyond anything in the Senate bill. Notably, the House bill requires disclosure of financial institutions' privacy policies, allows consumers to opt out of having their personal financial information shared by their bank with

non-affiliates, prohibits financial institutions from transferring customer account or credit card numbers to third parties for marketing purposes, and generally prevents disclosure of medical records without customer consent. There are no such provisions in the Senate bill.

Although still contentious, most believe these issues will not derail financial modernization.

How might these issues be resolved?

The end result will depend on negotiations not yet conducted among conferees. Still, because of the strong House vote, House conferees appear to have an edge in the negotiations, and the final bill probably will look more like H.R. 10.

A deal on CRA might be possible. Last year, Senator Gramm said he wanted a modernization bill that was "neutral" or "silent" on CRA. He is now in a position to negotiate to get there. The bill approved by the Senate contains all of Gramm's bargaining chips—the small bank CRA exemption, the so-called safe-harbor, and no requirement that all depository institutions in holding companies (or banks with op subs) have or maintain a "satisfactory" or better CRA rating.

Similarly, a deal on CRA may be possible for the Administration and Congressional Democrats. Perhaps, in order to get Gramm to give up on the small bank exemption and safe harbor provisions, they could trade away the House provisions requiring banks to maintain satisfactory ratings, thereby reaffirming the CRA "status quo" and still declaring victory.

It's unclear how the op sub issue will be resolved. The Treasury and the Fed each take incompatible positions. There is a strong temptation to accept the Treasury position on op subs from the House bill, and to reject that of the Fed's. After all, the President has veto power, and the Fed doesn't. On the

other hand, the Fed has won very important victories on the op sub issue in the Senate and in the House Commerce Committee, so the debate could go either way.

On unitary thrifts, the resolution is also unclear. As noted, the House-passed bill allows (and the Senate-passed bill prohibits) the transfer of existing unitary thrifts to commercial companies. The House approach may be slightly more likely to prevail.

As noted, the bills differ sharply on privacy issues. Despite Chairman Gramm's insistence that he will not accept privacy provisions beyond those in the Senate bill, it seems likely that the final provisions will resemble those in the House bill, which are bipartisan and were overwhelmingly approved by the House.

What is the debate regarding operating subsidiaries (op subs) vs. holding company subsidiaries?

The Federal Reserve opposes diversification through op subs, and supports diversification through holding company arrangements, for several reasons. First, banks are "subsidized," or have a funding advantage, due to their connection to the federal "safety net" (deposit insurance, discount window lending, and access to the payment system). If banks diversify into new activities through direct subsidiaries, the funding advantage will "spill over" to the subsidiary, putting other competitors at a disadvantage. The funding advantage would be contained and the competitive problems avoided by a holding company arrangement.

Second, op subs create a safety and soundness concern in that the op sub approach to new activities is riskier for the bank. A subsidiary is effectively part of the bank, and any problems in the subsidiary directly hurt the bank. As a result, the bank and the taxpayer-backed deposit insurance system are not effectively insulated from problems or losses in a direct subsidiary. If

new activities are conducted in a holding company, the bank is more insulated, as any losses would not directly impair the bank.

Third, with the op sub approach, the Federal Reserve would tend to lose hands-on supervisory control and understanding and information about the workings of the financial system. It would also lose supervisory clout, making it harder for the Fed to protect the stability of the financial system through crisis avoidance, intervention, and management.

Finally, some in Congress feel that transferring supervisory authority from the Fed to the OCC, the regulator of national banks, and thus, to the Treasury and the Administration, would undesirably concentrate regulatory authority and politicize bank regulation.

For their part, the Treasury and the OCC believe that banks should be free to choose to diversify through either an op sub or through a holding company as business considerations dictate. They doubt that there is any subsidy from the safety net, and argue that there is no difference, in any case, in subsidy between the op sub and holding company approaches. This casts doubt on the competitive unfairness argument against op subs. In their view, banks can be just as well protected from problems in subsidiaries as from problems in affiliates, so there are no real safety and soundness or insulation issues that differentiate the op sub from the holding company. And finally, given free choice of organizational structure, some banking organizations would continue as bank holding companies and some banks would continue to have state charters. Thus, in their opinion, Fed concerns about the loss of supervisory authority are exaggerated. Treasury also fears that if certain types of new activities are restricted to a holding company, the Fed would gain supervisory authority at the expense of the elected administration.

Are major changes to CRA likely?

No. The Administration, with its veto and Democratic congressional support, can prevent any weakening of CRA. Republican majorities in Congress, and Chairman Gramm in particular, can prevent any major strengthening of CRA. The biggest CRA change likely to be enacted is the bipartisan provision from S.900 that would require full public disclosure of all CRA agreements between banks and community groups.

How might modernization affect small banks?

Small banks should actually benefit. Both bills authorize small banks to underwrite municipal revenue bonds directly, and engage through both subsidiaries and affiliates in a broad array of new "agency" and "principal" activities. This would allow small banks to compete more effectively. Also, Federal Home Loan Bank reform included in modernization will expand small bank access to cheap FHLB funding.

Nonetheless, small banks dislike financial giants and the mixing of banking and commerce. Financial modernization promotes both. Small banks doubt they will be exempted from CRA, and they fear that they will not be able to compete with the new financial conglomerates or with "unfair" unitary thrift competitors. Furthermore, they fret that privacy provisions that let customers "opt out" of information-sharing with non-affiliates will put them at a disadvantage. They also worry that modernization will let states discriminate against banks, in their regulation of insurance activities.

What are the next steps for this legislation, and when might a bill be passed?

As of this writing, the House- and Senate-passed bills are ready for negotiation in conference. Many speculate that conference negotiations could be quite protracted and difficult, but there is a chance that final legislation could be sent to the President by the end of October 1999. If not, financial modernization will roll-over to the new session of Congress, effectively postponing any further legislative action until next year.

About the Author

Winthrop P. Hambley serves as the deputy congressional liaison at the Congressional Liaison Office of the Federal Reserve Board in Washington, D.C. where he has worked since 1989. In his current role since 1998, Mr. Hambley follows and reports on congressional proceedings, advises Board and staff members on views of the Congress, and coordinates the drafting of congressional testimony and correspondence. He works closely with all operating units of the Board, with congressional liaison offices of other regulatory agencies, and with representatives of trade associations and other outside parties.

Prior to joining the Federal Reserve System, Mr. Hambley served as a legislative assistant to U.S. Senator Paul S. Trible and as an economics instructor at the University of Virginia. He holds an A.B. degree from Columbia College and was a student in the doctoral program in economics at the University of Virginia.