UPDATE ON MODERNIZATION LEGISLATION

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I have been involved one way or another with the issue of financial services reform since about 1986. I like to tell people that, like Bill Murray in the movie "Groundhog Day," I feel doomed to repeat the same day over and over again. Since 1980, eight of the ten two-year Congresses have considered major financial services reform legislation. They've all had varying degrees of progress, but they've all failed to get to the finish line for one reason or another. The timing of this Symposium really is quite something. I think *this* is the year, and I've said this before and have been wrong before, but I do think this is the year that something quite significant will pass in Congress.

As was mentioned earlier, last week a bill was reported out of the Senate Banking Committee. Just last night, a bill was reported out of the House Banking Committee by an overwhelming bipartisan vote of fifty-one to eight, which I think augurs quite well for the future of this legislation. All of these proposals since the 1980s, or most of them anyway, have some common elements. So, let me just take a minute to describe in a nutshell what this type of legislation would do.

Basically it would allow the creation of a truly diversified financial company, which means that a single company could engage in banking, securities, insurance, and any other type of financial activity. Put another way, and perhaps more importantly, it means that mergers would now be permitted between a bank holding company on one hand, and a securities or insurance company, or both, on the other hand.

To get to this result, the bill repeals or substantially modifies key elements of the Glass-Steagall Act, the Bank Holding Company Act, and state law. Why? Because all of these laws, in one way or another, restrict cross-ownership and protect particular industries from competition. For example, the Glass-Steagall Act was originally intended to separate securities underwriters from banking institutions, and the Bank Holding Company Act was set up and amended specifically in 1982 to keep bank holding companies out of the insurance business. There are many complicated aspects of these pieces of legislation, particularly the ones that are on the table today. Before describing them, let me comment briefly on why I think it has taken so long to pass this legislation and why I think its chances are greatly improved this time around.

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In the past, because of the very reasons I suggested, these bills were passed to protect particular industries, and industries had a very big stake in protecting their turf. For example, when banks decided that the securities industry was very profitable and they wanted to try to dismantle the Glass-Steagall Act, there was intense resistance from the securities industry as a whole and from the mutual fund industry. And likewise, there was a great deal of fighting that went on between the insurance companies and the banks and the insurance agents and the banks. Congress generally finds it quite difficult to act when industries are battling this way. There are too many cross currents going on. It's difficult to help one industry without hurting another. That was always the problem in past efforts. One side would be seen as getting a benefit at the expense of the other, and the legislation just never could get across the finish line for that reason. To balance the interests of the competing groups was something that could not be achieved.

In the meantime, as Congress has failed to act, the regulators have been quite aggressive on a number of these fronts to break down some of these barriers. At the same time, the market has been blurring a lot of distinctions between the types of products, between banking products and securities products, between securities products and insurance products, and between derivatives and futures products. This blurring has driven an effort by regulators to break down barriers to allow institutions to engage in all of these products at once. For example, the Federal Reserve has acted under section 20 of the Glass-Steagall Act to essentially allow bank holding companies to own a full service securities underwriting and dealing firm provided that the firm limits its revenues from certain securities activities to less than 25% of its gross revenue. The limit is in effect for a variety of reasons that I won't go into that involve very precise statutory words. But the net effect, after starting out at 5%, moving to 10%, and then up to 25%, is that today it's possible for a Citigroup to own Solomon Brothers. That's perfectly within the law, and it starts to weaken what Glass-Steagall was originally intended to do. Further, it shows that there is a driving force among firms who want to do these kinds of combinations.

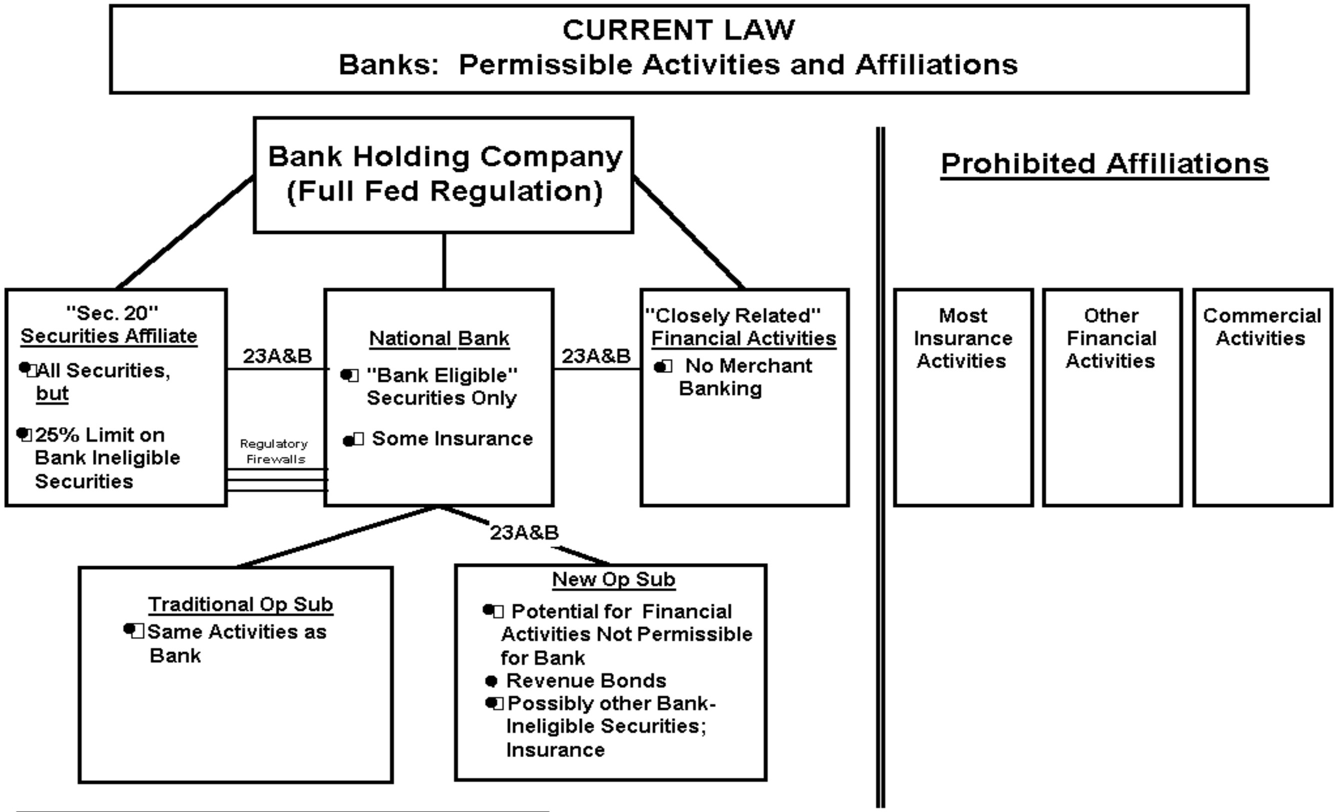
The same thing happened in insurance. The Comptroller of the Currency has been very aggressive and has said that certain financial products, annuities for example, are not really insurance products but are banking products. And if they're banking products, then banks can sell them. You might think that when the National Bank Act said that a company could only sell insurance in a town of under 5,000, it might mean that companies could only sell insurance in small towns. But the Comptroller means that as long as the company is in a place that has fewer than 5,000 people in it, wherever it is, it can sell anywhere. And all of these rulings preempt state insurance laws that might say something to the contrary. As a result, insurance agents and securities firms start to think that the handwriting is on the wall. Pretty soon the debate becomes less a question of *whether* we should reform these laws and rationalize the system, but instead *how* we should do it. Gradually, there have been more and more compromises reached among the competing industries so that right now, as I'll discuss in a minute, most of the industries have lined up in favor of moving forward, not just with the general concept of legislation that allows everybody to be in each other's business, but in very specific ways that people have begun to agree on, thus taking competitive issues off the table. So that's one, probably the major factor, that's allowing Congress to act and ratify and rationalize something that's already going on out in the marketplace and already going on in the current regulatory scheme.

A second reason I'm optimistic this time around is that we've never had the two Chairmen of the House and Senate Banking Committees make this a priority at the very beginning of a Congress. This time we have the entire congressional two-year cycle to try to get this legislation passed. The result is that there are only a few really major issues still outstanding. Are they serious issues? Yes, they are. They certainly could derail this legislation. But because the industry is so anxious to get a bill and so much in agreement in the type of bill that ought to be done, I think that it will get done before the end of this Congress.

I should stop and make one aside. People often try to call this just a financial services bill, but it really is related to banks. This bill doesn't affect financial companies that get together without a bank in their structure. What causes all the regulation, issues, and debate is when a company owns a bank—because the bank has the federal deposit insurance guarantee, the access to the discount window, and the access to the payment system. This creates the need for regulation that is at the heart of the legislative reform efforts.

Chart I shows the current structure for bank holding company regulation. The holding company itself is regulated by the Fed, and underneath this, in the middle, is a national bank. (It could also be a state bank.) The bank is allowed to engage in banking activities, obviously, but it also is able to engage in certain bank eligible securities activities inside the bank. On the west side, you see that section 20 companies can engage in some securities activities but not all securities activities. There are firewalls that are put in place between the two. On the other side of the bank, the east side, you see "closely related" financial activities, which include things like mortgage banking and credit card activities. But it does not include merchant banking

CHART I


CURRENT LAW
Banks: Permissible Activities and Affiliations
Bank Holding Company
(Full Fed Regulation)
"Sec. 20"
Securities Affiliate
All Securities, but
25% Limit on Bank Ineligible Securities
23A&B
Regulatory Firewalls
National Bank
"Bank Eligible" Securities Only
Some Insurance
23A&B
"Closely Related" Financial Activities
No Merchant Banking
Prohibited Affiliations
Most Insurance Activities
Other Financial Activities
Commercial Activities
23A&B
Traditional Op Sub
Same Activities as Bank
New Op Sub
Potential for Financial Activities Not Permissible for Bank
Revenue Bonds
Possibly other Bank-Ineligible Securities; Insurance

or equity investments in companies of the kind that investment banks make; and it doesn't allow insurance activities or any other type of financial activities. Finally, it most certainly doesn't allow commercial activities.

Finally, underneath the national bank, you see what things are permitted in subsidiaries. It used to be that traditional operating subsidiaries were all that was permitted for national banks and that they could do only what the bank itself could do. Now the Comptroller has allowed subsidiaries to engage in activities that are not permissible for the bank itself to engage in, such as underwriting municipal revenue bonds, and, possibly, other securities, and insurance.

That is the current basic structure, and because it's set up this way, and because of the limits on insurance, securities, and other financial activities, it prohibits mergers of an insurance company with a bank holding company, for example. Companies just couldn't do that under current law, except under limited circumstances. It is possible under the new limits for big securities firms and banks to affiliate, but it is not completely possible for all securities firms and for all bank holding companies to merge. The 25% limit is still a significant restriction of sorts.

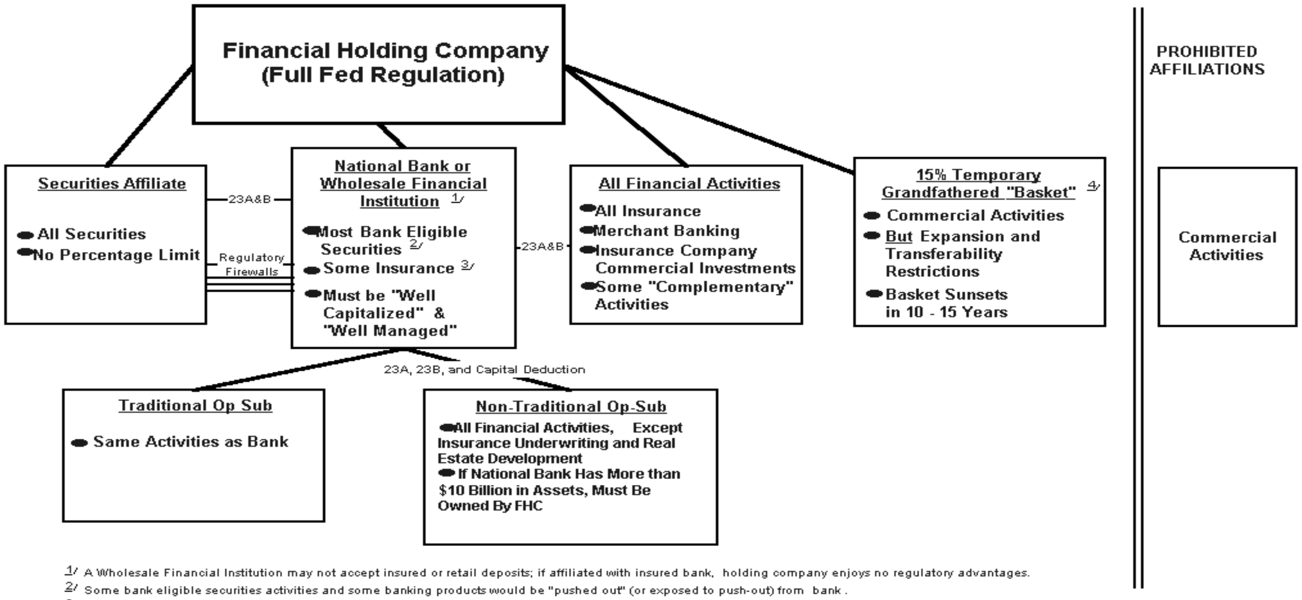
Chart II shows H.R. 10 as it was introduced in the House. It is not the bill that was marked up last week in the Senate Banking Committee, and it is not exactly the same bill that was marked up in the House Banking Committee, but it is close enough for purposes of what I am describing today. As you can see, compared to the previous Chart, there are far fewer prohibited affiliations. It is now possible for a holding company to own a securities affiliate that engages in securities activities without limits. It is possible to engage in all financial activities through a holding company subsidiary. That includes all insurance underwriting activities, all insurance agency activities, and merchant banking investments in companies. And there are some grandfathering provisions for financial holding companies to keep some of their commercial activities on a one-time basis.

In addition, the bill contains provisions with respect to operating subsidiaries. This version limited the operating subsidiary to agency activities that were not widely permissible for a bank. But that is not what the House and Senate Banking Committees recently provided. The House Banking Committee would allow operating subsidiaries to engage in any activity that affiliates can engage in, that is, full securities underwriting and any other kind of financial activity except for insurance underwriting and real estate development. The Fed favors a more restrictive version.

That's basically the concept. If the legislation passes, mergers among bank holding companies, insurance companies, and securities firms could proceed. But these are the types of rules that the companies would have to

CHART II

FINANCIAL SERVICES REFORM LEGISLATION
H.R. 10: HOUSE BANKING COMMITTEE VERSION
Banks: Permissible Activities and Affiliations



1/ A Wholesale Financial Institution may not accept insured or retail deposits; if affiliated with insured bank, holding company enjoys no regulatory advantages.
2/ Some bank eligible securities activities and some banking products would be "pushed out" (or exposed to push-out) from bank.
3/ Insurance activities permitted are different than those permitted under existing law; key issue is degree of exposure to discriminatory regulation by state.
4/ Applies to newly-formed FHCs. Annual gross revenues from FHC's commercial activities may not exceed 15% of FHC's gross revenues (excluding despository institution revenue).

play by. Most of the major issues that have arisen over the years have been solved; a few are outstanding. I'll discuss the resolved issues first.

The first is the Glass-Steagall Act itself and whether banks can engage in securities activities. The bill allows full securities underwriting, and there is no debate over that any more. The only issue in the securities area is whether the bank itself can engage in the same level of bank eligible securities activities that the SEC tried to regulate with Rule 3-b9, which the courts struck down fifteen years ago. That's a big area of debate in the Committee, and they have worked out some exceptions that look a lot like 3-b9. The SEC is not happy about the number and breadth of exceptions that are in the bill. The banks are quite happy about them, and we are not sure how that debate will finally be resolved; that is, it is unclear which activities will have to be pushed out of the bank and which can stay in the bank. But that will not hold up this bill.

I mention this issue because it is a good example of what Howell Jackson described in his essay.[1] The issue is not just that banks engage in securities activities, and that the SEC says that it ought to regulate them. There is also the question of *who decides* whether it is a banking activity or a securities activity to begin with. The SEC maintains that it should have the sole discretion to define "securities activity," and the bank regulators say just the opposite. It's a big fight in Congress, and the House Banking bill has an elaborate scheme to decide this sort of dispute between the SEC and the bank regulators. In essence, the SEC gets the first shot at making the decision, but if the bank regulators or an industry participant objects, the issue goes to court. The court will then decide, giving equal *Chevron* deference to the SEC and the bank regulators.

There are similar functional regulation issues in other parts of the bill. For example, one area is insurance. The bill doesn't permit a bank to underwrite an insurance product. But there have been big fights between the insurance underwriters and the banks regarding the definition of "insurance product." Is a standby letter of credit an insurance product? Is an annuity a banking product or an insurance product? Again, the bill comes up with a set of rules to settle such disputes. These are all real world examples of what Howell Jackson described in his essay.

The insurance industry has been very effective in its lobbying, and it had a hand in killing every prior version of this bill. In particular, the insurance agents always had enough power to get a bad amendment or a restrictive

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1. Howell E. Jackson, *Regulation in a Multisectored Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319 (1999).

amendment put on a bill, but they never had enough power to take that restrictive version and pass it into law. This time around they have seen the handwriting on the wall. About three years of work has produced a compromise between insurance agents and banks regarding the regulation of bank insurance activities conducted by national banks. It is an incredibly complicated and cumbersome provision, but both sides have shaken hands on it. It is now in both the Senate and House Banking bill.

Another issue that has been on the table is whether the bill's new kind of financial holding company could own a commercial firm, either without limit or perhaps capped to investments constituting no more than 5% or 25% of the holding company's total assets or revenues. There have been various proposals about this over the years. Neither bill permits such commercial investments, at least not directly; they are not allowed to happen. General Motors can't buy a bank, and a bank can't buy General Motors. But there is some flexibility as to what is considered "financial." Under the merchant banking provision in the bill, a financial holding company can take controlling equity interests in nonfinancial companies under certain circumstances. That starts to look like a connection between banking and commerce, but such investment activities are really very different. Why? Because such investments would not be integrated in to the structure of the holding company's business. The investment is made for investment profit, but it is not something that is cross-marketed with the products of the financial holding company.

On the regulatory side, in previous bills there have always been questions about whether there would be holding company regulation and who would administer it. That, too, has been decided; the Federal Reserve will regulate the holding company. People have agreed to that. They have made adjustments nicknamed "Fed Light"; I'm not sure how light it is. Some people call it "Fed Dark." But the fact of the matter is that this issue is basically settled now. The Federal Reserve will be the holding company regulator just as it is today for bank holding companies. Such Fed regulation once was anathema to the nonbanking companies, but they all seem to have bought into the concept in the last several years.

Similarly, on this question of regulation, there has been an issue of what happens to thrift institutions (which are not on this Chart). A lot of people had thought thrifts now look so much like banks that they should just be forced to become banks. That's not going to happen. The thrift industry has gotten healthy enough again to defend itself, and as a result, both bills now allow commercial companies to own the current universe of thrifts. No new diversified unitary thrift holding companies can be created, however. In the meantime thrifts that are not diversified can still be created and still be subject to a separate regulatory scheme governed by the Office of Thrift Supervision. That's pretty much settled. There was an effort in the Banking Committee yesterday to roll them all in to the bank holding company structure, but the vote went the other way. It would have allowed anybody to continue to have a commercial company owning a thrift.

Finally, we come to the question of functional regulation and who gets to regulate what. This has pretty much been sorted out except in the securities area, as I noted earlier. When the bill gets to the Commerce Committee, where John Dingell and other people very friendly to the SEC still sit, there will be some discussion about the "push-out" of securities activities, but basically the issues have been decided as well.

All together, the bill out of the two Banking Committees is supported very widely by the industry. But there are still three controversial issues that have not been resolved and could still sink this bill.

The first one regards the operating subsidiary, and that is the question of whether a subsidiary of a bank should be permitted to engage in the same degree of financial activities that could be engaged in by a holding company affiliate, even where the bank itself is not otherwise permitted to engage in such activities. For example, banks are prohibited from engaging in full securities underwriting, insurance underwriting, or real estate development activities. The Federal Reserve has taken a strong position that an operating subsidiary of a bank ought not to be allowed to engage in any of these new financial activities. It has argued that there is a subsidy that attaches to the banks that will leak to such subsidiaries; that the subsidiaries will thus come under the safety net; and thus, that such a structure is inappropriate and ought not to be permitted. The Treasury Department and the Administration have argued just as strongly that firewalls can be erected to make a subsidiary no different than a holding company affiliate with respect to any risk to the bank. Further, the Administration believes it is important as a matter of national policy for the Treasury Department to have a role in regulating these new financial activities.

This is a very serious dispute, and last year it evoked a veto threat from the President. It will evoke a veto threat again from the President this year; that is quite clear. In a way, the Federal Reserve actually has more friends in Congress than the Administration does. It sounds funny, but it's true. On the other hand, the Federal Reserve does not have a veto pen, which makes this a difficult problem. In the last Congress, I think people sided almost uniformly with the Fed, and even Democrats balked at the Treasury Department's position.

I would say that the trend is going away from the Federal Reserve and towards the Administration in this Congress. The House Banking Committee has reported out a bill that the Administration now supports. The Senate Banking Committee has not done so, but previous opponents of the Treasury Department's approach on the Democratic side in the Senate have now embraced the operating subsidiary approach as well, or at least included it in a substitute last week. I don't know how that is going to play out.

I personally think that it's going to be hard for the Federal Reserve to sustain its position. The lack of the veto pen and the current momentum is going to make it difficult. The Commerce Committee has traditionally supported the Federal Reserve on this and is likely to do so again. So this issue is by no means over. Nevertheless, the operating subsidiary issue is not one that the industry cares greatly about. I think it is fair to say that, while the industry would like the option of using an operating subsidiary, most don't really care—it is far more important that these new activities be authorized than it is to be able to do them in operating subsidiaries as well as affiliates. This whole issue really seen as either a "turf war," or a policy issue and debate, between the Federal Reserve and the Treasury Department. We'll see how that plays out.

The second outstanding issue, which I actually think is perhaps more problematic for passage, is again not so much an industry issue as a consumer issue. There is a big fight over whether the Community Reinvestment Act ("CRA") should be expanded in some manner as part of this legislation or whether it ought to be contracted. Senator Gramm, chairman of the Senate Banking Committee, is adamant that CRA not be expanded, even in cosmetic ways, and indeed it should be contracted. That suggestion is anathema to the consumer groups and to many Democratic senators. It has also evoked a veto threat from the President.

On the other hand, although the Administration doesn't want CRA applied generally to nonbanking companies, it does support the CRA provisions in the House bill. For example, in order to take advantage of all these new activities, the House Banking bill requires banks to have CRA ratings of adequate or better. That formulation has been pretty much resolved in the House. But it has not been resolved in the Senate. The Senate bill, as it came out of the Senate Banking Committee, contracted the application of CRA. This evoked a veto threat from the President, and the bill was voted out of the Committee on a party-line vote.

Senator Gramm feels very strongly about this, as do the Democrats, and that could hold up the bill from going anywhere. On the other hand, a deal could be struck; it could go to the floor of the Senate with things worked out between the two parties. No one quite knows. That is one of the biggest obstacles to this bill.

Finally, the third major issue I will talk about is something we also talked about this morning, and that is privacy. An argument is made that if you are going to permit affiliations between all these new types of companies, it is important to limit the sharing of information among these newly affiliated companies. On the other hand, the industry argues that the reason for the legislation is to view all of these companies as a single organization. The industry wants to cross-market products and services of different companies, and they worry about restrictions on their ability to share information.

I believe that, if there are too many restrictions, the privacy issue will kill the bill. This debate had been in the background in the House Banking Committee. Last week, however, it erupted. The House Banking Committee almost put in a restrictive information-sharing or privacy provision. A compromise was adopted that focused on required disclosures rather than giving customers the right to "opt out" of, or "opt in" to, information sharing arrangements.

That compromise won the day, although by a close vote. Once the compromise passed, people calmed down. My prediction is that this is not the last we have seen of the privacy issue. It will be redebated in the Commerce Committee and, depending on how that comes out, could very well affect the outcome of the bill.

Those are the outstanding issues. Such disputes did kill the bill at the end of the last Congress, but that was partly because the compromises were not reached until very late in the congressional session, with little time available to pass a final product. Now these compromises have all been reached at the beginning of a session, and we have a lot of time. The question is whether the few remaining differences, which are large, can be worked out or not. I don't know the answer, but I think you now have the basic template.