# THE FINANCIAL SERVICES ACT OF 1999

## HEARINGS

BEFORE THE

SUBCOMMITTEE ON
FINANCE AND HAZARDOUS MATERIALS

OF THE

COMMITTEE ON COMMERCE
HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

ON

**H.R. 10**

APRIL 28 and MAY 5, 1999

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# THE FINANCIAL SERVICES ACT OF 1999

**WEDNESDAY, APRIL 28, 1999**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10:17 a.m., in room 2123, Rayburn House Office Building, Hon. Michael G. Oxley (chairman) presiding.

Members present: Representatives Oxley, Gillmor, Largent, Bilbray, Ganske, Lazio, Shimkus, Wilson, Shadegg, Fossella, Bliley (ex officio), Towns, Deutsch, Stupak, Barrett, Luther, Capps, Markey, Rush, and Dingell (ex officio).

Staff present: David Cavicke, majority counsel; Robert Gordon, majority counsel; Linda Dallas Rich, majority counsel; Brian McCullough, professional staff member; Robert Simison, legislative clerk; Consuela Washington, minority counsel; Bruce Gwinn, minority professional staff member; and Christian Fjeld, minority legislative intern.

Mr. OXLEY. The subcommittee will come to order. Today is our first of two scheduled hearings this year on H.R. 10, the Financial Services Act of 1999. For this first hearing, we are fortunate to have with us our good friend, the Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan.

Chairman Greenspan will hopefully enlighten us on how financial holding companies would be regulated under H.R. 10 and describe the structural problems we still need to address. In particular, I look forward to a thorough education on operating subsidiaries and the dangers of expanding taxpayer subsidies under a new financial system.

The House spoke clearly on this issue last term, rejecting two floor amendments to expand the powers of bank operating subsidiaries. But the operating subsidiary has more lives than Freddie Krueger, and I am sure it will continue to revisit us at every step in this process.

I also expect to hear more about the operating subsidiary at the second hearing on May 5, to which we have invited Treasury Secretary Rubin and other financial regulators, as well as various industry representatives. H.R. 10 is a continual learning process for the members, and we appreciate the testimony of all of our witnesses.

Last term this subcommittee took a bill that was opposed by almost every financial regulator and industry group and forged a series of bipartisan agreements to create consensus protections for consumers. We continued to work on the bill as it went to the House floor, and we passed Glass-Steagall reform in the House for the first time in 65 years. Unfortunately, despite a series of overwhelming votes for the bill in the Senate, H.R. 10 just barely missed crossing the finish line, and American consumers were left empty-handed yet again.

This term we must renew our commitment to enacting financial services reform, building on the bipartisan solutions of our last effort. Our committee will exercise its jurisdiction to make continued improvements in the bill to ensure consistent regulation of financial activities and appropriate consumer protections. But like last term, we will work in a bipartisan manner with an eye toward increasing consensus on a number of very volatile issues.

I would again like to thank our good friend Chairman Greenspan for agreeing to appear before us today, and express our continued appreciation for the assistance and support of the Federal Reserve in working toward enactment of financial services reform.

Now I would turn to our ranking member, the gentleman from New York, Mr. Towns, for an opening statement.

Mr. TOWNS. Thank you, Mr. Chairman. Congress has been working on this legislation for a long, long time. I think it was Chairman Bliley who indicated that this was the 11th attempt to repeal Glass-Steagall since 1979. I am hopeful that we can produce a bill in the 106th Congress that finally gets the job done, but it must be done properly.

New York is the home to our most important securities firms like Goldman Sachs and Merrill Lynch, major money center banks like Citibank and J.P. Morgan, and important insurance companies like New York Life, Metropolitan Life, and the list goes on and on. The financial services industry is an important catalyst for economic growth in our country. Repealing Glass-Steagall will improve competition in financial services, it will help consumers, and it will maintain our global leadership in the financial community.

In the last Congress, this committee rescued Glass-Steagall repeal. We took legislation that had little support when reported to the Banking Committee, and we made changes that enabled the legislation to pass the House for the first time in 65 years. I would like to take this opportunity to commend the Chair of this committee Mr. Oxley, and, of course, the Chair of the full committee Mr. Bliley, and the ranking member Mr. Dingell, for their hard work and the leadership that they demonstrated in those days and times.

Today we will hear testimony from the Chairman of the Federal Reserve, Mr. Greenspan. Chairman Greenspan's reputation is legendary. We are pleased to have the opportunity to hear his views on improvements we can make in H.R. 10.

There are two issues that I hope our committee will address. The first is the operating subsidiary. In the last Congress we decided that we should not expand taxpayer subsidies by having securities or insurance underwriting in operating subsidiaries. Chairman Greenspan pointed out that the affiliate structure provides companies with everything they need with no risk to taxpayers.

The second issue we need to address is functional regulation. I expect that securities and insurance should be regulated the same way, no matter who is selling the product. I have long held this view. I believe that functional regulation is simply common sense.

In the last Congress, the House acted, but the Senate failed to act when faced with the issue of Glass-Steagall repeal. It is my hope that the Senate will resolve their differences, reconsider the committee's elimination of CRA protections, and move this important legislation forward.

Mr. Chairman, I look forward to this morning's testimony in the hopes that we can fashion legislation in the 106th Congress which will modernize the financial services industry without overriding the principles of consistency, safety and soundness as well as judicial jurisdictional roles that have been so important for this committee for years and years.

I yield back.

Mr. OXLEY. The gentleman yields back.

The Chair now recognizes the chairman of the full committee, the gentleman from Virginia, Mr. Bliley.

Mr. BLILEY. I thank you, Mr. Chairman. In the 105th Congress for the first time in history, the House of Representatives approved legislation to repeal Glass-Steagall and modernize the laws that govern our Nation's financial markets. Unfortunately, unlike horseshoes, we don't score any points with the American people for almost getting an important bill signed into law. H.R. 10 never made it to the Senate last year, otherwise we wouldn't be sitting here today to consider H.R. 10 once again.

This time around we are going to let the Senate go first before we move this bill in the Commerce Committee. I look forward to seeing the Senate succeed at the task that we were able to accomplish last Congress in the House. I still believe that the gentleman from Virginia, who first tried to repeal the law he coauthored, was right. The attempts of Carter Glass and many others over the years to repeal Glass-Steagall is still a good idea, but there are two very bad ideas that I intend to do everything in my power to ensure that this legislation does not include as we proceed in this Congress. One is threatening American taxpayers by expanding bank operating subsidiary powers. The other is undermining fair competition in the protection of investors and consumers by thwarting consistent regulation of securities and insurance activities engaged in by different entities.

Today we will hear from a very esteemed witness, our friend, the Chairman of the Board of Governors of the Federal Reserve System, Alan Greenspan. Chairman Greenspan will address the first of these very fundamental issues, that is the dangers of expanding bank powers through operating subsidiaries.

Welcome, Chairman, and thank you for joining us today to educate us about this extremely important, some would say the most important, aspect of the legislation that is now before this committee.

The House Banking Committee has worked very hard to forge compromises on this difficult legislation. Unfortunately, I feel these compromises would compromise the integrity of our financial markets. H.R. 10 as reported by the House Banking Committee contains both of the bad ideas I am most concerned about. It expands the taxpayer-funded government subsidy to bank operating subsidiaries that can engage in not only securities underwriting, but also merchant banking. It does not provide for consistent regulations of securities activities by banks and securities firms.

I look forward to learning from Chairman Greenspan about the implications of the legislation before us and how we might improve the bill. I also look forward to learning more about both of these issues at our upcoming hearing next month when we will hear from regulators, including the Treasury, as well as industry participants.

I want to thank Chairman Oxley for his continued leadership on this issue of such vast importance to the Commerce Committee and for holding this first hearing on financial services reform this Congress. I also thank my friend, the ranking member of the committee, John Dingell, for his steadfast principles of protecting the taxpayer and ensuring consistent regulation as we continue our bipartisan work on this legislation. I look forward to working with both of you, as well as the ranking member of the subcommittee Ed Towns all of the members on the committee as we once again take on the challenge of modernizing our financial service regulations for the next century and beyond. Thank you, Mr. Chairman.

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

The Chair now recognizes the ranking member, the gentleman from Detroit.

Mr. DINGELL. Mr. Chairman, I thank you. Mr. Chairman, I commend you for holding this hearing on H.R. 10, the Financial Services Act of 1999, the legislation reported by the Banking Committee to modernize the U.S. financial regulatory system, to enhance competition in the financial services industry, to provide protections for investors and consumers, and to increase the availability of financial services to citizens of all economic circumstances and for other purposes.

I also want to welcome my good friend Mr. Greenspan to the committee. Welcome. We are delighted to see you here. Your good works are widely known on many matters, including the operating of the economy, but your leadership is not appreciated as well as it should be. So I am delighted to see you here, and maybe people can get a better understanding of the real leadership you have shown on this matter also. In any event, welcome to you, Mr. Chairman.

Mr. Chairman, the Banking Committee's mark falls short of many of the goals that I am concerned with, and I must inform you that in its current form I will be regrettably compelled to oppose it vigorously.

I want to thank my old friend Mr. Bliley, the chairman of the committee, for his kind remarks and also for the fine leadership which he has shown in difficult times in addressing this legislation, not just in the last Congress and this Congress, but also in other years. His effort on this has made for a better and stronger economy.

Mr. Chairman, key consumer protection provisions that the chairman of this committee and the chairman and ranking member of the House Banking Committee joined me in adding to last year's bill are not in H.R. 10 this year. The SEC opposes the bill because it eviscerates consumer and investor protection. Yesterday the

North American Securities Administrators Association submitted a 10-page memorandum outlining serious concern with this bill. Last week the National Association of Insurance Commissioners sent us a strong letter stating that the State insurance commissioners oppose H.R. 10 as passed by the House Banking Committee because the bill is hostile to consumers, to the States, and to purchasers of insurance polices. I ask unanimous consent to include these documents in the hearing record along with my statement.

Mr. OXLEY. Without objection.

Mr. DINGELL. At the same time, Mr. Chairman, we received letters from American Bankers Association, Securities Association and the ABA Insurance Association telling us not to change a word in the securities and insurance language of the Banking Committee bill. In response it should come as no surprise that I have requested the staff on this side to go over every word with a magnifying glass because this tells me there is a skunk in the wood pile somewhere. The last time I checked, the rules of the House blessed this committee with jurisdiction over securities and the business of insurance and responsibilities for reviewing and addressing these matters. No matter how difficult, we must do so, and it is clearly in the public interest that we should.

I want to welcome, as I said, my good friend Chairman Greenspan. Like all of us, I am an admirer of his because of his outstanding period of public service going back so many years. I thank him for joining us today to share with us his wisdom on matters in which he is the Nation's most foremost expert.

I may also be the only man in this room old enough to remember the banking crisis of the early 1930's. Those were grim times. I remember what it did to the economy and the people of the country and what was necessary to restore the confidence of the American people in the Nation's banking system and in the securities markets. Moreover, the thrift debacle of the 1980's should serve as a much more fresh and current reminder.

My colleagues, I will not support a regulatory structure that imposes upon the American public the danger of a repetition of these terrible events and the possibility of a similar raid on the U.S. Treasury by banks which have not engaged in the necessary standard of responsible behavior. Congress should be anxious to prevent the loss of public confidence and prevent large losses to the public treasury. I am hopeful that Chairman Greenspan can share with us some of the relevant lessons of the recent Asian financial crisis and the decision of the Japanese to adopt a holding company format in their financial structure on a going-forward basis.

Absent significant changes in H.R. 10, and that is one of the responsibilities of this government, to protect consumers, to protect depositors, and to protect, of course, the taxpayers to whom we have a paramount responsibility, I would be compelled to oppose this bill with every bit of strength that I have. Like the President, I will also be compelled to oppose any legislation that weakens our commitment to the Community Reinvestment Act.

In Greco-Roman mythology, Sisyphus was the cruel king of Corinth. His punishment in Hades was to run up a hill with a stone that constantly rolled down upon him again. As we enter banking Hades this year and attempt to roll H.R. 10 up the legislative hill to the Senate again, I would urge my colleagues to keep faith that this can be done, but only if we do it the right way. Passing no bill is better than passing a bad bill.

I just would like to hold up for everybody to look at, there is an article in the Wednesday, today, April 28, 1999, Wall Street Journal. "Sitting pretty," it says. It's on the left-hand side of the page, "Strong banking system helps Australia prosper as neighbors struggle." Neighbors disregarded the lessons that the Australians have observed. Bankers have complained to me for years about the fact that the Japanese and other banks in that area were large, and that ours were smaller. I observed that it is better to have smaller, better, stronger banks than large, weak banks which impose danger on the American people. The warnings are there before all. I hope they will see them, and I look forward to the testimony of my good friend.

[The prepared statement of Hon. John D. Dingell follows:]

PREPARED STATEMENT OF HON. JOHN D. DINGELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. Chairman, I commend you for holding this hearing on H.R. 10, the Financial Services Act of 1999, legislation reported by the House Banking Committee to modernize the U.S. financial regulatory system, to enhance competition in the financial services industry, to provide protections for investors and consumers, to increase the availability of financial services to citizens of all economic circumstances, and for other purposes.

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Key consumer protection provisions that the chairman of this committee and the chairman and ranking member of the House Banking Committee joined me in adding to last year's bill are not in H.R. 10 this year. The SEC opposes the bill because it eviscerates investor protection. Yesterday, the North American Securities Administrators Association submitted a 10-page memorandum outlining their concerns with this bill. Last week the National Association of Insurance Commissioners sent us a letter stating that the state insurance regulators oppose H.R. 10 as passed by House Banking because the bill is hostile to consumers and the States. I ask unanimous consent to include these documents in the hearing record with my statement.

At the same time, we have received letters from the American Bankers Association Securities Association and the ABA Insurance Association telling us not to change a word in the securities and insurance language of the Banking Committee bill. In response, it should come as no surprise that I have instructed the staff to go over every word with a magnifying glass. The last time I checked, the rules of the House vest the Commerce Committee with jurisdiction over securities and the business of insurance and the responsibility for reviewing and addressing these matters. No matter how difficult, we must do so, and do so in the public interest.

I warmly welcome my good friend Chairman Greenspan and thank him for his years of excellent public service and for appearing before us today to share with us his wisdom on matters in which he is most expert.

I may be the only man in this room old enough to remember the aftermath of the banking crisis of the early 1930s. I remember what it did to the economy and people of this country and what was necessary to restore the American public's confidence in the Nation's banking system and the securities markets. Moreover, surely the thrift debacle of the 1980s should still be fresh in our minds.

My colleagues, I will not support a regulatory structure that exposes the American public to a repetition of those terrible events and a similar raid on the U.S. Treasury. Congress should be anxious to prevent the loss of public confidence and to prevent large losses to the public treasury. I am hopeful that Chairman Greenspan can share with us some of the relevant lessons of the recent Asian financial crisis, and the decision of the Japanese to adopt a holding-company format for their financial structure on a going-forward basis.

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Mr. Chairman, I thank you.

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SECURITIES AND EXCHANGE COMMISSION
*February 4, 1999*

The Honorable THOMAS J. BLILEY
*Chairman*
*Committee on Commerce*
*U.S. House of Representatives*
*2125 Rayburn House Office Building*
*Washington, DC 20515*

The Honorable JOHN D. DINGELL
*Ranking Member*
*Committee on Commerce*
*U.S. House of Representatives*
*2322 Rayburn House Office Building*
*Washington, DC 20515*

DEAR CHAIRMAN BLILEY AND CONGRESSMAN DINGELL: I am writing to share the Commission's views on financial services modernization as the Congress begins to considers pending legislation.

Last year, Commission staff worked with Congress in an effort to develop legislation that would preserve principles that are fundamental to effective oversight of the securities markets. Unfortunately, the extended negotiations so eroded these basic principles that the Commission cannot support the latest version of H.R. 10, as introduced in the 106th Congress.

Rather than attempt to address all the specific provisions in this particular bill, I believe it would be more useful, at this time, to step back and outline the broader concepts we feel should be incorporated in any financial modernization bill. I have attached a brief discussion of the Commission's overall objectives for financial services reform. My staff and I are readily available to discuss these objectives further with you or your staff.

I applaud the Congress' efforts to advance financial services modernization and look forward to working with you and the Committee on this important legislation.

Sincerely,

ARTHUR LEVITT
*Chairman*

Enclosure
cc: The Honorable Michael G. Oxley
Chairman, Subcommittee on Finance and Hazardous Materials
The Honorable Edolphus Towns
Ranking Member, Subcommittee on Finance and Hazardous Materials

SEC OBJECTIVES FOR FINANCIAL MODERNIZATION

The SEC's mandate is to protect investors and ensure the integrity of the U.S. securities markets. In order to keep our markets the fairest, safest, most transparent and most liquid in the world, the SEC must oversee all U.S. securities activities, irrespective of location, and continue to determine how they are defined.

Focusing on market integrity and investor protection, the SEC will work with the Congress to include the following key safeguards in any financial modernization legislation:

- *Maintain aggressive SEC policing and oversight of all securities activities.* Public confidence in our securities markets hinges on their integrity. The SEC has an active enforcement program committed to fighting securities fraud. Banking regulators have a different mandate—protecting the safety and soundness of institutions and their deposits—which does not consider the interests of defrauded investors. To continue its effective policing of the markets, the SEC must be able to monitor securities activities through regular examinations and inspections, including access to books and records of all activities.

- *Safeguard customers by enabling the SEC to set net capital rules for all securities businesses.* Securities positions are generally more volatile than banking activities. The SEC's capital and segregation requirements recognize this fact and are more rigorous in addressing market risk than those imposed by bank regulators. During recent turmoil in the financial markets, SEC-regulated entities were well-collateralized and none was ever at risk of failure. We must continue to protect our markets from systemic risk by ensuring that there is enough capital backing securities transactions to protect customers.
- *Protect investors by applying the SEC sales practice rules to all securities activities.* All investors deserve the same protections when buying securities, regardless of where they choose to do so, but gaps in the current scheme leave investors at risk. For example, banks are not required to recommend only suitable investments or provide a system for arbitrating customer disputes. The high, uniform standard of the Federal securities laws should apply to all sales of securities.
- *Protect mutual fund investors with uniform adviser regulations and conflict-of-interest rules.* Mutual fired investors should always receive the protections of the federal securities laws. Accordingly, all parties that provide investment advice to mutual funds should be subject to the same oversight, including SEC inspections and examinations. In addition, any type of entity that has a relationship with a mutual fund should be subject to the SEC conflict-of-interest rules.
- *Enhance global competitiveness through voluntary broker-dealer holding companies.* U.S. broker-dealers are at a competitive disadvantage overseas because they lack the global, consolidated supervision that foreign regulators often require. To address this concern, a U.S. broker-dealer predominantly in the securities business should have the option of SEC holding company supervision. This structure would impose risk-based supervision, consistent with the firm's principal business, and would help protect market integrity by. overseeing the entire corporate entity, not just an isolated domestic unit.

**NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.**
10 G Street N.E., Suite 710
Washington, DC 20002
202/737-0900
Telecopier: 202/783-3571
E-mail: general@nasaa.org
Web Address: http://www.nasaa.org

**NASAA**

## MEMORANDUM

TO: HOUSE COMMERCE COMMITTEE

FROM: Thomas E. Geyer, Ohio Securities Commissioner
Chair, NASAA Financial Services Modernization Project Group
Deborah A. Fischione
NASAA Director of Policy and Office Management

DATE: April 27, 1999

RE: Comments on H.R. 10 "As Reported"

NASAA has had the privilege of testifying before the House and Senate regarding financial services modernization legislation pending in the 106th session of Congress. The issues discussed below are among the more important issues for NASAA. This list does not purport to be exhaustive and NASAA reserves the right to add to or amend this list as the legislative process continues. NASAA is basing these comments on H.R. 10 as it was reported from the House Banking and Financial Services Committee on March 23, 1999. We look forward to working with the House Commerce Committee as you begin deliberations on the bill.

**1. Full Preservation of State Securities Enforcement Authority.**

NASAA appreciates the preservation of State securities enforcement authority established by Section 104(d) of H.R. 10. NASAA believes such preservation is essential in order for States to provide meaningful investor protection and effectively police the securities marketplace. This express preservation is consistent with the similar preservations set out in the National Securities Markets Improvement Act of 1996 and the Securities Litigation Uniform Standards Act of 1998. However, NASAA respectfully suggests three minor changes in order to give full effect to the express preservation clearly articulated in Section 104(d).

a. Delete Section 104(b)(4)(C).

Section 104(b)(4) generally seeks to preserve certain State laws from preemption. However, because of the use of a double negative, Section 104(b)(4)(C) appears to have the actual effect of preempting State securities enforcement. Such preemption seems inconsistent with the careful and express preservation of State securities enforcement authority contained in Section 104(d). NASAA believes that the most efficient solution to this oversight is to simply strike Section 104(b)(4)(C).

b. Add Preservation Language to Section 307.

Section 307 generally preempts State law that would "prevent or significantly interfere with the ability of any insurer, or any affiliate of an insurer . . . to become a financial holding company or to acquire control of an insured depository institution." NASAA's concern is with the affiliates of insurers. Such affiliates could be broker-dealers or investment advisers under the jurisdiction of the State securities authorities, and the broad preemption of Section 307 could conflict with the State securities enforcement preservation language carefully and expressly preserved by Section 104(d). To remedy this confusion, NASAA suggests that preservation language identical to that appearing in Section 104(d) be added to Section 307. This new language could appear as follows:

> <u>(4) subsections (1), (2) and (3) shall not be construed as affecting the jurisdiction of the securities commission (or any agency or office performing like functions) of any State, under the laws of such State, to investigate and bring enforcement actions, consistent with section 19(c) of the Securities Act of 1933, with respect to fraud or deceit or unlawful conduct by any person, in connection with securities or securities transactions.</u>

c. Change "and" to "or" in Section 104(b)(4)(D)(iii).

As previously mentioned, Section 104(b)(4) generally seeks to preserve certain State laws from preemption. Section 104(b)(4)(D) in effect provides that a State law will not be preempted if it satisfies all parts of a four-part test. Part three of the test (Section 104(b)(4)(D)(iii)) provides that a State law will not be preempted if it "does not effectively prevent a depository institution, wholesale financial institution, or subsidiary or affiliate thereof from engaging in activities authorized or permitted by this Act or any other provision of federal law." This provision is inconsistent with the express preservation of State securities law set out in section 104(d) because State securities enforcement action may properly and intentionally have the effect of preventing such activities. Consequently, NASAA believes it is inappropriate and inconsistent with Section 104(d) to provide that such an effect is fatal to State law. To remedy this, NASAA suggests that the "and" at the end of Section 104(b)(4)(D)(iii) be changed to "or." This would have the effect of changing the four-part preemption test into a preemption test with four alternative standards. In other words, a State law would avoid preemption if it met any one of the four standards set out in Section 104(b)(4)(D), rather meeting all four parts as is currently the case. NASAA believes that such an alternative standard is consistent with, and gives full effect to, the preservation of State securities enforcement authority set out in Section 104(d).

**2. Full Regulatory Deference and Functional Regulation.**

NASAA also appreciates the regulatory deference contained in Section 111, which would amend Section 5(c) of the Bank Holding Company Act of 1956 to require banking regulators to defer to the Securities and Exchange Commission, State insurance authorities and State securities authorities under certain circumstances. To accomplish full functional regulation, NASAA suggests one minor change to proposed Section 5(c)(5) of the Bank Holding Company Act, which deals with the functional regulation of securities and insurance activities. Specifically, NASAA recommends that Section 5(c)(5)(B) be amended to apply to brokers, dealers and investment advisers required to be registered with State authorities, in addition to applying to brokers, dealers and investment advisers actually registered under State laws. New Section 5(c)(5)(B) could read as follows:

(B) the relevant State securities authorities with regard to all interpretations of, and the enforcement of, applicable State securities laws (and rules, regulations, orders and other directives issued thereunder) relating to the activities, conduct, and operations of brokers, dealers and investment advisers registered or required to be registered under applicable State securities laws (or rules, regulations and other directives issued thereunder).

Many State securities enforcement actions are directed against persons who are unregistered. This proposed amendment would include such actions within the scope of required deference. This amendment would also make Section 5(c)(5)(B) more consistent with the express preservation of State securities enforcement authority set out in Section 104(d) of H.R. 10.

### 3. Full Functional Regulation of Securities Subsidiaries.

NASAA appreciates that H.R. 10 moves towards functional regulation of securities activities. However, NASAA believes that Section 124 of H.R. 10 contains a minor oversight, the correction of which will result in true functional regulation in this section. NASAA respectfully suggests a minor amendment to Section 124 of H.R. 10. Section 124 would add to the Federal Deposit Insurance Act new Section 46 regarding the functional regulation of securities and insurance subsidiaries of insured depository institutions. Currently, proposed new Section 46(a) provides in pertinent part that a broker or dealer that is a subsidiary of an insured depository institution shall be subject to regulation under the Securities Exchange Act of 1934. In order to accomplish full functional regulation, NASAA recommends that a reference to State securities law be added to this provision. A revised Section 46(a) could read as follows:

(a) Broker or Dealer Subsidiary.

A broker or dealer that is a subsidiary to an insured depository institution shall be subject to regulation under the Securities Exchange Act of 1934 and State securities laws in the same manner and to the same extent as a broker or dealer that --

This amendment accomplishes full functional regulation and also serves to establish a level-playing field by ensuring that subsidiary and non-subsidiary broker-dealers are subject to the same set of complementary State and federal securities laws.

In, addition, in order to provide for complete functional regulation of securities subsidiaries, NASAA suggests that a provision regarding investment adviser subsidiaries be added. Such a provision could be added as new section 46(b) and read as follows:

(b) Investment Adviser Subsidiary.

An investment adviser that is a subsidiary of an insured depository institution shall be subject to regulation of the Investment Advisers Act of 1940 and State securities laws in the same manner and to the same extent as an investment adviser that –

(1) is controlled by the same bank holding company as controls the insured depository institution; and

(2) is not an insured depository institution or a subsidiary of an insured depository institution.

It is important to note that the failure to add this suggested provision regarding investment advisers would result in significant ambiguity as to the appreciable regulation of investment adviser subsidiaries. If this suggested provision is added, current subsection "(b)", regarding insurance subsidiaries, should be redenomiated as subsection "(c)". And current subsection "(c)", definitions should be changed as follows:

(e) (d) Definitions.

For purposes of this section:

(1) the terms "broker" and "dealer" have the same meanings as in section 3 of the Securities Exchange Act of 1934; and

(2) with respect to the term "investment adviser"

(A) such term shall have the same meaning as in section 202(a)(11) of the Investment Advisers Act of 1940 if the investment adviser subsidiary is registered with the Securities and Exchange Commission under section 203 of the Investment Advisers Act of 1940; or

(B) such term shall have the same meaning as defined in the State law of the State in which the investment adviser has its principal place of business if the investment adviser subsidiary is ineligible to register with the Securities and Exchange Commission under section 203 of the Investment Advisers Act of 1940 and is instead registered with appropriate state authorities.

The bifurcated definition of "investment adviser" is necessary because of the bifurcation in oversight resulting from the National Securities Markets Improvement Act of 1996.

**4. Notice of Preemption of Certain State Provisions.**

Because NASAA's members are devoted to consumer protection, NASAA recognizes the importance of the consumer protection provisions contained in Section 176 of H.R. 10, which would add to the Federal Deposit Insurance Act a new Section 47 dealing with customer service and education issues. In light of the States' commitment to consumer protection and experience in administering securities laws, NASAA respectfully requests that State securities administrators be added to the consultation provisions in proposed new Section 47(a)(3).

In addition, NASAA is concerned that States will have neither notice of, nor an opportunity to be heard on, the preemption of State law by the joint regulations prescribed by the federal financial institutions regulators. Specifically, proposed new Section 47(f)(2)(B) of the Federal Deposit Insurance Act provides that such joint regulations will preempt State law if the federal financial institutions regulators determine jointly that the "protection afforded by such provisions for consumers is greater than the protection provided by a comparable provision" of State. While NASAA wholeheartedly agrees that the strongest consumer protection standard should govern, it offends notions of due process and fundamental fairness that federal authorities could preempt State law without public notice and an opportunity to be heard.

Consequently, NASAA would respectfully request that publication in the Federal Register and a public comment period be required. This could be accomplished by adding the following to the end of proposed new Section 47(f)(2)(B):

> Provided, however, that such joint determination shall not be effective unless such joint determination is made after notice of such joint determination is published in the Federal Register and subject to public comment for a period of not less than sixty days.

**5. The Definition of "Broker."**

NASAA agrees completely with eliminating the blanket exemption for banks in the definition of "broker" under the Securities Exchange Act of 1934. However, NASAA remains concerned that the approach taken by Section 201 of H.R. 10 creates a series of exceptions that swallow the general rule. NASAA's specific concerns are as follows:

a. Third-Party Brokerage Arrangements.

NASAA fully supports this exception, but respectfully suggests that it can be improved by being moved in line with the existing standards in this area. In particular, in February 1998, the National Association of Securities Dealers ("NASD") "bank broker-dealer rule," Rule 2350, took effect. In October 1998, the NASAA membership approved Model Rules for Sales of Securities at Financial Institutions, which track NASD Rule 2350. Both NASD Rule 2350 and the NASAA Model Rules address the issues relevant to third-party brokerage arrangements, namely; setting and physical separation, brokerage agreements and program management, customer disclosure and acknowledgment, communication with the public, and notice of termination. NASD Rule 2350 resulted after nearly three years of input from the banking and securities industries on how to properly regulate third party brokerage activities. Because NASD Rule 2350 represents a well-developed and well-reasoned approach, NASAA respectfully suggests that the third-party brokerage arrangement exception as proposed in new Section 3(a)(4)(B)(i) of the Securities and Exchange Act of 1934 be amended to include either a cross reference to NASD Rule 2350 or a list of the exact provisions contained in NASD Rule 2350.

b. Trust Activities.

NASAA does not object to codifying that banks engaged in traditional trust activities are excepted from the definition of "broker." However, NASAA is concerned that proposed Section 3(a)(4)(B)(ii), as drafted, permits banks to engage in activities exceeding those of traditional trust activities, without providing investors the protections of the federal and State provisions governing the conduct of investment advisers. The effect of the proposed exception for certain "trust" activities, including the extension of the exception to an "other department that is regularly examined by bank examiners," coupled with the solicitation activities permitted under this exception, is to permit banks to solicit publicly advisory business from deposit-holders and non-deposit-holders, devoid of the substantive federal and State regulation under the securities laws. NASAA respectfully suggests that the proposed limitless solicitation of advisory business be narrowed.

The language regarding solicitation activities now limits the activities to those banks that do not "publicly" solicit brokerage business. NASAA would note that this language, while appearing to limit a bank's solicitation activities, now would permit banks' brokerage businesses to actively solicit deposit holders (in a non-public fashion).

NASAA respectfully recommends that the proposed new Section 3(a)(4)(B)(ii)(II) be revised as follows.

> (II) does not ~~publicly~~ solicit brokerage business, other than by advertising that it effects transactions in securities in conjunction with advertising its other trust activities.

c. Private Securities Offerings.

NASAA respectfully believes that the exception set out in proposed Section 3(a)(4)(B)(vii) falls short of establishing true functional regulation for private securities offerings. Documented sales practice abuses have occurred in private placement transactions, and investors need the assurance that the intermediary who is selling the security is trained and subject to the obligations applicable to other broker-dealers. To afford true functional regulation in this area, the securities should either be required to be sold through a registered broker-dealer, or in the alternative, to at least require bank employees to take and pass the examination contemplated in Section 203 of H.R. 10, which would add Section 15A(j) to the Securities Exchange Act of 1934.

NASAA is pleased with Section 3(a)(4)(B)(vii)(II), since NASAA believes that, to the extent a bank maintains an affiliation with a broker-dealer firm, all private placements be effected through that broker-dealer rather than through the bank itself. However, NASAA would respectfully suggest that the existing language creates little incentive for a bank to establish an affiliation with a broker-dealer firm through whom to channel these securities transactions.

NASAA believes that the registration and regulatory provisions provided under the

Securities Exchange Act of 1934, State provisions, and self-regulatory organization rules are critical components of the investor protection equation. Regulators use these provisions to monitor the activities of broker-dealers and to screen out those entities and individuals that should not be permitted to engage in the offer and sale of securities in our markets. NASAA is also concerned that, by excusing banks from compliance with virtually all of the Securities Exchange Act of 1934 registered broker-dealers will suffer a significant competitive disadvantage when seeking to distribute securities in a nonpublic offering.

d. De Minimis Exception.

NASAA continues to oppose the de minimis exception in proposed Section 3(a)(4)(B)(x). By allowing securities transactions to occur outside the established complementary State/federal securities oversight framework, the exception is inconsistent with true functional regulation and creates an unlevel playing field.

Nonetheless, if the de minimis exception is to be included in H.R. 10, NASAA respectfully suggests that the de minimis be in terms of customers, rather than transactions.

Underlying the de minimis exception seems to be the belief that banks should be allowed to carry out a certain few securities transactions as an accommodation for certain bank customers. Accordingly, a de minimis exception based on the number of customers seems more logical. Further, "customers" are more easily counted. "Transactions" is an amorphous concept not generally defined in the securities laws. Confusion would certainly arise as to what activity constituted a "transaction."

In contrast, it is clear who constitutes a customer. Support for this approach can be gleaned from the National Securities Markets Improvement Act of 1996, where Congress defined certain investment adviser de minimis standards in terms of people, not transactions.

Specifically, NASAA suggests that the de minimis be set at one hundred customers. In suggesting this number, NASAA started with the fact that the de minimis exception is designed to allow smaller, typically rural banks to undertake securities transactions as an accommodation and convenience for certain customers. From that starting point, it is reasonable to assume that small banks have about 2,000 customers. Using the general banking industry guidelines that 20% of an institution's depositors account for 80% of an institution's deposits, there would be 400 customers who would be larger depositors of a 2,000 depositor institution. It is safe to assume that these 400 larger depositors would be more likely to engage in securities transactions. And since the exemption is designed to be "de minimis" in nature, it would be reasonable to permit transactions for up to 100 or 25% of those customers.

Thus, NASAA would propose that the de minimis exemption read as follows:

(x) De minimis Exception.

> The bank effects transactions in securities on behalf of not more than 100 customers in any calendar year; provided that such transactions are not effected by an employee of the bank who is also an employee of a broker or dealer; and provided further that prior to executing the first securities transaction in any calendar year on behalf of a customer under this de minimis exception, the bank obtains from the customer a written acknowledgement indicating the customer understands that the bank executing securities transactions on behalf of the customer within the de minimis exception to the federal definition of "broker", and the consequences thereof.

The written acknowledgment is designed to assist the bank in accounting for the number of transactions within the de minimis.

**6. The Importance of Registration for Sales of Private Securities Offerings.**

NASAA fully supports Section 203 of H.R. 10, which would add to the Securities Exchange Act of 1934 Section 15A(j) requiring the NASD to create a limited qualification category for an associated person of an NASD member firm effecting nonpublic securities transactions. While this provision creates a limited registration category for associated persons of member firms, it would presume such qualification if the same individual happened to be distributing the same securities not for a broker-dealer but for a bank.

It would appear that this provision is added to permit associated persons of NASD member firms to engage solely in the distribution of securities through a nonpublic offering without having to undertake full registration as a registered representative. It is NASAA's observation that very few registered representatives engage solely in the distribution of private placements. Additionally, it would appear that bank employees would be "grandfathered" from any examination requirement. However, Section 203 does not appear to require the "non-grandfathered" bank employees to satisfy any qualification requirements to distribute these securities.

This provision would appear to place NASD member firms at a competitive disadvantage with banks in the private placement market. It is assumed that, like other limited examinations, the examination is a "subset" of the Series 7 examination. Broker-dealer representatives would be permitted to take this limited examination. However, bank personnel effecting the same transactions would not be required to take this examination, even though the conduct in which they would be engaged could be identical to that of the broker-dealer representative. There exists no other provision of the federal securities laws or of H.R. 10 that would place any requirements or registration upon these bank personnel. To provide some minimal protections for the depositor/investor, NASAA believes it imperative for bank personnel to at least be required to take this limited qualifying examination.

The mechanism that would provide for true functional regulation would be to require the NASD to create this limited qualification examination, but require associated persons of member firms and bank personnel to take and pass this qualification examination (or be qualified under a more comprehensive examination, such as the Series 7) prior to effecting transactions in securities not involving a public offering. NASAA believes that the following language would address this issue:

> (j) Registration for Sales of Private Securities Offerings. A registered securities association shall create a limited qualification category for any associated person of a member who effects sales as part of a primary offering of securities not involving a public offering, pursuant to section 3(b), 4(2), or 4(6) of the Securities Act of 1933 and the rules and regulations promulgated thereunder, <u>shall permit any bank employee to take the qualification examination required for this limited registration category for purposes of section 3(a)(4)(B)(viii)(II) of this title</u>, and shall deem qualified in such limited qualification category, without testing, any bank employee who, in the six month period preceding the date of enactment of this Act, engaged in effecting such sales.

As a practical matter, the NASD currently administers qualifying examinations for individuals not associated with a member firm, and thus would appear capable of administering this new examination for members and non-members alike. For example, NASAA would note that individuals not affiliated with a member firm could, in certain circumstances, sit for the Series 7 examination, which is owned jointly by the NASD and New York Stock Exchange. NASAA would note that little reason exists to excuse bank personnel from sitting for a qualification examination as a prerequisite of effecting private securities transactions. It would appear that the exception in proposed Section 3(a)(4)(B)(vii) of the Securities Exchange Act of 1934 could be conditioned upon the transaction being effected either through a registered broker-dealer or through a bank employee that has passed a qualifying examination:

> (II) at any time after one year after the date of enactment of the Financial Services Act of 1998, is not affiliated with a broker or dealer that has been registered for more than one year; and
>
> <u>(III) is effected solely by bank employees that have attained a</u>

passing score on the qualification examination created pursuant to section 15A(i) of this title or through a broker or dealer; and

~~(III)~~(VI) effects transactions exclusively with qualified investors.

**7. Definition and Treatment of Banking Products.**

NASAA fully concurs with the removal of the concept of "derivatives" from the definition of "traditional banking product" set out in Section 205 of H.R. 10. This section now appropriately lists items in which banks have historically dealt. NASAA has one aditional investor protection concern with Section 205, and that is that Section 205(a)(5)(B) would permit loan participations to be sold to non-qualified investors. The sale of loan participations presents the opportunity to shift the risk of bank loans, defaulting mortgages or insolvent borrowers onto investors. Consequently, only those investors meeting the financial standards of being a "qualified investor" should be permitted to purchase these products.

As a result, NASAA respectfully suggests that Section 205(a)(5)(B) be deleted.

**8. Governmental Entities as Qualified Investors.**

In general, NASAA believes that the definition of "qualified investor," set out in Section 206 of H.R. 10, sets out an appropriate standard for persons and entities who can "fend for themselves" when making investment decisions. However, NASAA remains concerned with the relatively low threshold of $50,000,000 in investments for governmental entities.

NASAA is concerned that many county and local governments will meet this threshold yet not possess the sophistication or knowledge to be appropriately deemed "qualified investors." This relatively low standard and the absence of any required professional management make this part of the definition, NASAA believes, inadequate. Many state, county and local government pensions are advised by volunteers, or elected or appointed officials who are not principally engaged in the business of investment management. Requiring that professionals manage the investments, or that the investments be of a size where the fund will be professionally managed as a matter of course, would greatly decrease the likelihood that entities that sell to qualified investors will later become defendants in securities suits alleging unsuitable recommendations or other violations of the securities laws.

To remedy this problem, NASAA would respectfully suggest that governmental entities be treated as "qualified investors" only if a registered broker-dealer, investment adviser, insurance company, or insured depository institution professionally manages the investments. In the alternative, NASAA would respectfully suggest that this classification of qualified investor be required to own and invest a greater quantity of investments, such as $250 million. This higher threshold would greatly increase the likelihood that professional advisers manage the portfolio, due to its size. Language addressing this issue could appear as follows:

> (xiii) any governmental or political subdivision, agency or instrumentality of a government who owns and invests on a discretionary basis not less (I) than $250,000,000 ~~$50,000,000~~ in investments, or (II) than $50,000,000, provided that investments are managed by (AA) a bank (as defined in paragraph (6) of this subsection); (BB) a savings and loan association (as defined in section 3(b) of the Federal Deposit Insurance Act), (CC) a broker, dealer, or insurance company (as defined in section 2(a)(13) of the Securities Act of 1933), (DD) an investment adviser registered under the Investment Advisers Act of 1940 or with any state, or (EE) a foreign bank (as defined in section 1(b)(7) of the International Banking Act of 1978).

**9. True Functional Regulation of Banks who act as Investment Advisers.**

To provide for true functional regulation over persons providing investment advice to others for compensation, NASAA would respectfully suggest an amendment to the definition of "investment adviser" found at Section 202(a)(11) of the Investment Advisers Act of 1940, in addition to Section 217 of H.R. 10. Just as advisers to investment companies should be subject to the substantive regulatory provisions of the Investment Advisers Act of 1940, NASAA believes it imperative that advisers to retail clients be subject to appropriate federal and State provisions, regardless of whether the investment advice is offered by a bank or nonbank adviser.

Consistent with the exceptions for "qualified investors," it would appear consistent to permit banks to provide advice to "qualified investors" other than investment companies and still maintain the exception from the definition of "investment adviser" This exception would also be consistent with the private securities offering exception in proposed Section 3(a)(4)(B)(vii) discussed previously. NASAA's concern is that those advisers providing advice to retail clients be subject to even-handed and fair regulation at the local level.

NASAA would respectfully suggest that the proposed definition of "investment adviser" be amended slightly as follows (this language assumes the amendment proposed at Section 217 of H.R. 10):

> (11) "Investment adviser" means any person who, for compensation . . . but does not include (A) a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956 which is not an investment company, except that the term 'investment adviser' includes any bank or bank holding company to the extent that such bank or bank holding company acts as an investment adviser to a registered investment company <u>or to any person other than a 'qualified investor,' as that term is defined in section 3(a)(55) of the Securities Exchange Act of 1934</u>, but if, in the case of a bank, such services are performed through a separately identifiable department of division, the department or division, and not the bank itself shall be deemed to be the investment adviser . . .

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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS
*April 22, 1999*

Honorable TOM BLILEY
*Chairman*
*Committee on Commerce*
*2125 Rayburn HOB*
*Washington, DC 20515*

Honorable JOHN D. DINGELL
*Ranking Minority Member*
*Committee on Commerce*
*2328 Rayburn HOB*
*Washington, DC 20515*

STATE INSURANCE REGULATORS OPPOSE HR 10 AS PASSED BY THE HOUSE BANKING COMMITTEE BECAUSE THE BILL IS HOSTILE TO CONSUMERS AND THE STATES

GENTLEMEN: HR 10, as passed by the House Committee on Banking and Financial Services, is very harmful to insurance consumers and the States. Consequently, we believe it is absolutely essential that the Committee on Commerce exercise its jurisdiction over insurance matters to fix HR 10, and protect the American public from the dangers of unregulated insurance products in the marketplace.

In its current form, HR 10 needlessly sweeps away State authority used to regulate the solvency and market conduct of insurance activities conducted by banks and traditional insurers that affiliate with them. If the Federal government prevents the States from supervising those insurance activities, they will not be regulated at all. There is no Federal guarantee program for insurance losses, so the costs of such regulatory failures will fall directly upon policyholders, claimants, State guarantee funds, and State taxpayers.

The NAIC requests that the Committee on Commerce correct the insurance regulatory problems in HR 10. To help accomplish that goal, State regulators are undertaking two important initiatives—(1) NAIC is providing the Commerce Committee with a package of amendments to HR 10 that, if adopted, will adequately protect insurance consumers and the States without impairing the goals of the bill's sponsors; and (2) NAIC and State regulators are commencing an intensive, public campaign to inform consumers, State officials, and Members of Congress regarding the harm that passage of HR 10 will cause.

As an organization of State officials responsible for protecting the public, the National Association of Insurance Commissioners (NAIC) pointed out the following serious flaws in HR 10 during our testimony before the House Banking and Financial Services Committee on February 11, 1999.

- HR 10 flatly prohibits States from regulating the insurance activities of banks, except for certain sales practices. There is no justification for giving banks an exemption from proper regulations that apply to other insurance providers.
- HR 10 prohibits States from doing anything that might "prevent or restrict" banks from affiliating with traditional insurers or engaging in insurance activities other than sales. This exceedingly broad standard undercuts ALL State supervisory authority because every regulation restricts business activity to some degree. HR 10's total preemption of State consumer protection powers goes far beyond current law, and casts a dangerous cloud over the legitimacy of State authority in countless situations having nothing to do with easing financial integration for commercial interests. It could also throw into question the regulatory cooperation between State insurance regulators and Federal banking agencies being achieved under current law.
- HR 10 uses an "adverse impact" test to determine if State laws or regulations are preempted because they discriminate against banks. This unrealistic standard fails to recognize that banks are government-insured institutions which are fundamentally different from other insurance providers. Sound laws and regulations that are neutral on their face and neutral in their intent would still be subject to preemption under such a standard.
- HR 10 does not guarantee that State regulators will always have equal standing in Federal court for disputes which may arise with Federal regulators.

Frankly, we are quite disappointed and concerned that the House Banking and Financial Services Committee chose not to fix these and other problems pointed out by NAIC. We were told that all parties affected by HR 10 will suffer a certain amount of pain, but nobody has informed insurance consumers that they are among the groups who will suffer when State laws and regulations are preempted.

The NAIC and State insurance regulators strongly oppose HR 10 as passed by the Banking and Financial Services Committee. Nor do we believe the public will be complacent about the negative impact that HR 10 will have upon the safety and soundness of financial products involving insurance, a unique product which is purchased to protect people during the times in their lives when they are most vulnerable.

The NAIC looks forward to working positively and cooperatively with the Commerce Committee and its Members as you perform your responsibilities on HR 10. We cannot—and will not—stand by silently if the push for HR 10 becomes a means for effectively deregulating the insurance activities of banks and the traditional insurance providers who affiliate with them. The public interest would not be served with that outcome.

Sincerely,

GEORGE M. REIDER, JR.
*President, NAIC*

GEORGE NICHOLS, III
*Chairman, NAIC Committee on Financial Services Modernization*

cc: Honorable Michael G. Oxley, Chairman
Honorable Edolphus Towns, Ranking Minority Member
Subcommittee on Finance and Hazardous Materials
Members of the Committee on Commerce

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ABA SECURITIES ASSOCIATION
*April 21, 1999*

The Honorable THOMAS J. BLILEY, *Chairman*
*The Committee on Commerce*
*2125 Rayburn House Office Building*
*U.S. House of Representatives*
*Washington, DC 20515*

DEAR CHAIRMAN BLILEY: In this letter, the ABA Securities Association ("ABASA") respectfully submits its views on the capital markets provisions in H.R. 10, the "Financial Services Act of 1999," which the Commerce Committee is scheduled to consider during the next month. ABASA is a separately-chartered subsidiary of the

American Bankers Association ("ABA") that represents the banking organizations that are most actively involved in securities and capital markets.

In general, ABASA strongly supports the existing capital markets provisions of H.R. 10. Among its many positive provisions are full securities underwriting and dealing authority for affiliates and subsidiaries of banks; removal of the existing prohibition on director, officer, and employee interlocks between banks and securities firms; broadened "merchant banking" investment authority; increased authority for banks to underwrite and deal in municipal bonds; and an expanded definition of the types of financial activities in which bank holding companies would be permitted to engage.

At the same time, H.R. 10 would significantly roll back the existing securities law exemption from broker-dealer regulation that is now expressly applicable to all banks. The result would be that certain lawful banking activities would be "pushed out," or exposed to push-out, from the bank to a separate affiliate that was registered and regulated as a securities broker-dealer. However, H.R. 10 recognizes that many of the traditional banking activities should not trigger brokerage registration. H.R. 10 does this through a series of narrowly drawn exemptions from push-out for specific types of activities in which banks currently engage.

ABASA has long opposed push-out provisions as costly, unnecessary, and inconsistent with the fundamental purposes of financial services modernization. Despite this long-held position, ABASA has continually worked hard and in good faith to support a constructive compromise on push-outs that would help lead to passage of an overall bill that included the positive capital markets provisions described above. These efforts have included many worthwhile exchanges with your Committee, the House Banking Committee, the Senate Banking Committee, the federal banking regulators, the Securities and Exchange Commission, and the Treasury Department. In addition, at the request of House leadership in the 105th Congress, ABASA participated with our colleagues at the Securities Industry Association ("SIA") in compromise discussions regarding this same issue.

After many years of these intensive discussions and negotiations, the result has been an extremely hard-fought and carefully-balanced compromise involving substantial concessions from all parties involved. The compromise replaces the existing blanket exemption from push-out for all banking activities with a set of specific statutory exemptions for particular types of banking activities that have been and will continue to be more appropriately regulated under the banking laws than the securities laws. Other existing banking activities not covered by the exemptions—such as retail securities brokerage—would be pushed out to a broker-dealer. All of these new exemptions are spelled out in detail in statutory language in order to provide market participants with some high degree of certainty.

In this context, ABASA strongly supports the push-out provisions in the Senate Banking Committee's version of financial reform legislation. ABASA also continues to support the push-out provisions of H.R. 10 as reported by the House Banking, which, although involving more push-outs than the Senate version, is nevertheless consistent with the fundamental compromise described above. Indeed, it is our understanding that the H.R. 10 provisions are nearly identical to those included in the financial services legislative compromise that resulted at the end of 1998 from last year's negotiations among you and the Chairmen of the House and Senate Banking Committees, and that the SEC, while not agreeing to this version, made clear at the end of last year's debate that they would not strongly oppose the final compromise bill that included these provisions.

Accordingly, ABASA urges the Commerce Committee to adopt the securities and capital markets provisions in H.R. 10, including the push-out provisions reflecting the compromise discussions from last year. We firmly believe that the hard-fought compromise it reflects is an extremely delicate one, and that any significant departure from it would jeopardize critical support for the overall legislation.

Thank you for considering our views. We look forward to working with you and your staff, and answering any questions you may have.

Sincerely,

THE ABA SECURITIES ASSOCIATION

cc: The Honorable John D. Dingell, Ranking Minority Member,
Committee on Commerce
The Honorable Michael G. Oxley, Chairman,
Subcommittee on Finance and Hazardous Materials
The Honorable Edolphus Towns, Ranking Minority Member,
Subcommittee on Finance and Hazardous Materials

ABA INSURANCE ASSOCIATION
*April 15,1999*

The Honorable JOHN D. DINGELL
*Ranking Minority Member*
*The Committee on Commerce*
*2322 RHOB*
*U.S. House of Representatives*
*Washington, DC 20515*

DEAR REP. DINGELL: The American Bankers Association Insurance Association, Inc., is writing regarding the insurance provisions in H.R. 10, which has been approved by the House Banking and Financial Services Committee and is now pending in the House Commerce Committee. The ABA Insurance Association (ABAIA) is an affiliate of the American Bankers Association. Its members are the leading banking organizations in the United States involved in the business of insurance.

While the insurance provisions in H.R. 10 are not perfect, ABAIA supports them. As approved by the House Banking Committee, the bill would permit banks to affiliate with an insurance company or insurance agency. Such affiliates would be regulated principally by the states, subject to an anti-discrimination standard intended to ensure that banks and their insurance affiliates are treated fairly. States would have the right to review affiliations between banks and insurance firms, and the federal banking regulators would be required to defer to the states in the examination and supervision of insurance affiliates.

The insurance provisions in H.R. 10 reflect a fragile compromise between the interests of the banking and insurance industries, state and federal regulators, and consumers. These provisions, particularly Section 104, reflect months of negotiations between interested parties, including ABAIA, and we fear that a departure from them could cause the entire bill to unravel. Therefore, we urge you to maintain the compromise as it stands.

We would, however, like to raise two matters, which are not within the scope of the insurance compromise. First, Section 176 of the bill directs the federal banking regulators to establish an "appropriateness" standard applicable to the sale of insurance by a bank. This is an undefined standard, which we fear could lead to significant litigation. Furthermore, it is a standard that would be applicable only to banks engaged in the sale of insurance, not to insurance companies or agencies unaffiliated with banks. Consumer confusion would be inevitable. Therefore, we recommend the elimination of this requirement.

Second, Section 305 prohibits a national bank or a subsidiary of a national bank from underwriting or selling title insurance, unless the bank or subsidiary was engaged in the activity prior to the date of enactment of the bill. This is an anti-competitive provision that simply has no place in a financial modernization bill. Title insurance sales, in particular, pose no safety and soundness threat to a bank or its depositors. With this provision in place, a mortgage banking subsidiary of a national bank could not sell title insurance lawfully underwritten by a holding company affiliate. We urge the elimination of this anti-competitive, anti-consumer provision.

Thank you for your consideration of these views.

Sincerely,

ABA INSURANCE ASSOCIATION

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[Wednesday, April 28, 1999—The Wall Street Journal]

SITTING PRETTY

By S. Karene and David Wessel, Staff Reporters of The Wall Street Journal

When Asia's economies hit the skids nearly two years ago, it looked like Down Under was soon to be down and out.

After all, 60% of Australia's export goods were bound for Asia, many of them commodities such as copper, nickel and aluminum, whose prices were tumbling. Asians also accounted for about half the nation's foreign tourists, and hotels like the Radisson Resort, along the beach-strewn Gold Coast of Australia's eastern shore, soon reeled from a decline in arrivals. Several private economists looked around and cut their growth forecasts.

But Australia hasn't just avoided the Asian-Pacific downturn; it has roared ahead. While the economies of most of its Asian trading partners contracted last year, Australia's expanded 5.1%, surpassing the U.S.'s 3.9% pace and making it one of the fastest-growing economies in the developed world. And 1999 is likely to be its eighth consecutive year of growth.

After a decade of unflattering comparisons to Asia's once-booming economies, Australia now is basking in praise from the most unlikely sources—including the proud Singaporeans who had looked down on Australians as poor cousins.

*Tortoise vs. Hare*

During a visit to Australia last month, Singapore Prime Minister Goh Chok Tong recalled the fable of the tortoise and the hare, likening Australia to the tortoise who surprises the Asian hares by winning the race. "Australia has a good record over the past 15 years or so" of policies that "have given an underpinning to the country," Mr. Goh said. "In many parts of Asia, we were concentrating on fast growth, quick infrastructure, but forgetting the fundamentals."

What accounts for Australia's success? Equal parts good fortune and good management.

Australia's central bank had begun cutting interest rates for domestic reasons a year before the Asian crisis began in July 1997, so there was a strong dose of stimulus in the country's economic pipeline. Moreover, the nation had weathered an Asian-style banking aft in the 1980s; by the mid-1990s, Its banks had been rebuilt and its regulators were battle-hardened.

"The one, two and three main reasons that Australia isn't in the contagion is because of the strength and soundness of the banking system." says Robert Joss, an American banker recruited in 1993 to turn around Westpac Banking Corp., one of Australia's biggest banks, after it nearly collapsed under bad debt.

On the management front, Australia let its dollar float freely back in 1983, so it had no rigid exchange rate to defend, as did such countries as South Korea and Thailand, which tried unsuccessfully and expensively to tie their currencies to the U.S. dollar. Once the Asian crisis was afoot, its central bank—in contrast to that of neighboring New Zealand—read the situation correctly, and didn't tighten monetary policy to shore up its currency.

Meanwhile, Australian exporters—which deregulation and privatization had forced to become more nimble—diverted their wares from sinking Asian economies to healthier ones elsewhere. When the South Korean market went sour, for example, Qantas Airways redeployed aircraft on more promising Indian routes. As Indonesia's economic crash hammered sales of live cattle there, Australian producers began wooing buyers In Mexico and Libya. All told, Australia's sales of goods to Asia, including Japan, slid 6% last year, in value terms, from 1997, while exports to the U.S. and Europe climbed 34% and 42%, respectively. And its total exports of goods and services rose in 1998, by a modest 2%, to 114.9 billion Australian dollars (US$74.56 billion).

Australia's floating dollar apparently has allowed it "to sail almost unscathed through the Asian crisis," says Paul Krugman, an international economist at the Massachusetts Institute of Technology. In a new book, he asks: "If Australia could so easily avoid getting caught up in its neighbors' economic catastrophe, why couldn't Indonesia or South Korea do the same?"

His controversial answer: The financial markets have a double standard. When the currency of a country in which they have confidence, say Australia, plunges, they see it as an excuse to buy; the country benefits, and the market's good opinion is confirmed. When the same thing happens elsewhere—in Indonesia, for example—investors flee, the country suffers, and the market's bad opinion is ratified.

But John Edwards, chief economist of HongkongBank of Australia Ltd., contends that the answer lies in the structural changes Australia has made. "They weren't the reason we grew, but they were the reason we weren't a victim of the Asian crisis, although we shared a number of characteristics of countries that were victims." These include a heavy foreign-debt load and a relatively big deficit in the current account, a gauge of trade in goods and services, plus certain fund transfers.

Though "you can't just take a template from somewhere else and slap it on," Australia is "an inspiration for implementing tough economic reforms," because it has overcome "a number of challenges that Asian economies are going to face," says Alex Erskine, who watched the Asian crisis unfold as Citibank's regional market strategist in Singapore.

Of course, the story isn't over yet. Economic growth is likely to slow in the months ahead, though the IMF is predicting better than 3% growth for 1999, and Australia's already large trade deficit is widening.

However, for all their differences in geography, natural resources, history and culture, Asia's economies might have learned something by studying Australia's mistakes of the 1980s.

Long before Asia overdosed on easy credit, Australia had done much the same thing, though on a smaller scale. It deregulated its financial sector and, in 1985, opened the doors to 16 foreign banks. Hungry for market share, the new competitors from abroad lent readily, which spurred lending at the four big domestic banks, including Westpac. Real-estate prices soared, and a crop of highflying entrepreneurs emerged, including Perth businessman Alan Bond, with his flagship Bond Corp. Holdings Ltd. By the early 1990s, a recession had pricked the asset bubbles. Mr. Bond's empire collapsed, owing creditors $10 billion, and he now is in jail for corporate misdeeds. Regulators say troubled debt now amounts to 1% of the outstanding loans of all banks in Australia, down sharply from a 1992 peak of 10%.

Before the 1980s crisis, the science of assessing credit risk "just didn't exist" in Australian banking, says Les Phelps, executive general manager of the nation's bank regulator. In its wake, banks such as Westpac moved to implement a better risk-management system and provide greater disclosure, and regulators added staff, increased the frequency of bank visits, and standardized and tightened definitions of such things as troubled assets.

"After the disasters of the cowboy era, everybody got religion," says Mr. Joss, who recently left Westpac to become dean of Stanford University's business school. "Corporate balance sheets are much healthier in Australia today than they were six or eight years ago." As both equity and debt capital got scarcer, Australian companies had to manage resources better, something that Asian companies must learn to do, he says. The government, too, is in better financial shape today, having recorded a budget surplus, excluding asset sales, last year and predicting another surplus for the fiscal year ending in June.

As a result, Australia was better prepared than some other economies when Thailand's 1997 devaluation set off a chain reaction that turned growth in Asia into recession. Not surprisingly, the Australian dollar fell, losing 25% of its value as. the crisis deepened. The currency, which had been at 80 U.S. cents in late 1996, weakened to 74 cents after Thailand devalued, and touched bottom at 55 cents after Russia's default and devaluation in August 1998.

Inside the Australian central bank, however, policy makers concluded that the country's dollar would have to stay weak for at least six months before a resulting rise in import prices would stoke inflation. Betting correctly that the currency would rebound, the bank, unlike many of its counterparts, didn't tighten monetary policy, though it spent US$2.5 billion, 20% of its hard-currency hoard, to buy the Australian dollar in an effort to stem selling that was deemed mostly "speculative." Its wager paid off; the Australian dollar has been hovering around 63 U.S. cents, and inflation has been steady at around 1.6%.

Central bank chief Ian Macfarlane remains cautious, however. "We had been expecting a noticeable slowdown, and we still are," he says. "But it will be a slowing off a much higher basis than we formerly thought."

What happened in New Zealand, which also overhauled its economy in the 1980s, underscores the importance of Mr. Macfarlane's policy decision. New Zealand's central bankers had been tightening monetary policy through the end of 1996 to cool inflationary pressures, and began easing in early 1997. But partly out of fear that the weakening New Zealand dollar would stir up inflation, It didn't ease quickly enough—and a recession ensued.

"We'd probably have eased more if we'd actually had a realistic understanding" of the magnitude of both the Asian crisis and a drought that hurt local agricultural production, says Donald Brash, New Zealand's central banker. Still, Mr. Brash thinks that because of the time it takes for such changes to affect an economy, monetary policy would have needed to be "much easier in 1996" to stop New Zealand—whose economy now is growing again—from sliding into recession in early 1998.

But propelling a capitalist economy forward takes more than strong banks and central bankers who are prepared to risk a weakening currency. It also takes businesses that can and do respond when the world around them changes.

For years, Australian businesses and workers had struggled to cope with the dismantling of policies that, in the government's view, were restraining the Australian economy. Tariff barriers protecting Australian industries were stripped away. The rigid national wage-setting structure that had governed pay has moved toward a productivity-based system of labor agreements reached at individual, companies. Air travel, electricity and telecommunications have been opened to competition.

The changes were painful and controversial, but the resulting flexibility now is yielding benefits.

Take, for example, Zip Heaters (Aust) Pty. Ltd., Sydney, which makes instant water heaters for hot drinks. Like many other Australian manufacturers, Michael Crouch, chairman of the closely held company, which employs about 200, decided in the mid-1980s to look outside Australia to build his business. Zip now exports to about 20 countries, deriving 65% of its earnings from overseas. Indeed, Mr. Crouch boasts that several world leaders, including British Prime Minister Tony Blair, use Zips; Mr. Blair's office wouldn't comment, citing a standing policy.

Before the Asian crisis, Zip was exporting about 10% of its output to Asia. That figure has been halved, but Zip has shifted its focus to the buoyant British market, where Mr. Crouch says sales have more than offset the Asian slump.

Over the past five years, deregulation has cut his business costs—helping trim 20% off Zip's energy bills, for example. But Mr. Crouch credits Australia's low interest rates—Australian companies can borrow at about 5% to 6%—and its flexible exchange rate as the biggest factors in his company's favor. "I can't emphasize enough how important that has been to Australian manufacturers," he adds.

Mr. OXLEY. I thank the gentleman.

The gentleman from Oklahoma, Mr. Largent.

The gentleman from Illinois, Mr. Shimkus.

The gentleman from New York, Mr. Lazio.

Mr. LAZIO. Just briefly, Mr. Chairman. I want to thank you for the wonderful work you did last year for removing the H.R. 10. This is another significant opportunity for the committee to step forward and to affirm the evolution of the marketplace. I think in many ways that is exactly what H.R. 10 is. We are affirming the evolution of the marketplace. The demand is driving the integration of financial services, and if there is any doubt about that, certainly the Citigroup merger was a reaffirmation of the fact that there is enormous demand for risk products through the insurance affiliates, securities products to fulfill the hunger for the capital needs throughout the world, and banking products which in many ways are defying our ability to define them in pure terms. What is a derivative? What is a mortgage-backed security? It is partly a risk instrument, partly an investment instrument; certainly in many ways a security instrument.

So I want to compliment you, Mr. Chairman, and I want to compliment Chairman Greenspan for his constructive and sustained efforts both in the Banking Committee and Commerce Committee. This has developed into an important partnership and has brought us to where we are on the verge of providing the framework for the 21st century for our American financial services enterprises to thrive throughout the world and to meet the demand in insurance and securities and banking.

Mr. OXLEY. I thank the gentleman.

[Additional statements submitted for the record follow:]

PREPARED STATEMENT OF HON. JOHN SHADEGG, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA

Thank you Mr. Chairman. I am pleased that Federal Reserve Chairman Greenspan is able to join us today to discuss financial services modernization, an issue that has become a perennial topic for this committee.

I am an ardent supporter of financial modernization and believe this legislation is necessary to allow America's banking and financial services to compete in the global market. Financial services legislation is needed to repeal the Depression-era banking laws created in response to a decade of financial loss, the crash of the stock market, and numerous bank closures. These laws, including the Bank Holding Company Act and the Glass-Steagall Act, separated banking and insurance activities, and banking and securities activities, respectively.

It was believed that banks, whose main function is to protect the customer's financial holdings, should not engage in risk-oriented financial services such as securities and insurance. At the time, this separation of activities was expected to prevent future bank failures incorrectly attributed to involvement in securities. In fact, many bank failures during this era were not a direct result of securities activity but rather this mishandling of deposits by the banks themselves. Mr. Glass recognized this and attempted to repeal his own legislation only one year later.

There is now widespread consensus that banks, securities firms, and insurance companies should be afforded the opportunity to consolidate their services to provide customers one-stop shopping for financial products. However, I share Chairman Greenspan's reservations about allowing these services to be provided through an operating subsidiary of a bank holding company.

Although the banking laws of the 1930's may have been misguided in their attempts to rectify the economic crisis that existed, I believe the financial services legislation approved by the this subcommittee should provide consumers protection against any future financial crisis. This can best be achieved through affiliates of a financial holding company. A financial holding company provides multiple financial services to consumers while separating the high risk securities and insurance activities from the federally insured banking activity.

Furthermore, if we are to maintain the current regulatory standards over banking, securities and insurance products, functional regulation must be a key component of financial services legislation. Specifically, the regulation of securities by the Securities and Exchange Commission and the regulation of insurance products by state insurance agencies is vital to providing consumers the most sound financial services available.

Again, I thank Chairman Greenspan for appearing before this subcommittee today and I commend Chairman Bliley and Chairman Oxley for their leadership on this issue. As a new member of the House Commerce Committee, I look forward to addressing H.R. 10, the Financial Services Act of 1999, more closely and creating a reform package that will provide consumers comprehensive and affordable financial services.

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PREPARED STATEMENT OF HON. TOM BARRETT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. Chairman and Democratic Ranking Member Dingell, I appreciate the opportunity to submit opening remarks for today's hearing on H.R. 10, the Financial Modernization Act.

Nearly 70 years has passed since Congress enacted laws governing the financial services industry. Although these laws have served our country well for many years, no one could have envisioned the global and technologically sophisticated financial marketplace that exists today.

The financial services marketplace is evolving at a fast and furious pace, and the complexity of services offered by financial institutions challenges the capacity of the existing regulatory structure to meet market needs while safeguarding consumers.

After many years of debate on this issue, I hope that this Congress will enact a financial modernization bill that will benefit consumers while ensuring that our financial services industry can operate efficiently, competitively and securely in the 21st century.

H.R. 10 is now before this committee. As we move this legislation forward, I hope that the members of this committee will not lose sight of the needs of local communities, especially underserved urban and rural neighborhoods. In our pursuit to modernize the financial services system, we need to make sure it works for all communities.

As we all know, the future of our local communities, and the Community Reinvestment Act (CRA) in particular, has been a key issue in legislative efforts to overhaul our nation's outdated laws governing the financial services industry.

I am very pleased that the House Banking Committee reported out a bill that preserves CRA and expands it to cover the new wholesale financial institutions established in H.R. 10. CRA has proven to be necessary and effective. This law has channeled over $680 billion in reinvestment dollars for home loans, small business development and economic revitalization programs in low-income urban and rural neighborhoods across our country.

I thank Chairman Alan Greenspan for being here today, and I also want to take this opportunity to applaud him for his testimony about the success of CRA before the House Banking Committee in February. To quote Mr. Greenspan, CRA has "very significantly increased the amount of credit that's available in the communities, and if one looks at the detailed statistics, some of the changes have really been quite profound."

I would also be remiss if I did not say that I am appalled by Senator Gramm's attempt to scale back CRA, and limit its impact. The bill that Senator Gramm pushed through the Senate Banking Committee would exempt more than 60% of all banks nationwide, and almost 75% in Wisconsin. I strongly oppose this legislation, and will oppose any bill that weakens CRA.

As this committee meets once again to consider a rewrite of our nation's financial services laws, we have an opportunity to preserve and expand CRA. Although I understand that it will be difficult to push through any changes that would expand CRA-like obligations to insurance companies, securities firms, mortgage firms and other financial companies allowed to affiliate with banks, I still plan to pursue these issues.

These issues are very important to address because H.R. 10 would permit the unprecedented conglomeration of banks, securities firms, and insurance companies. These huge financial conglomerates would be allowed to shift their activities from banks to CRA-exempt affiliates and subsidiaries. Therefore, banks would have fewer resources to make home and small business loans to low- and moderate income communities.

Mr. Chairman and Mr. Dingell, I sent over three proposals to the Democratic staff a few weeks ago that I hope you will consider including in the financial modernization markup vehicle you present to the members of this committee. They seek to ensure that community reinvestment keeps pace with the major structural changes that would occur in the banking and broader financial services industry as a result of H.R. 10.

I would like to submit copies of each of these proposals for the record along with my written testimony. Two of the proposals were offered by Rep. Luis Guiterrez during the House Banking Committee markup of H.R. 10. One concerns a data disclosure requirement for insurance company affiliates of banks, and the other expands CRA to non-bank affiliates that make loans or engage in banking activities.

The third proposal is one that I offered during a Banking Committee markup of H.R. 10 in the 105th Congress. It passed in committee as an amendment to H.R. 10, but was not in the version of H.R. 10 that came up for a floor vote. It would establish an Advisory Council on Community Revitalization that would make recommendations to Congress on how to meet the capital and credit needs of underserved communities in the wake of financial modernization.

I would also like to submit for the record a copy of a proposal that I finished drafting yesterday. It simply calls on the federal financial regulatory agencies to conduct a study to examine the impact that H.R. 10 would have on the Community Reinvestment Act if enacted. If the regulators determine that the law has had an adversarial impact on CRA, they would have the authority to issue regulations addressing the problem. This proposal is not controversial, and makes common sense. As you may know, the Banking Committee approved version of H.R. 10 already includes a provision requiring a study on the impact H.R. 10 would have on small financial institutions.

I hope that every member of this committee will support the preservation of CRA, and will strongly consider the proposals I have submitted for consideration today. They will help ensure that in our effort to update our antiquated banking laws and bring the U.S. financial services system into the 21st century that we do not leave our communities behind.

Mr. OXLEY. We now turn to our sole witness for today, the Honorable Alan Greenspan, the Chairman of the Fed.

Mr. Greenspan, again, welcome back to the committee, and thank you for your good work in this and many other areas.

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

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I would particularly like to thank the committee for the invitation that gives me the opportunity to present the views of the Federal Reserve on the current version of H.R. 10. Last year I testified at length before this committee on many of the issues related to your deliberations on this legislation. In the interest of time, I thought it might be best if I limit my formal comments to the critical issue of whether the important new powers being contemplated are exercised in a financial services holding company through a nonbank affiliate or in a bank through its subsidiary.

Let me be clear. We at the Federal Reserve strongly support the new powers that would be authorized by H.R. 10. We believe that these powers, however, should be financed essentially in the competitive marketplace and not financed by the sovereign credit of the

United States. This requires that the new activities be permitted through holding companies and prohibited through banks. To do otherwise is potentially a step backward to greater Federal subsidization and eventually to more regulation to contain the subsidies. I and my colleagues accordingly are firmly of the view that the long-term stability of U.S. financial markets and the interests of the American taxpayer would be better served by no financial modernization bill rather than one that allows the proposed new activities to be conducted by the bank as proposed by H.R. 10. In that regard, we join Congressman Dingell in his remarks with respect to that issue.

Government guarantees of the banking system provide banks with a lower average cost of capital than would otherwise be the case. The subsidized cost of capital is achieved through lower market risk premiums on both insured and uninsured debt and through lower capital than would be required by the market if there were no government guarantees. The lower cost of funding gives banks a distinct competitive advantage over nonbank financial competitors.

Under H.R. 10, the subsidy that the government provides to banks as a byproduct of the safety net would be directly transferable to their operating subsidiaries to finance powers not currently permissible to the bank or its subsidiaries. We should be clear how the subsidy would link directly to an operating subsidiary. Because of the subsidy, the funds a bank uses to invest the equity of its subs are available to the bank at a lower cost than that of any other potential investor, save the U.S. Government. Thus, operating subsidiaries under H.R. 10 could conduct new securities, merchant banking and other activities with a government subsidized competitive advantage over independent firms that conduct the same activity.

H.R. 10 does not contain provisions that effectively curtail the transfer of the subsidy to operating subsidiaries or address this competitive imbalance. The provisions of H.R. 10 that would require the deduction of such investments from the regulatory capital of the bank, after which the bank must still meet the regulatory definition of “well-capitalized,” attempt but fail to limit the amount of subsidized funds that an individual bank can invest in its subsidiaries. What matters is not regulatory capital, but actual or economic capital. The vast majority of banks now hold significantly more capital than regulatory definitions of “well-capitalized” require. This capital is not “excess” in an economic sense that is somehow available for use outside the bank. It is the actual amount required by the market for the bank to conduct its own activities. Thus, deductions from regulatory capital would in no way inhibit the transfer of the subsidy from the bank to the subsidiary.

Some have argued that the subsidy transference to the subsidiaries of banks is no different from the transfer of subsidized bank dividends through the holding company parent to holding company affiliates. The direct upstreaming of dividends by a bank to its holding company parent that in turn invests the proceeds in subsidiaries of the holding company, while legally permissible, in fact does not occur. The empirical evidence indicates that, on net, at the largest organizations—that is, over $1 billion in assets—there has been no financing of a bank's holding company affiliates with subsidized equity of the associated bank.

The dividend flows from banks to their parent holding companies have been less than the sum of holding company dividends, interest on holding company debt, and the cost of holding company stock buybacks, a substitute for dividends. All of that part of the subsidy reflected in earnings has flowed directly to investors.

That bank dividends are not used to finance holding company subsidiaries should not be surprising. It simply is not in the interest of the consolidated banking organization to increase bank dividend flows beyond parent company capital-servicing needs because the resulting decline in bank capital would increase funding costs of the bank.

Research at the Federal Reserve indicates that over the past quarter century, for the largest banks the cost of uninsured bank funds has tended to rise as a bank's capital ratio fell and vice-versa. This is just what one should expect. As the risk-absorbing equity cushion falls, the risk for uninsured creditors rises. The flow of dividends from the bank to the parent holding company reduces bank capital. That reduction in turn reduces the risk buffer for uninsured creditors, increasing the funding costs of the bank on all the uninsured liabilities by more, the data show, than the small subsidy transference of funding the additional equity investment in the affiliate.

Thus, were a bank holding company to finance its nonbank affiliates from bank dividends, that is, to directly pass on the bank subsidy to the holding company affiliates, the profitability of the consolidated organization would decline. If there were no net costs to the bank from upstreaming dividends to its parent for affiliate funding, it would be the prevalent practice today. It is not. In short, the subsidy appears to have been effectively bottled up in the bank. The Federal Reserve Board believes that this genie would be irreversibly let out of the bottle, however, should the Congress authorize wider financial activities in operating subs. Subsidized equity investments by banks can be made in their own subsidiaries without increasing funding costs on all of the bank's uninsured liabilities because the consolidated capital of the bank would not change in the process. When a bank pays dividends to its parent, the bank shrinks, and its capital declines. When a bank invests in its subsidiary, its capital remains the same.

None of this is relevant today since the activities authorized to bank subsidiaries cannot differ from those available to the bank itself under current law. Hence, there is no additional profit to the overall banking organization in shifting existing bank powers to a subsidiary—the activity would receive the same subsidy in the subsidiary as it now gets in the bank. But H.R. 10 would currently permit activities not now permitted in the bank. Those activities, when performed in bank subsidiaries and financed with subsidized bank equity capital, would increase the potential profit to the overall banking organization. It would also inevitably induce the gravitation to subsidiaries of banks, not only of the new powers authorized by H.R. 10, but all of those powers currently financed in holding company affiliates at higher costs of capital than those available to the banks.

How important is this subsidy? Even today when losses in the financial system and hence the value of the subsidy are quite low, the cost of debt capital to banks still averages 10 to 12 basis points below that of the parent holding companies. That difference in bond ratings today between banks and the holding companies, let alone the larger difference between banks and other financial institutions, is a significant part of the 20 to 30 basis point gross margin on an A-rated or better investment grade business loans, more than enough to significantly change lending behavior if it were not available.

Business loan markets are particularly competitive, and hence there is little leeway for a competitor with higher funding costs to pass on such costs to the borrower. For example, the weakened credit standing of the Japanese banks has engendered a risk premium that these entities have paid and today would have to pay to fund their U.S. affiliates. This has required them to sharply reduce their business loan volume in the United States. Japanese bank branches and agencies in the United States have reduced their share of business loans from over 16 percent of the total U.S. market in 1995 to less than 11 percent today.

In short, the subsidy is a critical competitive issue in competitive markets. Allowing the bank to inject Federal subsidies into the proposed new activities could distort capital markets and the efficient allocation of both financial and real resources. New affiliations, if allowed through banks, would accord them an unfair competitive advantage over comparable nonbank firms. The holding company structure, on the other hand, fosters a level playing field within the financial services industry contributing to a more competitive environment.

Mr. Chairman, in addition to our concern about the extension of the safety net that would accompany the widening of bank activities through operating subsidiaries, the Federal Reserve Board is also sensitive to the implications of operating subsidiaries for the safety and soundness of the parent bank. Most of the new activities contemplated by H.R. 10 would not be accompanied by unusually high risk, but they could imply more risk. Although, to be sure, diversification can reduce that risk, the losses that would accompany riskier activities from time to time would fall on the insured bank's capital if the new activities were authorized in bank subsidiaries. Such losses at holding company affiliates would fall on the uninsured holding company. This is an important distinction for the deposit insurance funds and potentially the American taxpayer. This potential for loss and bank capital depletion is another reason for urging that the new activities be conducted in a holding company affiliate rather than in a banking subsidiary.

H.R. 10 is supposed to virtually eliminate this concern. The Office of the Controller of the Currency has asserted that it would order an operating sub immediately to be sold or declared bankrupt and closed before its cumulative losses exceeded the bank's equity investment in the failing sub. Combined with the provision of H.R. 10 adjusting regulatory capital for investment in subs, this provision is intended to cap the effect on the bank of subsidiary loss to the amount of the bank's original investment. Since that amount would have already been deducted from the bank's regulatory capital, the failure of a subsidiary, it is maintained, could not affect the regulatory capital of the bank.

We had extensive experience with attempts to redefine reality by redefining regulatory capital in the thrift industry in the 1980's. This approach was widely viewed as a major mistake whose echoes we are still dealing with today. Economic, as opposed to regulatory, capital of the bank would not, as I have already noted, be changed by this special regulatory capital accounting, and such deductions from equity capital would not be reflected under GAAP.

Perhaps more to the point, it seems particularly relevant to underline the losses in financial markets—large losses—can occur so quickly that regulators would be unable to close the failing operating sub as contemplated by H.R. 10 before the subsidiary's capital ran out. Indeed, losses might even continue to build, producing negative net worth in the subsidiary. At the time of closure of a subsidiary, there is nothing to prevent the total charges for losses against the parent bank's regulatory capital from exceeding the prior deduction required by H.R. 10. And closure and bankruptcy can and will be tied up in courts during which time the bank's capital and name are at risk. Our experience following the stock market crash of 1987—when a subsidiary of a major bank not only lost more than the bank's investment in its sub, but the bank was unable to dispose of the subsidiary for several years—underscores the seriousness of such concerns.

While contemplating movements in stock prices, let me note that merchant banking is potentially the most risky activity that would be authorized by H.R. 10, and would be especially risky for the insured bank if permitted to be conducted in bank subsidiaries.

Let me close, Mr. Chairman, by noting again that the Board is a strong advocate of financial modernization in order both to eliminate the inefficiencies of the current Great Depression regulatory structure and to create a system more in keeping with the technology and markets of the 21st century. We strongly support the thrust of H.R. 10 to accomplish these objectives. Equally as strongly, however, we also believe that the new activities should be authorized for banks through the holding company structure. That structure, especially for the new activities, also has the significant benefit of promoting effective supervision and the functional regulation of different activities. The holding company structure, along with the so-called "Fed-lite" provisions in H.R. 10, focuses on and enhances the functional regulation of securities firms, insurance companies, insured depository institutions and their affiliates by relying on the expertise and supervisory strengths of different functional regulators.

Thank you very much, Mr. Chairman. I request that my full remarks be included for the record.

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

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

I would like to thank the Committee for the opportunity to present the views of the Federal Reserve on the current version of H.R. 10, the approach to financial modernization most recently approved by the House Banking Committee. Last year, I testified at length before this Committee on many of the issues related to your deliberations on this legislation. Our views have not changed on the need to modernize our banking and financial system, on consolidated supervision, on the emphasis on reduced regulation, on the unitary thrift loophole, and especially on continuing to prohibit banks from conducting through their subsidiaries those activities that they are prohibited to do themselves. In the interest of time, however, I thought it might be best if I limit my formal comments only to the latter, that is, the setting of the underlying structure of American banking in the 21st century. The issue is whether the important new powers being contemplated are exercised in a financial services holding company through a non-bank affiliate or in a bank through its subsidiary. Such a decision would be of minor significance, and decidedly not a concern of legislators and regulators, if banks were not subsidized.

We at the Federal Reserve strongly support the new powers that would be authorized by H.R. 10. We believe that these powers, however, should be financed essentially in the competitive market place, and not financed by the sovereign credit of the United States. This requires that the new activities be permitted through holding companies and prohibited through banks.

*Operating Subsidiaries*

The Board believes that any version of financial modernization legislation that authorizes banks to conduct in their subsidiaries any activity as principal that is prohibited to the bank itself, is potentially a step backward to greater federal subsidization, and eventually to more regulation to contain the subsidies. I and my colleagues, accordingly, are firmly of the view that the long-term stability of U.S. financial markets and the interests of the American taxpayer would be better served by no financial modernization bill rather than one that allows the proposed new activities to be conducted by the bank, as proposed by H.R. 10. For reasons I shall discuss shortly, the Board is not dissuaded from this view by provisions that have been incorporated in H.R. 10 to address our concerns.

*Subsidies.* Government guarantees of the banking system—deposit insurance and direct access to the Fed's discount window and payments system guarantees—provide banks with a lower average cost of capital than would otherwise be the case. This subsidized cost of capital is achieved through lower market risk premiums on both insured and uninsured debt, and through lower capital than would be required by the market if there were no government guarantees. The lower cost of funding gives banks a distinct competitive advantage over nonbank financial competitors, and permits them to take greater risks than they could otherwise.

The safety net subsidy is reflected in lower equity capital ratios at banks, that are consistently below those of a variety of nonbank financial institutions. Importantly, this is true even when we compare bank and nonbank financial institutions with the same credit ratings: banks with the same credit ratings as their nonbank competitors are allowed by the market to have lower capital ratios. While the differences in capital ratios could reflect differences in overall asset quality, there is little to suggest that this factor accounts for more than a small part of the difference.

Under H.R. 10, the subsidy that the government provides to banks as a byproduct of the safety net would be directly transferable to their operating subsidiaries to finance powers not currently permissible to the bank or its subsidiaries. The funds a bank uses to invest in the equity of its subs are available to the bank at a lower cost than that of any other potential investor, save the United States Government, because of the subsidy. Thus, operating subsidiaries under H.R. 10 could conduct new securities, merchant banking, and other activities with a government subsidized competitive advantage over independent firms that conduct the same activity. That is to say, the use of the universal bank structure envisioned in H.R. 10 means the transference of the subsidy to a wider range of financial businesses, producing distortions in the competitive balance between those latter units that receive a subsidy and identical units that do not—whether those units are subs of holding companies or totally independent of banking.

H.R. 10 does not contain provisions that effectively curtail the transfer of the subsidy to operating subsidiaries or address this competitive imbalance. The provisions of H.R. 10 that would require the deduction of such investments from the *regulatory* capital of the bank (after which the bank must still meet the *regulatory* definition of well-capitalized) attempt, but fail, to limit the amount of subsidized funds that an individual bank can invest in its subs. What matters is not *regulatory* capital, but actual or *economic* capital. The vast majority of banks now hold significantly more capital than regulatory definitions of "well-capitalized" require. This capital is not "excess" in an economic sense that is somehow available for use outside the bank; it is the actual amount required by the market for the bank to conduct its own activities. The actual capital maintained by a bank is established in order to earn the perceived maximum risk-adjusted rate of return on equity. Unless this optimum economic capital is equal to, or less than, regulatory capital, deductions from regulatory capital would in no way inhibit the transfer of the subsidy from the bank to the subsidiary.

Some have argued that the subsidy transference to subsidiaries of banks is no different from the transfer of subsidized bank dividends through the holding company parent to holding company affiliates. The direct upstreaming of dividends by a bank to its holding company parent that in turn invests the proceeds in subsidiaries of the holding company, while legally permissible, in fact does not occur—and for good reasons, as I will explain below. In the 1990's, dividend flows from banks to their parent holding companies have been less than the sum of holding company dividends, interest on holding company debt, and the cost of holding company stock buy backs, a substitute for dividends. Thus, the empirical evidence indicates that, on net, at the largest organizations there has been no financing of a bank's holding company affiliates with subsidized equity of the associated banks. All of that part of the subsidy reflected in earnings has flowed to investors. (There are a few large individual institutions that have, in some years, upstreamed dividends in excess of investor payments, but the cumulative amounts are very small and the conclusions are unchanged.)

That bank dividends are not used to finance holding company subsidiaries should not be surprising. It simply is not in the interest of the *consolidated* banking organization to increase bank dividend flows beyond parent company capital-servicing cash flow needs because the resultant decline in bank capital would increase funding costs of the bank. Research at the Federal Reserve indicates that, over the past quarter of a century, for the largest banks the cost of uninsured bank funds has tended to rise as a bank's capital ratio fell and vice-versa. This is just what one should expect: As the risk-absorbing equity cushion falls, the risk for uninsured creditors rises. The flow of dividends from the bank to the parent holding company reduces bank capital. That reduction, in turn, reduces the risk buffer for uninsured creditors, increasing the funding cost of the bank on *all* the uninsured liabilities by more—the data show—than the small subsidy transference of funding the *additional* equity investment in the affiliate.

Thus, were a bank holding company to finance its nonbank affiliates from bank dividends—that is, to directly pass on the bank's subsidy to the holding company's affiliates—the profitability of the consolidated organization would decline. If there were no net costs to the bank from upstreaming dividends to its parent for affiliate funding, it would be the prevalent practice today. In short, the subsidy appears to have been effectively bottled up in the bank. The Federal Reserve Board believes that this genie would be irreversibly let out of the bottle, however, should the Congress authorize wider financial activities in operating subs. Subsidized equity investments by banks can be made in their own subsidiaries without increasing funding costs on all of the bank's uninsured liabilities because the consolidated capital of the bank would not change in the process. But since the activities authorized to banks' subsidiaries cannot differ from those available to the bank itself, there is no additional profit to the overall banking organization in shifting bank powers to a subsidiary.

But H.R. 10 would permit activities not now permitted in a bank. Those activities, when performed in bank subsidiaries and financed with bank equity capital would increase the potential profit to the overall banking organization. It would also inevitably induce the gravitation to subsidiaries of banks, not only of the new powers authorized by H.R. 10, but all of those powers currently financed in holding company affiliates at higher costs of capital than those available to the bank. H.R. 10 thus effectively authorizes all holding company powers to be funded in the bank at funding costs significantly lower than the funding costs of its holding company.

For the 35 of the 50 largest bank holding companies for which comparisons are available, ratings on debentures are *always* somewhat higher at the bank than at the holding company parent and, of course, higher ratings translate into lower interest rates. As might be expected, the data show that the value of these differences in bond ratings is higher during periods of market stress, when subsidies are more valuable, because the market is more risk sensitive. But even today, when losses in the financial system are quite low, the cost of debt capital to banks still averages 10 to 12 basis points below that of the parent holding companies. That difference in bond ratings today between banks and bank holding companies, let alone the larger difference between banks and other financial institutions, is a significant part of the 20 to 30 basis point *gross* margin on A-rated or better investment grade business loans—more than enough significantly to change lending behavior if it were not available.

Business loan markets are particularly competitive, and hence there is little leeway for a competitor with higher funding costs to pass on such costs to the borrower. For example, the weakened credit standing of the Japanese banks has engendered a risk premium that these entities have paid—and today would have to pay—to fund their U.S. affiliates; this has required them to sharply reduce their business loan volume in the United States. Japanese bank branches and agencies in the United States have reduced their share of business loans from over 16 percent of the market in 1995 to less than 11 percent today.

In short, the subsidy is a critical competitive issue in competitive markets. Allowing the bank to inject federal subsidies into the proposed new activities could distort capital markets and the efficient allocation of both financial and real resources. New affiliations, if allowed through banks, would accord them an unfair competitive advantage over comparable nonbank firms. The holding company structure, on the other hand, fosters a level playing field within the financial services industry, contributing to a more competitive environment.

*Safety and Soundness.* In addition to our concern about the extension of the safety net that would accompany the widening of bank activities through operating subsidiaries, the Federal Reserve Board is also sensitive to the implications of operating subsidiaries for the safety and soundness of the parent *bank.* Most of the new activities contemplated by H.R. 10 would not be accompanied by unusually high risk, but they could imply more risk. The Board believes these activities add the potential for new profitable opportunities for banking organizations, but it is almost always the case that the more potentially profitable the activity, the riskier it is. Although, to be sure, diversification can reduce that risk, the losses that would accompany riskier activities from time to time would fall on the insured bank's capital if the new activities were authorized in bank subsidiaries. Such losses at holding company affiliates would, of course, fall on the uninsured holding company. This is an important distinction for the deposit insurance funds and potentially the taxpayer. This potential for loss and bank capital depletion is another reason for urging that the new activities be conducted in a holding company affiliate rather than in a banking subsidiary.

H.R. 10 is supposed to virtually eliminate this concern. As I earlier noted, the bank's equity investment in the bank subsidiary under H.R. 10 would be deducted from the bank's *regulatory* capital, with the requirement that the remaining regulatory capital still meet the well-capitalized standard. At the same time, the OCC has asserted that it would order an operating sub immediately to be sold or declared bankrupt and closed before its cumulative losses exceeded the bank's equity investment in the failing sub. Combined with the provision of H.R. 10 adjusting regulatory capital for investment in subs, this provision is intended to cap the effect on the bank of subsidiary losses to the amount of the bank's original investment. Since that amount would have already been deducted from the bank's regulatory capital, the failure of the subsidiary, it is maintained, could not affect the *regulatory* capital of the bank.

The Board is concerned that this regulatory accounting approach, that does not address the actual capital of a bank, could provide a false sense of security. We had extensive experience with attempts to redefine reality by redefining regulatory capital in the thrift industry in the 1980's. This approach was widely viewed as a major mistake whose echoes we are still dealing with today. Regulatory capital at the time soon began to mean nothing to the market, and, as a consequence, Congress in FDICIA ordered the banking agencies to follow Generally Accepted Accounting Principles (GAAP) whenever possible. In the current context, there is—as in the 1980's—no reason to believe the new regulatory definitions will change the reality of the market place. *Economic,* as opposed to *regulatory,* capital of the bank would not, as I have noted, be changed by this special regulatory capital accounting and such deductions from equity capital would not be reflected under GAAP. It is the economically more relevant GAAP statements to which uninsured creditors of *banks* look when deciding to deal with a *bank,* and they will continue to do so after financial modernization. Bank creditors will, in any event, continue to view the investment in the bank subsidiary as part of the capital protecting their position—for the simple reason that it does. If they see the economic and GAAP capital at the bank declining as operating sub losses occur, they will react as any prudential creditor should—regardless of artificial regulatory accounting adjustments or regulatory measures of capital adequacy.

Perhaps more to the point, it seems to me particularly relevant to underline that losses in financial markets—large losses—can occur so quickly that regulators would be unable to close the failing operating sub as contemplated by H.R. 10 before the subsidiaries capital ran out. Indeed, losses might even continue to build, producing negative net worth in the subsidiary. At the time of closure of a subsidiary, there is nothing to prevent the total charges for losses against the parent bank's regulatory capital from exceeding the prior deduction required by H.R. 10.[1] Our experience following the stock market crash of 1987—when a subsidiary of a major bank not only lost more than the bank's investment in its sub, but the bank was unable to dispose of the subsidiary for several years—underscores the seriousness of such concerns.

H.R. 10 would exclude from permissible bank subsidiaries only insurance underwriting and real estate development. One of the permissible activities is merchant banking, which does not have a long or significant 20th century history in this country. Merchant banking currently means the negotiated private purchase of equity investments by financial institutions, with the objective of selling these positions at the end of some interval, usually measured in years Merchant banking has become so important an element of full service investment banking in this country, so much so that to prohibit bank-related investment banks from participating in these activities would put them at a competitive disadvantage. The Board has consequently supported merchant banking as an activity of a holding company subsidiary, but believes it is potentially the most risky activity that would be authorized by H.R. 10, and would be especially risky if permitted to be conducted in bank subsidiaries.

Existing law permits some limited exceptions to the otherwise prohibited outright ownership of equity by banks and their subsidiaries, but these are quite limited both in the aggregate and in the kinds of businesses in which equity can be purchased, as well as in the scale of each investment. True merchant banking, as envisioned by H.R. 10, would place no such limits—either per firm or in total. The potential rewards for such equity investments are substantial, but such potential gains are the mirror image of the potential for substantial loss. In addition, poor equity performance generally occurs during periods of weak nationwide economic performance, the same intervals over which bank loan portfolios are usually under pressure, raising concerns about the compounding of bank problems during such periods.

*Functional Regulation*

The holding company structure—especially for the new activities—also has the significant benefit of promoting effective supervision and the functional regulation of different activities. The holding company structure, along with the so-called "Fed-lite" provisions in H.R. 10, focuses on and enhances the functional regulation of securities firms, insurance companies, insured depository institutions and their affiliates by relying on the expertise and supervisory strengths of different functional regulators, reducing the potential burdensome overlap of regulation, and providing for increased coordination and reduced potential for conflict among functional regulators.

*Executive Branch Prerogatives*

There is a final point I want to make since it appears to have driven Treasury's recent opposition to financial modernization legislation that has not adopted the universal bank model. It is not necessary to adopt the universal bank model in order to preserve the executive branch's supervisory authority for national banks or federal savings associations; nor is it necessary in order to preserve the share of this nation's banking assets controlled by national banks and federal savings associations. In fact, the share of assets controlled by national banks is predominant and growing, in part the result of the enactment of interstate branching authorities, an initiative the Federal Reserve fully supported. As shown in the tables in the appendix to my statement, national bank assets have increased in each of the last three years while state bank assets have declined over the past two years. As of year-end 1998, 58.5 percent of all banking assets were under the supervision of the Comptroller of the Currency, up from a little over 55 percent at the end of 1996. As the second table clearly suggests, the largest banks, especially those with large branching systems, tend to be national banks, providing a distinct advantage to national banks in an environment of interstate branching.

Furthermore, Congress for sound public policy reasons has purposefully apportioned responsibility for this nation's financial institutions among the elected executive branch and independent regulatory agencies. Action to alter these responsibilities would be contrary to the deliberate steps that Congress has taken to ensure a proper balance in the regulation of this nation's dual banking system.

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[1] Moreover, should creditors of the subsidiary choose to attempt to recover their funds from the bank parent, the removal of the loss charged against the bank's capital could occur only when a court has affirmed both the bankruptcy and the rejection of the claims on the bank made by the subsidiary's creditors. This process could and would take some time, during which, even if the court eventually found for the bank and/or the regulator, further losses by the subsidiary could continue to impinge on the bank's capital. And, again, the point is that the bank would have been at risk during that interval.

*Summing Up*

The Board is a strong advocate of financial modernization in order both to eliminate the inefficiencies of the current Great Depression regulatory structure and to create a system more in keeping with the technology and markets of the 21st century. We strongly support the thrust of H.R. 10 to accomplish these objectives. Equally as strongly, however, we also believe that the new activities should not be authorized for banks through operating subsidiaries. We believe that the holding company structure is the most appropriate and effective one for limiting transfer of the Federal subsidy to new activities and fostering a level playing field both for financial firms affiliated with banks and independent firms. It will also, in our judgement, foster the protection of the safety and soundness of our insured banking system and the taxpayers, enhance functional regulation, and achieve all of the benefits of financial modernization for the consumer and the financial services industry.

Table 1—Net Change in Commercial Bank Assets from De Novos, Mergers, and Charter Conversions

Assets ($ Billions)
1995-1998

| | 1995 | 1996 | 1997 | 1998 | 12/31/94-12/31/98 |
|---|---|---|---|---|---|
| **National Banks** | | | | | |
| Additions From: | | | | | |
| De Novo Banks | 4.5 | 6.8 | 7.6 | 5.3 | 24.2 |
| Mergers with Other Charter Types | 22.0 | 86.4 | 119.6 | 41.3 | 269.3 |
| Charter Conversions | 20.6 | 52.5 | 60.4 | 15.8 | 149.3 |
| Total Additions | 47.1 | 145.7 | 187.6 | 62.4 | 442.8 |
| Deletions From: | | | | | |
| Failures | 0.0 | 0.1 | 0.0 | 0.0 | 0.1 |
| Mergers with Other Charter Types | 16.2 | 136.5 | 8.2 | 20.6 | 181.5 |
| Charter Conversions | 49.7 | 6.0 | 9.2 | 17.3 | 82.2 |
| Total Deletions | 65.9 | 142.6 | 17.4 | 37.9 | 263.8 |
| Net Increase in National Bank Assets from De Novos, Mergers, and Charter Conversions | (18.8) | 3.1 | 170.2 | 24.5 | 179.0 |
| **State Banks** | | | | | |
| Additions From: | | | | | |
| De Novo Banks | 11.1 | 3.5 | 2.4 | 2.9 | 19.9 |
| Mergers with National Banks | 16.2 | 136.5 | 8.2 | 20.6 | 181.5 |
| Charter Conversions | 47.9 | 8.2 | 14.7 | 22.0 | 92.8 |
| Total Additions | 75.2 | 148.2 | 25.3 | 45.5 | 294.2 |
| Deletions From: | | | | | |
| Failures | 0.7 | 0.0 | 0.0 | 0.0 | 0.7 |
| Mergers with National Banks | 22.0 | 86.4 | 119.6 | 41.3 | 269.3 |
| Charter Conversions | 18.9 | 52.4 | 47.0 | 13.6 | 131.9 |
| Total Deletions | 41.6 | 138.8 | 166.6 | 54.9 | 401.9 |
| Net Increase in State Bank Assets from De Novos, Mergers, and Charter Conversions | 33.6 | 9.4 | (141.3) | (9.4) | (107.7) |

Table 2—Percent Distribution

Various Indicators of Relative Size By Charter Class of Commercial Bank
[As of December 31, 1998]

| Indicator | Charter Class | | |
|---|---|---|---|
| | National (OCC) | State Member (FR) | State Non-member (FDIC) |
| **Top 25 By Size** | | | |
| Consolidated Assets | 71.7 | 26.9 | 1.4 |
| Domestic Deposits | 80.5 | 17.1 | 2.4 |
| Offices in U.S. | 88.9 | 7.4 | 3.7 |
| **Top 50 By Size** | | | |
| Consolidated Assets | 69.1 | 29.0 | 1.9 |
| Domestic Deposits | 75.2 | 21.9 | 2.9 |
| Offices in U.S. | 82.2 | 13.7 | 4.1 |

Table 2—Percent Distribution—Continued

Various Indicators of Relative Size By Charter Class of Commercial Bank

[As of December 31, 1998]

| Indicator | Charter Class | | |
|---|---|---|---|
| | National (OCC) | State Member (FR) | State Non-member (FDIC) |
| **All** | | | |
| Consolidated Assets | 58.5 | 24.1 | 17.4 |
| Domestic Deposits | 57.4 | 19.5 | 23.1 |
| Offices in U.S. | 57.3 | 16.6 | 26.1 |
| **Number of Banks Operating Full-service Facilities in:** | | | |
| 2 states | 53 | 15 | 35 |
| 3 states | 8 | 8 | 6 |
| 4 states | 4 | 2 | 1 |
| 5 states | 3 | 0 | 0 |
| More than 5 states | 11 | 1 | 1 |

Mr. OXLEY. Without objection, so ordered. We thank you for your testimony, Mr. Chairman, and the Chair will begin the questioning, even though it appears that we have both the red and the green light on.

As you know, the Banking Committee made some changes in the operating subsidiary language from the bill that passed the House last session. It is my understanding that the product that came out of the Banking Committee preserved in the operating subsidiary the securities underwriting and merchant banking segments and indeed eliminated insurance underwriting from within the op sub. Your view on their efforts is what? Is that a good start toward removing the operating subsidiary language totally? What is your opinion of what the Banking Committee did?

Mr. GREENSPAN. Mr. Chairman, I think that having both securities and merchant banking in operating subsidiaries as the structure is envisaged in H.R. 10 creates a very serious problem for the structure of American banking as we enter the 21st century. A number of people have looked at this question of the operating sub versus affiliate issue either as a matter of turf between the Treasury and ourselves or strictly as a marginal question of an option that a banking organization should be allowed to make judgments on for business reasons. It is not a turf issue, it is a fundamental issue with respect to how the United States wishes to restructure its regulatory apparatus, given the extraordinary changes that are now currently under way in the technology of finance which is going to have a very dominant effect on how financial services are created and delivered to consumers and to business.

If there were no subsidy involved in this issue, Congress, indeed no one, should question the freedom of individual business organizations to make business judgments as to where they put particular organizations. This is not a choice. If given the opportunity, any sensible banker confronted with a lower cost of capital in an operating subsidiary than in a nonsubsidized organization would not consider that a choice. There is only one possibility. You put it in the sub of the bank. And that, in my judgment, will create significant corrosion to what has been a superb financial system that has developed in this country.

Mr. OXLEY. You stated in your testimony that you felt that the subsidy amounted to about a 10 to 12 basis points advantage. Was that based on a study that the Fed conducted? And if you could perhaps give us a little better detail as to how that study was conducted.

Mr. GREENSPAN. Mr. Chairman, why don't I include for the record—what we did is we really tabulated for 35 bank holding companies the credit rating given to the debentures of the holding company and the credit rating given to the major bank of that holding company. What we found is that in no cases did the bank holding company have as good a rating as the bank, and in some cases the difference was more than just marginal. But I will include those data for the record.

[The information referred to follows:]

As part of our ongoing research into the size of the safety-net subsidy, the attached tables summarize work by Federal Reserve staff to measure the difference in borrowing costs between the lead bank in large banking organizations and the holding company parent. Since 1990, the interest rate on long-term debt issued by the lead bank has averaged about 10 basis points less than the interest rate on comparable debt issued by the bank holding company; on an annual basis, this funding cost advantage for the bank has ranged from about 8 to 9 basis points in recent years up to 14 basis points in 1990 and 1991.

The calculation of this difference in borrowing costs is done in two steps. The first step compares Moody's rating on long-term debt issued by the lead bank and by the parent holding company for all of the top 50 banking organizations that have ratings on comparable debt for both entities. This comparison can be done for 35 of the top 50 organizations. As shown in table 1, the bank debt carries a higher rating than the holding company debt in every case. The difference averages about 1¼ rating "notches", where one notch represents the difference between, for example, debt rated A1 and A2. The second step translates the 1¼ notch difference into the implied borrowing cost advantage for the lead banks. We do this using annual Moody's indexes of interest rates on bonds at various ratings within the investment-grade range. Table 2 displays this borrowing cost advantage in each year since 1990.

The notes to tables 1 and 2 provide further information about the calculations.

Table 1

Debt Ratings of Top 50 Bank Holding Companies and Their Lead Banks

(Number of institutions in each category)

| Rating of Lead Bank Relative to Holding Company | Number of Institutions |
|---|---|
| Higher | 35 |
| One notch | 27 |
| Two notches | 8 |
| Same | 0 |
| Lower | 0 |
| Not available | 15 |

Notes: This table compares the debt rating of each of the top 50 U.S. bank holding companies with the debt rating of its lead bank, based on data from Moody's Investors Service, **Banking Statistical Supplement, United States,** August 1998. Whenever possible, we compare the ratings of long-term senior debt issued by the bank and the holding company; if such ratings are not available, we compare the ratings of long-term subordinated debt issued by both entities. This comparison could not be done for 15 of the top 50 banking organizations because the holding company and the lead bank did not have ratings on comparable debt. For all of the other 35 banking organizations, the bank's debt was rated more highly than the debt of its holding company parent. For 27 of these organizations, the bank's debt was rated one "notch" above the holding company's, while for eight organizations, it was rated two notches above the holding company's. One notch represents the finest gradation in Moody's rating scale; for example, one notch separate debt rated A1 and A2, while two notches separate debt rated A1 and A3. On average, the lead bank was rated 1¼ notches above its holding company parent.

Table 2

Funding Cost Advantage for Lead Banks Relative to Bank Holding Companies

| Year | Funding Cost Advantage (in basis points) |
|---|---|
| 1990 | 14.3 |
| 1991 | 13.9 |
| 1992 | 11.5 |
| 1993 | 9.8 |
| 1994 | 9.0 |
| 1995 | 8.2 |
| 1996 | 9.4 |
| 1997 | 8.2 |
| 1998 | 9.4 |

Notes: This table values the average 1¼ notch rating advantage for the lead bank relative to its holding company parent. The figures in this table result from multiplying 1¼ notches by the average difference in interest rates per rating notch, evaluated annually. This difference was calculated from Moody's indexes of interest rates for bonds rated Baa, A, Aa, and Aaa. Each of these broad rating categories (except for Aaa) contains three notches. Thus, a mid-level Baa rating is three notches below a mid-level A rating, which is itself three notches below a mid-level Aa rating. We assume that a mid-level Aa rating is three notches below the Aaa rating, even though there are no explicit gradations within the Aaa category. Because the Moody's interest rates for adjacent rating categories reflect difference of three notches, we divided the interest-rate spread between Baa-rated and A-rated bonds by three to obtain the difference per notch, and did the same to calculate the per-notch interest rate spread between the A and Aa ratings and the Aa and Aaa ratings. We then averaged the resulting per-notch interest-rate spreads to generate the funding cost advantage shown in the table for each year.

Mr. OXLEY. Without objection, that will be made part of the record and we appreciate that. Let me just end with one question. As my memory serves me, throughout the 1980's, the Treasury consistently opposed expanded powers for operating subs. What, in your estimation, is the reason that Treasury may have changed or I should say has obviously changed their minds in that regard?

Mr. GREENSPAN. Well, that is factually correct. Indeed, having been involved in many endeavors jointly with Treasury to create a financial modernization bill, we never differed on that question. So that Treasury in a certain sense had been even more strongly against operating subs than we.

I don't wish to make judgments as to why this Treasury has come to the position that it has. That is a question, I think, most appropriately put to the Secretary of the Treasury when you have him up here. I don't want to try to characterize his answer because he can do it better than I.

Mr. OXLEY. Thank you, Mr. Chairman. The gentleman from New York, Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman. The Treasury has criticized Japan for having extensive subsidies and conflicts of interest in their financial system and has encouraged the Japanese to adopt a holding company structure for their banking system. Why isn't this good advice for the United States?

Mr. GREENSPAN. Well, again, Congressman, I think that ought to be directed to the Secretary of the Treasury.

Mr. TOWNS. But I just want to draw from all of this knowledge that you have and I don't want to pass up this opportunity.

Mr. GREENSPAN. Well, having heard me for the last 20 minutes or so, I don't want to bore you with repeating a lot of what I have said previously, sir.

Mr. TOWNS. Moving on, then, let me ask you this. Is it really possible that an operating subsidiary could lose more than the capital of the parent bank before regulators could close the operating subsidiary?

Mr. GREENSPAN. No, it wouldn't lose more capital than the parent bank. That would be a Herculean task. But it surely could lose more than the capital of the subsidiary itself, meaning more than the capital that the parent bank would invest in the sub. And I think that is the crucial issue. That is, there is a presumption that it is easy to insulate the parent bank from losses in the sub. Our experience specifically in the case which I indicated in 1987, and in a lot of other related issues, is that is wishful thinking. When we are in a financial crisis, depository institutions, whether they are subs or anything else, have relatively low capital. They are highly leveraged institutions. And you can run through that capital in a rapidly changing market faster than a hot knife goes through butter, and the notion that we regulators have the capacity to fend that off I think is misplaced.

Mr. TOWNS. Could you explain the wholesale financial institution provision, how it works?

Mr. GREENSPAN. There has been, as I am sure you are aware, Congressman, a fairly major expansion in wholesale banking and a demand for a lot of sophisticated services that occurs as a consequence of the really quite dramatic change in technology that has occurred over the years. So there is essentially some form of increased demand for an institution which would be a wholesale bank. It will be regulated and has the characteristics under H.R. 10 of a regular commercial bank with the sole exception that it is not insured by the FDIC and cannot accept deposits below $100,000. So it is essentially a wholesale institution which is essentially a bank.

Mr. TOWNS. Thank you. In the last Congress, this committee reported legislation that included provisions allowing the SEC to be a holding company, regulatory, or a broker that owned a relatively small bank. Do you have any objection to this provision?

Mr. GREENSPAN. None whatsoever. Indeed, as I recall, we testified I think exactly in that regard to this committee a year ago. In any event, should a large securities firm purchase a small bank, the presumption that somehow the Bank Holding Company Act should be applicable in the sense that it currently is envisaged sort of makes no sense. I mean, our view basically is that the oversight of the financial services holding company in that type of situation almost surely should be the securities firm, not the bank.

Mr. TOWNS. Thank you very much Mr. Chairman.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Ohio, Mr. Gillmor.

Mr. GILLMOR. Thank you very much, Mr. Chairman. I would like to pursue, Mr. Chairman, a couple of questions on the concept of "too big to fail" as it functions as a practical matter. The bigger the institution, it gets special treatment, and I think it basically amounts to a subsidy by smaller and medium institutions. To what extent in looking at mergers do you consider that, if at all?

Mr. GREENSPAN. Congressman, you are raising one of the really more difficult supervisory problems that we at Federal Reserve have.

We are acutely aware that almost by definition a merger creates larger institutions and should the larger institution fail at some point, it clearly could have significant contagion effects in the financial system and those systemic concerns obviously are crucial to us.

The answer is yes, we do look at the issues and we try to envisage how, should that institution run into difficulty, we would create a responsible liquidation, one that would not undercut the safety and soundness of the overall system. It is a very difficult issue.

The presumption, however, that we will just automatically bail out large institutions is false. Were we actually to make that an issue of policy, I think we would find that the efficiency of the American banking system, which is really quite impressive, would deteriorate. Our issues face not on the question of how to keep the organization in place, but how you create a degree of structured liquidation so that the pieces are taken apart in a manner which does not create difficulties for the rest of the system.

In any event, we don't look at it as an issue of too big to fail. We look at it as an issue of very difficult to liquidate. If the markets presumed that we really did have a too big to fail policy in this country, the ratings on bank debentures, even though they are higher than bank holding company debentures, are nowhere near the rating you would give to a U.S. Treasury issue or an organization essentially guaranteed directly or indirectly by the U.S. Government. There is still a pretty big gap there which implies, fortunately, that the markets realize that an institution cannot be too big to fail.

But the question you raise makes it more difficult for us and we have spent a considerable amount of additional time looking at those larger institutions in the context of the type of principle that I just enunciated.

Mr. GILLMOR. One of the things that I have been working on has been an amendment which would require that that be one of the factors that would be considered. And I am just wondering if you would have—I would like to get that language to you when we get it finalized but I am wondering if you would have any strenuous objection to that concept since, as you indicate, you are already looking at that to a degree.

Mr. GREENSPAN. Congressman, I really don't think that it is legislatively necessary. We have all the legislative powers that are required to implement that particular issue. And as far as I can judge, not only the Federal Reserve but all of the other supervisory organizations, both banking and otherwise, are acutely aware of the issue that you raise, and it is hard for me to imagine that that is not an issue that is continuously on the table.

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

Mr. GILLMOR. Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman from Michigan, Mr. Dingell.

Mr. DINGELL. Mr. Chairman. I thank you. I have here before me something that I am very interested in because it tells me that the Japanese have chosen the route of holding companies rather than operating subs. Is that because the banks in Japan are very weak and the Japanese found that not only the banking system but the financial system is weak and they are choosing the stronger of the two courses which would give them a better chance of a strong system and a better chance to an earlier recovery?

Mr. GREENSPAN. I would say yes to both questions, yes.

Mr. DINGELL. Mr. Chairman, I ask unanimous consent that this be inserted in the record at the appropriate place.

Mr. OXLEY. Without objection.

[The information referred to follows:]

[Tuesday, April 27,1999—The Wall Street Journal]

DAIWA SECURITIES BECOMES HOLDING FIRM

By Jathon Sapsford, Staff Reporter of The Wall Street Journal

TOKYO—Daiwa Securities Co. Monday became the first globally recognized Japanese corporation to restructure under a holding-company format, reviving a business custom once banned by U.S. occupiers after World War II.

It is a strategy the world will be hearing more of from Japan. Businesses in nearly every industry—banking, telecommunications, technology and manufacturing—have said they are looking at remaking themselves as holding companies and then turning their divisions into subsidiaries as a way of cutting costs.

Daiwa is the first big company to take the plunge. "I believe that the conventional [Japanese] style . . . is not sufficient for meeting future challenges," said Daiwa President Yoshinari Hara, in a full-page add in Japan's newspapers on Monday. "This is why we have chosen the holding company structure."

Daiwa's move, on the surface at least, will turn it into the Japanese equivalent of a U.S. holding company. Daiwa said It will change its name to Daiwa Securities Group Inc. and that this will be the entity its current stakeholders own. It will split its divisions off into a series of 10 subsidiaries owned by the holding company. Those subsidiaries will pay dividends to the parent, which in turn will pay dividends to shareholders.

The goal for Japanese companies considering holding-company transformations is to reduce bureaucracy and increase flexibility. Through the holding company, corporations could "exit" businesses that aren't making a profit by selling them off or folding them into a joint venture with another company that is stronger, in the given area. That is proving difficult for many big companies to do under the current structure, according to Japanese business officials.

A holding-company structure would allow corporations to pay some staff more than others, thus rewarding initiative and performance—a practice that runs counter to Japan's egalitarian pay structure. The goal is to dismantle a system under which employees are paid on the basis of their seniority, regardless of how much they contribute to the company's bottom line. By splitting divisions into separate companies, Daiwa, for example, could pay retail-stock salesmen a salary commensurate with the limited skills required to sit at a branch counter and sell shares.

Meantime, it could pay more to staff in its investment-banking division, which demands more experience and responsibility. "The key difference is that you can pay people different amounts," said Garry Evans, a strategist at HSBC Securities Japan Ltd.

Holding companies were at the center of this country's *zaibatsu*, the conglomerates of the pre-World War II era. The U.S. banned them during the Allied occupation of Japan for fueling the Japanese war effort. The individual units spun off at that time grew into huge empires with broad lines of businesses under the same roof.

Now, companies ranging from big banks such as Sanwa Bank Ltd. and Fuji Bank Ltd. to manufacturer's like Nissan Motor Corp. and telecommunications company Nippon Telegraph & Telephone Co. have expressed interest in the holding-company format.

Tax issues, however, remain a big hurdle. Transferring assets from a parent company to a subsidiary is a process subject to a "gift tax" under Japanese law. That can be expensive for banks, which would have to pay as much as half the value of the loan assets on their books. The government is studying a change in the tax code to make such transfers easier. Daiwa said part of its transfer taxes will be offset by its retained earnings.

Mr. DINGELL. Mr. Chairman, now I note here some years back NationsBank to its mostly elderly bank customers was selling risky funds with an understanding on the part of the buyers that their money was protected by the Federal Government. NationsBank peddled these securities in conjunction with an operating subsidiary, Nation's Securities. Now, question: By expanding the capabilities of operating subs, does H.R. 10 open the door for future, more varied fraudulent practices by banks and their subsidiaries?

Mr. GREENSPAN. Well, I certainly think that the issue is one that we have to be concerned about. It is very important that we put a Chinese wall or other safeguard, however we wish to describe it, between securities activities and banking activities and very especially not in any way indicate that the safety net which is under banking activities as authorized by the Congress not be somehow suggested as available to people buying securities. And I suspect that the greater the distance you have between the bank and the organization selling securities, the less that problem is likely to emerge. I should say that it is one of the more difficult issues that banking supervisors have confronted in recent years and I suspect that were we to authorize the structure of the operating sub, as indicated in H.R. 10, it would make our job more difficult.

Mr. DINGELL. Thank you. Now, Mr. Greenspan, you have referred to the possibility that H.R. 10 could galvanize a holding company to shift capital to a bank as opposed to a separate holding company affiliate in order to take advantage of the Federal subsidy. I note, however, the Department of Treasury reports empirical evidence which they indicate does not necessarily support this prediction. Parenthetically I will say I am on your side but I want to get your comments.

Treasury cites mortgage banking. Of the top 20 holding companies, six currently conduct mortgage banking activities in an affiliate, nine conduct such activities in the bank or a subsidiary of the bank, and five use a combination of bank and affiliate. What does this tell you? How do you explain this if you please?

Mr. GREENSPAN. We are aware of the criticism and we have looked at it in some detail and we don't agree with their factual analysis for a number of reasons. First, it is certainly true that there are a lot of activities that legally could be exercised within the bank and are actually exercised in an affiliate of the holding company. There are a number of reasons. In many cases in earlier years they were geographical, there were tax reasons. But the most interesting issue is that there has been a substantial move of powers currently authorized in the bank but having been exercised in holding company affiliates which have been moved to the bank. With respect to a number of these types of activities, if the capital required is very low, then the advantage of putting an activity in the bank where the cost of capital is less may not matter. And then if there is no capital, meaning there is no subsidy, then there is no reason why one would necessarily put it in either an affiliate of the holding company or in the bank itself.

With respect to those mortgage companies that are in both areas, I think you will find that in innumerable cases, especially in the very large cases, that although the activity starts within the holding company, it is essentially funded with moneys from the bank at subsidized rates. I would conclude that looking at the whole set of powers and how they proceed, as we went to interstate branching and as we changed a number of the tax laws and as we changed regulation, many of the reasons which induced banking organizations to keep powers in affiliates of holding companies, even though they were legally available to the bank have changed, and there is a dramatic and unquestioned flow of those powers under current law from bank holding company affiliates into the bank. What is left out there are essentially those types of activities for which capital is not important, agency type of activities, for example, and therefore the lower cost of the capital of the bank doesn't help very much, or very idiosyncratic questions with respect to tax, with respect to special factors within the organization. Those are rare and diminishing.

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

Mr. DINGELL. Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman from Oklahoma, Mr. Largent.

Mr. LARGENT. Chairman Greenspan, I would like to ask you one question and that is to ask you to take us into the boardroom of a bank and explore the motive, rationale, incentive for a bank to choose an operating subsidy format or a holding company format beyond the points that you brought out in your testimony about having a competitive advantage through the taxpayer subsidy. What are the incentives for banks to choose operating subsidies versus a holding company format?

Mr. GREENSPAN. The major advantage is basically the cost of capital. I have been associated with banking as a consultant and as a director for very many years and the conventional wisdom was always when you have a power, new or otherwise, try to exercise it in that part of the organization where the cost of capital is least. Since most banking products have very narrow profit margins, it really matters when you lower the cost of capital by a very few basis points. So while there may be, in particular cases again, idiosyncratic characteristics of a special type of organization or power that may suggest that other things equal, you may organize it as an affiliate or as a sub of the bank, the cost of capital overwhelms all of those other characteristics because you can organize a subsidiary of a bank almost identically in every respect the way you organize an affiliate of the holding company. The presumption that somehow the holding company affiliate is more costly to organize than the subsidiary of a bank I have seen no evidence for. It may be, but I have never seen something which is of significance in this regard.

Mr. LARGENT. Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Florida, Mr. Deutsch.

Mr. DEUTSCH. Thank you, Mr. Chairman. Mr. Greenspan, through the testimony, through the questions, you have given, I think, a pretty good overview. If you could take maybe a minute, especially as I assume we are either on C-SPAN or MS-NBC, to discuss from a layman's perspective the difference between what the Banking Committee bill passed and what you are proposing? What do you see as the effect for the average consumer?

Mr. GREENSPAN. Take the difference between, for example, H.R. 10 as passed by the Banking Committee and the bill that came through this House last year. Well, there are really two ways of looking at it, and it is difficult to put various probabilities on it, but most of the provisions in both bills improve the movement of services to the average consumer. Most of the differences occur in ways which are far more reaching to the economy as a whole and affect consumers because they affect the economy, affect their jobs, affect basically the standard of living of the whole economic system. To the extent that you have subsidized misdirected capital, you are creating a less efficient flow of capital and therefore a less efficient economic system, jobs which are more difficult to get and jobs which pay less. To the extent that you have an issue of safety and soundness which can create real serious problems in the financial system, such as what happened to the savings and loans during the 1980's, then again consumers are really quite potentially impacted.

I would not endeavor to say that the individual provisions of either the current H.R. 10 or last year's House Commerce print differ significantly with respect to the direct transmission of services, delivery of services to consumers, but they have profoundly important differences for broader issues which affect consumers as workers and protect them with respect to their retirement funds and their future.

Mr. DEUTSCH. If I can try to get through three other questions relatively quickly as well. One of the things which I have learned over the last couple of months talking to people who have an interest from an industry perspective on H.R. 10 is effectively under the present regulatory structure, my sense is that you, in fact banks, at a sophisticated level through large consumers in fact are already effectively engaged in equity trading through swaps of a variety of kinds. So effectively it is already going on at a relatively sophisticated level, but is that an accurate assessment of what is going on today?

Mr. GREENSPAN. I think we have to distinguish between the so-called section 20 affiliates of the holding companies which actually, of course, do operate in the securities business in competition with nonbanking organizations. They do not have access to the subsidy of the bank and they operate on a competitive playing field. Some of them, I might add, argue that they are more regulated than securities firms and they feel in a sense that they are operating at a disadvantage. There is, to be sure, equity within the bank in many different areas but it is highly restricted by regulation. That is, we have regulations which very significantly delimit what equity holdings can occur as a consequence of, for example, a failure of a loan to repay and the collateral tends to be equity, for example. There is a lot of that which goes on. But it is very significantly contained in a manner which does not create the types of problems which I try to outline in some detail in my prepared remarks.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Illinois, Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman. And, Mr. Chairman, it is good to have you here. I want to focus my question on the local community bankers who are state chartered, small in size, locally owned, may or may not be in competition with a credit union. I am describing the ones in my district. Community oriented, fulfilling a niche of local services and in today's environment providing needed capital for farmers in this agricultural crisis.

They have all—I voted for the bill. I support especially our version that came out in the last Congress. But they have all been pretty adamantly opposed to it. One question is should they have been, based on your perspective? Should they have been opposed to the bill that passed the House? And second, what can we do with a similar bill that passed the House, what can we do to make the bill better for local community bankers?

Mr. GREENSPAN. Well, it is certainly the case that there is much in H.R. 10 and, indeed, in last year's House Commerce print, which effectively is directed at the organization of the larger institutions. And in the case of the House Commerce Committee's print, an endeavor to try to create a regulatory structure which will contain the types of instabilities which I think are currently involved and implicit in H.R. 10. Essentially, the smaller banks have a very significant interest in the safety and soundness of the Federal deposit insurance fund. And from the issue of the extent to which operating subs can create difficulties for deposit insurance and the taxpayers clearly, the smaller banks which have a very substantial interest in the deposit insurance fund are directly affected.

Second, there is also a very important interest of smaller banks in the overall safety and soundness of the banking system because they are major players in the whole structure. There are not as many provisions which directly affect them as for the larger institutions, but they are not bystanders with marginal interest. The safety and soundness of the overall system cannot but be a very critical issue to smaller banks whether we are talking about agricultural banks or talking about other community banks. Everybody is very crucially tied to the total financial system and that that functions effectively has got to be in their interest.

Mr. SHIMKUS. And, Mr. Chairman, what can we do to the bill if it was similar to the print of last year, to make it better for the community bankers? Do you see anything that can be changed?

Mr. GREENSPAN. I would say that the bill that came out of this committee last year was fairly good. There is the obvious question here of the unitary thrift, which as far as I am concerned and as far as we have testified previously, both before the House and before this committee previously, the unitary thrift issue, which is an opening up, in my judgment, of banking and commerce, which could be a serious issue and which creates a good deal of concern for community bankers was closed in the House Commerce print. It is not fully closed potentially here.

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

Mr. SHIMKUS. Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman from Michigan, Mr. Stupak.

Mr. STUPAK. Thank you, Mr. Chairman. And welcome, Mr. Greenspan. I would like to ask you about the operating subsidies. If the U.S. adopts the operating subsidy model for banks, is it likely then that other countries would follow this subsidy model?

Mr. GREENSPAN. I am afraid they already do. One of the things which distinguishes the American banking system from much of the rest of the world is that there is far greater direct and indirect subsidization of banks abroad than here. And I think as a consequence of that, the quality of banking abroad has been demonstrably inferior, less competitive, less effective in delivering services to consumers than the American banking system. I think they are becoming aware of that fact. I trust that they recognize that less direct government implied subsidization or indirect, as is more often the case, would be helpful to the effective competitive capability of their banking systems.

Mr. STUPAK. If we got involved and if the United States started to do subsidies, do you believe that other countries would increase their subsidies to their banks to try to stay competitive with the U.S. banks?

Mr. GREENSPAN. That is a good question. I doubt it, but I wouldn't be able to rule it out. They do an awful lot now. They do it more indirectly in the sense that a lot of them have universal banks and, in fact all of the powers are in the bank, you don't even need an operating sub. And the general notion of too big to fail, which does create problems in the United States, is a far more relevant issue in other countries. And indeed, undoubtedly a goodly part of the reason why we have had a lot of problems with the banks in the Asian crisis is because there was an implicit government guarantee and as a consequence of that, there was an awful lot of lending into those institutions on the expectation that the central bank of the smaller countries would bail them out. At the end of the day, even though the central banks tried, they didn't have the resources to do it.

Mr. STUPAK. And of course we all know the impact on the global financial markets when that occurred.

Mr. GREENSPAN. Exactly.

Mr. STUPAK. In small communities which a subsidy of the op sub received from the banking magnify their competitive advantage over other entities like brokers, and is it possible that independent brokers in small markets such as in my area would be disadvantaged by the bank subsidy?

Mr. GREENSPAN. They are and it depends on how much capital they require. In other words, if you have a very small brokerage firm which does not require a great deal of capital, meaning you essentially are giving more advice and not involved in securities trading in any particular way, it is conceivable to me that the amount of capital required would not be large and that an exactly comparable activity within a small bank might not be all that more competitive than the small brokerage because the amount of capital is less. But the principle is the same, and to the extent that you get into larger and larger securities operations, then the question of subsidized capital really makes a difference.

Mr. STUPAK. Okay. How would you respond to the comments that you support the holding company structure because the Federal Reserve is its regulator?

Mr. GREENSPAN. I am aware of that and the basic issue is that clearly we are the regulator of holding companies. That if the op sub becomes active as premised in H.R. 10, and as all of the activities move to the sub—I might just say parenthetically, if that weren't the case that the argument that they are making that it doesn't happen makes no sense to me—the argument is that the powers will move to the sub, that the holding company will become a shell, that the Federal Reserve will lose all of its power, and that therefore that is the reason why we are concerned. Truly we are concerned about the breakdown of the holding company. It would make it more difficult for us to supervise. But that is not the reason why we are arguing for this particular issue. Because if we were truly concerned about Federal Reserve turf, we would have never been before the Congress very strongly advocating the bill which created significant interstate branch banking in this country, which we were strongly supportive of before the Congress, even though we knew it would significantly enhance the quality of the national bank franchise charter compared with the state charter, which is what we obviously are dealing with and supervise. It was good for the country, it was good for the financial system. It was good for banking. We strongly supported it, even though it essentially reduced the turf of the Federal Reserve.

We don't think that that particular view of why we are very much concerned about the operating subs' impact on the financial system and the country squares with our actions in recent years.

Mr. OXLEY. The gentleman's time has expired. The gentlewoman from New Mexico.

Mrs. WILSON. Thank you, Mr. Chairman. Chairman Greenspan, my district also has some of these large national banks and huge chains now, but we also have the smaller community banks and as I understand it, under the proposal that came out—not the proposal that came out of the Banking Committee but the separate subsidiary kind of approach, that a community bank in order to sell title insurance would require the formation of a holding company and another subsidiary. And I wonder whether you think that that is favorable to large institutions. Is this a barrier? Is this a kind of barrier to competition for those smaller banks. And if you were on the board of one of those small banks how would you recommend that they address this challenge of not being part of a holding company?

Mr. GREENSPAN. Legally, they can be done in either—I mean, let me just say up front, the crucial issue of title insurance is that it requires very little capital to operate. Whether you do it in the bank or in an affiliate of the holding company frankly doesn't really much matter. And I am not sure that there is any competitive advantage one way or the other. Indeed, any type of agency activity in which there is very little capital involved probably can be effectively initiated in the sub of the bank or an affiliate of the holding company and frankly it would have very little economic significance.

I mean, our concern is relevant to the types of activities for which there is a large amount of capital required. Then it matters. Most of the activities which smaller banks are involved in usually don't fall into that category and as far as I am concerned, this question of the operating sub versus the affiliate is really a larger bank question.

Mrs. WILSON. So it is your understanding that under either of the draft bills that those small community banks could write title insurance and would not have to——

Mr. GREENSPAN. That is my understanding, but let me just check with my counsel before they tell me I have created a major legal mistake. Well, I just learned for the first time ever I have been told that my general counsel is not quite sure about title insurance. But let me say, I am sure about the economics of it.

Mrs. WILSON. I know it is of concern to some of my community bankers and perhaps we might connect and sort that out on their behalf. I appreciate that.

Mr. GREENSPAN. Why don't we get back to you and give you in writing what we know about this issue. But just let me say in summary, none of the issues that I raised about subsidies apply to any type of activity in which the capital requirement is de minimis or not a crucial competitive question.

Mrs. WILSON. Thank you.

Mr. OXLEY. The gentlewoman's time has expired. The counsel informs me that the next hearing will include several issues on insurance and I would invite the gentlewoman's participation at that point.

We now recognize the gentleman from Massachusetts.

Mr. MARKEY. Thank you. Welcome, Mr. Chairman. I would like to focus on the issue of what happens to consumers' most personal information, their financial records or their health and insurance information, when banks and brokerage firms and insurance companies all merge with one another under H.R. 10. I am greatly concerned, as you know, about this issue.

I have been reviewing the financial privacy provisions of H.R. 10, which appear in the bill, the medical and health privacy provisions and the preexisting language. In my view these provisions provide consumers with little or no real privacy protection. For example, Mr. Chairman, the financial privacy language covers only banks and thrifts, not broker-dealers, not investment companies, not investment advisors, and not insurance companies. Wouldn't you agree that financial privacy legislation should also cover Wall Street investment firms, mutual funds, financial planners and other investment advisors as well?

Mr. GREENSPAN. Congressman, I think you are raising one of the questions that is going to become increasingly difficult for the whole regulatory structure because I think there are two basic conflicting issues here which are implicit in the issue that you are concerned about.

I am conflicted on this question, and I guess that I represent probably what most people in the business world have problems with as a libertarian, as I am very sensitive to the issue of privacy, and I think that one of the things that is so important about this government, about this country is that we try to protect the individual, his rights, and the privacy question in ways that are not in any way handled in most other countries. There are very few countries in this world who handle this issue in a way which I personally feel comfortable with.

Mr. MARKEY. Well, I support wholeheartedly the libertarian side of your personality, and I could just end the answer right there.

Mr. GREENSPAN. But there is another side where the conflict occurs, and that is the general awareness of how important in the future the question of information is going to be with respect to the production of goods and services.

Mr. MARKEY. And I appreciate that, Mr. Chairman, very much. But the point that I am trying to make here is that the bill itself only covers a very small part of the universe. It only covers banks and thrifts. It doesn't cover anything else. So if you merely—and even in that language, it merely requires that the bank tell the customer what its privacy policy is with respect to the disclosure of customer information to third parties other than agents of the depository institution, and it only applies to transfers for marketing purposes as opposed to any other business purpose. So as I read the language, so long as the banker tells its customers that its privacy policy is that the customers essentially have no privacy, then they would be in compliance with the narrowly drawn provision. Is that your understanding as well?

Mr. GREENSPAN. Well, I haven't read the bill in detail and don't feel competent to really come to grips with this issue. I do agree with you in your concerns. It may well be that if I ever got into the language and got into a big debate, I probably would be maybe more on your side than I am now stating. But I am aware of the fact that there is another side to this issue.

Mr. MARKEY. And I appreciate that other side. The other side is so well represented here that your articulate representation of it is superfluous. Our views on the other side I think will help to balance out the debate.

Mr. GREENSPAN. Let me just say, Congressman, that this is not a small issue. It is an issue which is very important: It brings to bear really two fundamental aspects of this country. One, our very strong striving to bring information technology to the forefront, to allow information to be critical in the production of goods and services, which is one of the reasons why we are doing so well, but on the other hand there is this issue, and it did not exist before.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Illinois.

Mr. MARKEY. Congratulations, Mr. Chairman. Can we have a second round, Mr. Chairman?

Mr. OXLEY. No.

Mr. GREENSPAN. I will be glad to answer you in private.

Mr. MARKEY. I have a whole series of questions. I would appreciate it.

Mr. RUSH. Chairman Greenspan, you have stated pretty clearly your opposition to the op sub model. This is in contrast with the administration's adamant support of this. I mean, and I know that reasonable people can disagree, do you have any idea about why the administration is as adamant in their support of the op sub model as you are in opposition to it?

Mr. GREENSPAN. I think I do, but since you are going to have the Secretary of the Treasury up here, he is very capable of expressing in considerable detail his reasons, and I don't think I should endeavor to characterize them.

Mr. RUSH. In that case, do you think that there is any possibility of the op sub model existing with the necessary safeguards to protect safety and soundness?

Mr. GREENSPAN. I have stated that if you have an institution which by its nature is something which creates serious difficulties for the financial system and whose benefits are very difficult to find, meaning the benefits that are alleged for op subs can very readily be put into holding company affiliates, as best I can judge, I find it very difficult to find reasons to go forward. So the presumption of doing it and then trying to find a mechanism which prevents it from happening strikes me as sort of the direction we ought to try not to go.

Mr. RUSH. Now, Chairman Greenspan, H.R. 10 provides for a GAO study within 6 months upon passage of the bill. Do you think that 6 months is an adequate enough time to really ascertain the financial impact of the bill, of the op sub model? Do you think that that is sufficient or should it be a longer period of study?

Mr. GREENSPAN. I think there is, as I understand it, and I think I remember now there is a 6-month requirement to examine the regulatory burden, but I think that is a broader issue involved.

The answer to your question is we should be able to do it in 6 months.

Mr. RUSH. Should be able to do it in 6 months?

Mr. GREENSPAN. Well, to examine the burden that as I remember, I may be mistaken on this, Congressman, but my recollection is that what is required in H.R. 10 probably can be fulfilled in the timeframe. But as I say, I may be mistaken.

Mr. RUSH. It seems to me that the economic impact of H.R. 10, there is a 6-month period that the GAO is supposed to report the economic impact.

Ms. WASHINGTON. It is section 110 of the bill, Congressman.

Mr. GREENSPAN. The economic impact on very small banks.

Mr. RUSH. On small and community banks. Right.

Mr. GREENSPAN. Six months should be an adequate amount of time.

Mr. RUSH. Should be an adequate amount of time?

Mr. GREENSPAN. If may be that when we get into it and somebody says that is a mistake, but you put a deadline on, something happens, things get done. Maybe that is not a bad idea.

Mr. RUSH. Okay. Thank you.

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

Chairman Greenspan as always, we appreciate your patience and your excellent testimony, and the subcommittee now stands adjourned.

[Whereupon, at 11:51 a.m., the subcommittee was adjourned.]

# THE FINANCIAL SERVICES ACT OF 1999

## WEDNESDAY, MAY 5, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10:07 a.m., in room 2123, Rayburn House Office Building, Hon. Michael G. Oxley (chairman) presiding.

Members present: Representatives Oxley, Tauzin, Gillmor, Bilbray, Ganske, Shimkus, Wilson, Fossella, Ehrlich, Bliley (ex officio), Towns, Deutsch, Stupak, Engel, DeGette, Barrett, Luther, Capps, Markey, Hall, Rush, and Dingell (ex officio).

Also present: Representative Whitfield.

Staff present: David Cavicke, majority counsel; Robert Gordon, majority counsel; Linda Dallas Rich, majority counsel; Brian McCullough, professional staff; Robert Simison, legislative clerk; Consuela Washington, minority counsel; and Bruce Gwinn, minority professional staff.

Mr. OXLEY. The subcommittee will come to order. I am pleased to convene the second hearing on H.R. 10, the Financial Services Act of 1999.

At our last hearing, we enjoyed the considerable expertise of Federal Reserve Board Chairman Alan Greenspan who educated us about the potential hazards of legislation that would expand bank powers to operating subsidiaries rather than affiliates.

Chairman Greenspan is always compelling, but at that hearing he made several observations that bear repeating. He noted that he, as well as his colleagues on the Board of Governors of the Federal Reserve, believe that the long-term stability of U.S. Financial markets and the interests of the American taxpayer would be better served by no financial modernization bill rather than one that allows the proposed new activities to be conducted by the bank in an operating subsidiary as would be the case under H.R. 10 as reported by the House Banking Committee.

Chairman Greenspan pointed out that the operating subsidiary structure poses a risk to the safety and soundness of our Nation's banking system. It also creates a competitive imbalance that would subvert the free-market principles that are the foundation for the success of our capital markets.

I share the Chairman's concerns about these potential hazards. I am also troubled by the lack of functional or consistent regulation that would be created by H.R. 10.

It is imperative that this legislation ensure that no matter where an investor buys his stock, he can be assured of the protection of the Federal securities laws. Just as important is the need to treat businesses that are engaged in the same activity in the same way. It makes no sense to exempt banks from the regulatory requirements to which securities and insurance firms are subject if they are going to be engaging in the very same business as those securities and insurance firms.

Today we are fortunate to have before us the Secretary of the Treasury, the Honorable Robert Rubin. I look forward to learning more about his views on the issues today, and I understand they differ somewhat from our previous witness, Chairman Greenspan.

We also will be hearing testimony today from the Chairman of the Securities and Exchange Commission, the Honorable Arthur Levitt. Chairman Levitt has been an outspoken defender of investors and a champion of functional regulation. Chairman Levitt has also supported the committee's position in the last Congress to avoid the dangers to both safety and soundness and efficient functional regulation that would be posed by the expansion of bank powers through an operating subsidiary.

Joining Chairman Levitt will be the distinguished Commissioner of Insurance for the State of Kentucky, George Nichols, who has testified before this committee in the past. I look forward to Commissioner Nichols' views on the importance of functional regulation of insurance activities as well as the numerous other significant issues raised by this bill for both consumers and providers of insurance.

Our third panel today will provide us with the perspective of industry participants—securities firms, banks, insurance underwriters, and insurance agents. It will help us better understand the implications of the legislation before us to folks who actually compete in the marketplace.

We will open our hearing today with testimony from two of our distinguished colleagues from the Banking Committee: The Honorable Richard Baker from Louisiana, the chairman of the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises and the Honorable Marge Roukema, chairman of the Subcommittee on Finance Institutions and Consumer Credit.

I thank each of our witnesses for joining us today, and I look forward to learning from each you as my colleagues, both Republican and Democrat, work to forge a compromise that will be necessary to create a strong bill to promote fair competition, protect investors and consumers, protect our nation's taxpayers and the safety and soundness of our financial marketplace, preserve our Nation's position as the leader in the rapidly developing global financial market.

That ends the Chair's opening statement.

I now turn to the ranking member, the gentleman from New York, Mr. Towns.

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

Let me begin first by welcoming my colleagues, Congressman Baker and, of course, Congresswoman Marge Roukema.

The subcommittee holds the second hearing on H.R. 10, the Financial Services Act of 1999. As I indicated last week, Congress has been working on this legislation for a long, long time. I think it is time that we get this bill done. We have a number of distinguished witnesses today.

I would like to first welcome Treasury Secretary Robert Rubin. I appreciate Secretary Rubin's commitment to the Community Reinvestment Act, and I look forward to hearing his views today. Like Secretary Rubin, we should oppose efforts to roll back protection of CRA.

I would also like to welcome Insurance Commissioner Nicholas and SEC Chairman Levitt. Protecting consumers is an important part of any financial service bill. We will consider your views very, very carefully.

This committee has historically supported functional regulation, which is the idea that the same product is regulated by the same rules regardless of who is selling the product. This seems to me to be common sense. We cannot want a system in which industries shop around for the friendliest regulator.

I would also like to welcome the representatives from the industry, which are on the financial panel. Glass-Steagell has been a barrier to competition for much too long. The benefits of increased competition will accrue, and then it will make our financial firms stronger internationally. We recognize that you need the legislation and look forward to hearing your views.

In the last Congress, this committee took the lead on financial service legislation. We took legislation that had little support; and working together, we made changes that enabled the legislation to pass the House for the first time in 65 years.

In the coming weeks, we will craft a substitute to H.R. 10. I look forward to working with Chairman Bliley, and I look forward to working with the chairman of the subcommittee, Congressman Oxley, and, of course, Mr. Dingell, who is the ranking member of the full committee to make certain that we have legislation that, when we finish at the end of the day, we will all be proud of.

Thank you very much, Mr. Chairman, I yield back.

Mr. OXLEY. The gentleman yields back.

The Chair now recognizes the gentleman from Richmond, the chairman of the full Commerce Committee, Mr. Bliley.

Chairman BLILEY. Thank you, Mr. Chairman.

I too want to welcome our two colleagues, the gentleman from Louisiana and the lady from New Jersey. And I know it will disappoint you, but I put my statement in the record.

[The prepared statement of Hon. Tom Bliley follows:]

PREPARED STATEMENT OF HON. TOM BLILEY, CHAIRMAN, COMMITTEE ON COMMERCE

Today the Subcommittee on Finance and Hazardous Materials holds its second hearing on H.R. 10, the Financial Services Act of 1999. This legislation is important to the future of the securities, insurance, and banking industries. Removing statutory and regulatory barriers to competition will improve the efficiency for financial service providers. The efficiency will translate to greater services and lower costs for consumers and providers. But only if it is done right.

I have been committed to deregulatory legislation for other industries provided that the legislation does not bestow competitive advantages to one market segment over another. It is not the government's role to choose winners and losers through the legislative process, nor is it the role of regulators. Unfortunately, this has been the case in the financial services industry.

In large part this has been the case to date. Banks enjoy a lower cost of capital than non-banks through deposit insurance, access to the discount window, and access to the Federal Reserve payment system. This would not be a competitive advantage if banks were confined to competing with one another and not with securities and insurance firms, as stipulated in the Glass Steagall Act. However, in the past two decades, banking regulators have interpreted the statutes in a manner to allow banks to begin competing with securities and insurance firms.

The very activities that banks were originally supposed to be prohibited from conducting are now offered through affiliates, and in some cases directly through the banks. This erodes the salutary effect of fair competition. Securities and insurance inns are still unable to own a bank, and do not share the funding advantages of banks. As a result, banks are acquiring securities firms at an alarming rate and reducing the competition that we seek to increase.

While I am in favor of providing the corporate community flexibility to choose the structure that optimizes their strategic plans, I do not favor legislating a structure, such as the operating subsidiary, that provides competitive advantages for banks over their independent competitors. Additionally, there remain serious policy concerns about the consequences to the taxpayers of permitting new, risky activities in the subsidiary of a bank. I remain unconvinced of the need to gamble with an untested model that has proved disastrous in other economies. I have received additional analysis on the question of operating subsidiaries from Federal Reserve Chairman Greenspan, and I ask unanimous consent to include this analysis in the record.

In this regard, I share the concerns expressed by Chairman Greenspan at our hearing last week. I look forward to the testimony of our witnesses today, including Secretary Rubin, and learning more about this most important issue.

Another issue of concern to this Committee is the provision of consistent regulation for financial products, regardless of where the financial activity is conducted. In this regard, I look forward to the comments of Chairman Levitt and Commissioner Nichols. I am also grateful to the witnesses on the fourth panel who will present industry views to financial services modernization.

I would also like to welcome our guests on the first panel today, our colleagues from the Banking Committee: the Gentleman from Louisiana and Chairman of the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, Richard Baker, and the Gentlelady from New Jersey and Chairwoman of the Subcommittee on Financial Institutions and Consumer Credit, Marge Roukema.

Mr. Chairman, I commend you, for holding this hearing and I look forward to working with you to improve this legislation.

# Federal Reserve Response to the Treasury Department's Questions and Answers Concerning Operating Subsidiaries and Affiliates

**May 4, 1999**

***Question*** ***Page***

**1. <u>What's the difference between a subsidiary and an affiliate of a bank?</u>**

**Operating subsidiaries are direct subsidiaries of a bank. Accordingly, any losses (or gains) of an operating subsidiary directly impact the net worth, financial condition and profits of the parent bank. Losses of an operating subsidiary must be immediately and fully reflected in the consolidated financial statements of the parent bank under generally accepted accounting principles (GAAP).**

**Holding company affiliates are <u>not</u> subsidiaries of a bank, but instead are subsidiaries of an uninsured holding company. Accordingly, any losses incurred by an affiliate do <u>not</u> directly impact the financial condition of an affiliated FDIC-insured bank. Instead, the losses are borne by the uninsured parent holding company and reflected in the uninsured holding company's consolidated financial statements. This difference is critical and demonstrates why the holding company structure better protects the safety and soundness of insured banks and the federal deposit insurance funds.**

**2. <u>What's the Treasury's position on allowing subsidiaries to engage in financial activities</u>?**

**The Treasury Department would permit operating subsidiaries of national banks to engage as principal in activities that Congress has long forbidden national banks to conduct directly. For example, Treasury would allow operating subsidiaries to underwrite and deal in all types of equity and debt securities and to engage in merchant banking activities. Since the major business of merchant banks is to make equity investments in other firms, operating subsidiaries of national banks could acquire interests in, including full ownership of, commercial firms under Treasury's proposal.**

**Although the Treasury initially proposed to permit operating subsidiaries of national banks to underwrite all types of insurance (including property and casualty insurance), the Treasury recently conceded that operating subsidiaries could be prohibited from**

engaging in these activities. In addition, the Treasury has consistently stated that operating subsidiaries should not be authorized to engage in real estate investment and development activities, presumably in recognition of the substantial losses that these activities have already caused taxpayers in previous thrift and banking crises and the great risks involved with these activities generally.

### 3. Would the risks of activities conducted in a subsidiary adversely affect the safety and soundness of the parent bank?

Yes. Any losses incurred by an operating subsidiary have a negative economic impact on the parent bank. When an operating subsidiary loses money, the value of the bank's investment in the subsidiary is reduced, just as losses on loans reduce the value of the bank's assets. This economic impact is immediately and fully reflected—as lower earnings and lower capital at the parent bank—in the consolidated financial statements of the parent bank under GAAP. In fact, an operating subsidiary's losses could significantly exceed the bank's investment in the subsidiary and all of these losses must be reflected in the parent bank's consolidated financial statements under GAAP.

The numerous counterparties that enter into financial transactions with, or provide funding to, a bank on a daily basis (e.g. derivative, repurchase, foreign currency, and inter-bank lending counterparties) evaluate the bank's capital, earnings and GAAP financial statements when determining whether to engage in transactions with the bank and at what price. As a result, losses at an operating subsidiary can have a significant impact on the parent bank's liquidity and cost of funds.

Because of these connections, a parent bank has a strong incentive to provide financial support to a troubled subsidiary. These incentives explain why banks may provide extensive financial support to a troubled subsidiary even though the bank is under no legal obligation to do so, and even where the amount of assistance exceeds

**the value of the bank's investment in the subsidiary.[1] Even if a parent bank does not provide financial support to a troubled operating subsidiary, the public and a bank's financial counterparties and debtholders could lose confidence in the parent bank because of publicity concerning the subsidiary's difficulties.**

**The Treasury Department contends that these risks can be adequately mitigated through a variety of prophylactic measures. The Treasury Department also asserts that, with these safeguards, a parent bank would face no greater risks from an operating subsidiary than from a holding company affiliate. The Treasury Department's proposed safeguards, however, do not adequately address the risks inherent in the operating subsidiary structure, nor are they equivalent to the protections afforded banks by the holding company structure.**

*** <u>Sections 23A and 23B</u>. The Treasury proposal would <u>not</u> apply section 23A to transactions between a bank and its operating subsidiaries to the full extent that section applies to transactions between a bank and its holding company affiliates—even though the bank's potential for loss from activities conducted by an affiliate is less than for activities conducted in a subsidiary.**

- **In particular, Treasury would *exempt* a bank's equity investment in an operating subsidiary from the limits contained in section 23A.[2] Accordingly, a national bank could invest substantially more of its subsidized funds in, and have a substantially greater equity exposure to, a subsidiary than to an**

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**1 For example, Continental Bank had more than $500 million in unsecured credit outstanding to its First Options subsidiary after the October 1987 market crash even though Continental Bank originally paid only $125 million for the subsidiary and the bank's extensions of credit violated a funding firewall established by the OCC. Ultimately, Continental Bank lost more than $280 million on its First Options subsidiary—significantly more than the bank's initial investment of $125 million.**

**2 Under section 23A, an insured bank's <u>total</u> equity and debt investment in, and loans and extensions of credit to, any single affiliate cannot exceed 10 percent of the bank's capital and surplus, and such transactions with all affiliates cannot exceed 20 percent of the bank's capital and surplus.**

**affiliation.**

- **Furthermore, although Treasury would apply section 23A to *lending* transactions between a bank and its operating subsidiaries, supervisory experience with bank subsidiaries has shown that such firewalls are subject to manipulation or breach, especially in times of financial stress. In 1986, the Comptroller imposed a funding firewall between Continental Illinois National Bank and its newly acquired options clearing subsidiary -- First Options. When First Options experienced severe financial difficulties following the October market crash, however, Continental Bank breached the firewall by providing the subsidiary with a total of more than $500 million in unsecured credit, even though the Comptroller's office informed the bank that these transactions would violate the firewall.**

*** Capital Deduction. Instead of relying on section 23A's established limit on a bank's equity investment in an affiliate, Treasury would merely require that a national bank deduct its equity investment in an operating subsidiary from the bank's regulatory capital and total assets. According to Treasury, this capital deduction would protect the bank because, even if the subsidiary failed, the bank would remain well capitalized for regulatory capital purposes.**

- **Such a regulatory accounting device, however, would not fully protect a bank from losses at a subsidiary. As noted above, GAAP requires that all losses incurred by a subsidiary be fully reflected in the financial statements of the parent bank -- even if those losses exceed the bank's investment in the subsidiary. In today's rapidly evolving financial markets, a subsidiary could lose multiples of its capital within hours, and *all* of that loss would fall on the parent bank's capital. Because a bank's counterparties and creditors rely primarily on the bank's GAAP statements, these losses at an operating subsidiary could quickly reduce the bank's ability to raise funds, increase its cost of funds, and cause a loss of public confidence in the parent bank. These consequences could occur even though the bank remained "well**

**capitalized" for purposes of Treasury's *regulatory* accounting standard.**

**Treasury acknowledges these risks, but claims that the damage to the parent bank's financial condition could be remediated by selling or liquidating the troubled subsidiary and, thereby, removing the subsidiary from the bank's consolidated financial statements. Such an action would simply achieve an objective — separation of the subsidiary's losses from the parent bank's reported earnings and capital – that would be assured in all cases through the holding company structure. Moreover, even under Treasury's scenario, the parent bank would continue to suffer the economic and reputational damage arising from the subsidiary's losses until the troubled subsidiary was sold or liquidated. Supervisory experience proves that liquidating or selling a troubled company is not an easy task, and any such "resolution" could take an extended period of time. For example, Continental Bank was unable to dispose of its First Options subsidiary for several *years* after the bank initially decided to sell the subsidiary.**

- **Another fundamental flaw in Treasury's "capital deduction" proposal is that it relies on the incorrect and potentially dangerous precedent that all capital held by a bank above an arbitrarily defined regulatory minimum is "excess" capital that can be disposed of without consequence. What matters in the real world is not *regulatory* capital, but actual or *economic* capital. The vast majority of banks today hold significantly more capital than necessary to meet the regulatory definition of "well capitalized." This is because the market believes such a higher level of capital is necessary to support the bank's operations. The amount above the regulatory "well capitalized" threshold, therefore, is not "excess" capital in an economic sense that is somehow freely available to support the activities of an operating subsidiary.**

- **The Congress and the American public also should be wary of regulatory accounting artifices, such as the one proposed by Treasury, that seek to shield a bank from the true economic impact of events. The use of similar regulatory accounting devices in the 1980s was ignored by the market and succeeded only in delaying regulatory closures and increasing the eventual costs of the savings and loan bailout. In light of this experience, Congress wisely mandated in 1991 that regulatory accounting principles shall be "uniform and consistent with generally accepted accounting principles." See 12 U.S.C. § 1831n(a).**

*** Proposed Equity Investment Limitation Would *Not* Protect the Parent Bank. The Treasury contends that, under its safeguards, there would be no economic difference between the ability of a bank to make an equity investment in an operating subsidiary or pay a dividend to its holding company (which could be used to capitalize an affiliate). This allegedly would be so because the bank would be permitted to invest in a subsidiary only the amount it could legally pay as a dividend.**

- **The payment of a dividend and an equity investment in a subsidiary, however, have different economic consequences for a bank. A national bank is not subject to future losses that might arise from a holding company's investment of a bank dividend in a nonbank subsidiary -- any such losses would fall on the holding company parent. A bank's equity investment in a subsidiary, however, is subject to depletion by losses at the subsidiary. These losses reduce the value of the bank's investment in its subsidiary and must be consolidated into the bank's financial statements prepared under GAAP. Thus, an equity investment in an operating subsidiary creates continuous loss exposure for the national bank, while payment of a dividend does not.**

**4. How would allowing new financial activities in subsidiaries affect the federal deposit insurance funds?**

The Treasury correctly points out that operating subsidiaries provide their parent bank with potential for diversification and profit. In addition, if a failing bank owns a healthy operating subsidiary, the FDIC could sell the operating subsidiary to reduce the costs associated with closing the parent bank.

The operating subsidiary approach, however, also creates the potential for loss and that loss -- like any profit --- accrues to the parent bank. Moreover, a troubled operating subsidiary also may *cause* or complicate the failure of its parent bank, thereby increasing any losses incurred by the deposit insurance funds. These risks were clearly illustrated during the thrift crisis of the 1980s, when the operating subsidiaries of thrifts contributed significantly to the billions of dollars of losses absorbed by the federal deposit insurance funds and American taxpayers

**5. Insofar as a bank may receive a federal subsidy through deposit insurance and the payment system, could the bank transfer the subsidy more readily to a subsidiary than to an affiliate?**

Yes. Insured banks enjoy a federal subsidy because of the existence of the federal safety net, which refers to FDIC deposit insurance and access to the Federal Reserve's discount window and payment system. Because of their access to the federal safety net, banks can raise funds at a lower cost than nonbank entities.

* Existence of Subsidy. Treasury suggests that a net subsidy may not exist. The existence of a subsidy, however, is clearly exhibited in publicly assigned debt ratings -- which are virtually always higher at banks than at their parent holding company. It is clear in the higher capital ratios required of nonbanking financial firms, even those

**that receive the same debt ratings as banks. It also is clearly exhibited in the tendency of banking organizations, when geographic restrictions were eased, to shift back to the bank and its subsidiaries activities previously conducted in holding companies.[3] The primary reason for these transfers, according to management of the organizations themselves, is to obtain cheaper funding and to avoid the limitations contained in sections 23A and 23B of the Federal Reserve Act.**

**The fact that some banking organizations continue to conduct mortgage banking operations in nonbank affiliates does not prove that a subsidy does not exist. A holding company may choose not to convert a nonbank mortgage affiliate to an operating subsidiary of a bank for a variety of reasons unrelated to the subsidy, such as to avoid negative tax consequences or to preserve an established trade name separate from the bank. Many nonbank mortgage affiliates also receive a substantial part of their funding from an affiliated bank. Nevertheless, as noted above, the clear trend is for holding companies to shift mortgage and other activities to an affiliated bank or operating subsidiary when permitted by law and a principal reason for these transfers—according to bank managers themselves—is to maximize their subsidy advantage.**

**Furthermore, as Chairman Greenspan has testified, the value of the subsidy varies from bank to bank; riskier banks clearly receive a larger subsidy from the safety net than safer banks. In addition, the value of the subsidy varies over time; in good times, such as now, markets demand a low risk premium and it is difficult to discern the safety net subsidy. Thus, it is not surprising that some banks continue to operate mortgage affiliates, especially in these good economic times.**

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3 **In recent years, the percentage of the consolidated assets of bank holding companies associated with nonbank activities (other than section 20 subsidiaries which engage in securities activities not permissible for banks) has declined by approximately 50 percent as holding companies have transferred assets from holding company affiliates to bank subsidiaries.**

*** <u>Operating Subsidiaries Extend the Safety Net and Related Subsidy</u>. The operating subsidiary structure would extend the safety net (and its related subsidy) to the activities conducted by the operating subsidiary, and create an unbalanced playing field for those financial service providers that seek to compete with the subsidized subsidiary. The Treasury proposal would allow a bank to establish and fund an operating subsidiary with low-cost funds raised by the bank through its access to the safety net. Such actions would extend the federal safety net to the activities conducted by the operating subsidiary, and provide operating subsidiaries with a significant funding advantage over financial service providers that choose to remain independent from a bank.**

*** <u>The Holding Company Structure Provides Better Protection Against Extension of the Safety Net and its Subsidy</u>. Treasury contends that, with its proposed safeguards, a bank could not transfer the subsidy inherent in the safety net to an operating subsidiary any more readily than to an affiliate. Treasury's position is not correct.**

- **As noted above, Treasury would <u>not</u> require that a bank's equity investment in an operating subsidiary comply with the limits contained in section 23A governing a bank's equity investment in an affiliate. Accordingly, even under Treasury's proposal, a bank could invest substantially more of its low-cost funds in an operating subsidiary than in an affiliate. Moreover, creditors of the subsidiary, aware that the bank can provide more subsidized funds to the subsidiary and that the bank will have a strong incentive to support the subsidiary in both good times and bad, will also provide funds to the subsidiary at a lower rate, adding to the subsidy enjoyed by the subsidiary.**

- **Treasury's proposed "dividend limitation" would create only an *illusion* of parity with respect to a bank's ability to transfer subsidized funds to an operating subsidiary or affiliate. Although the Treasury would generally prohibit a bank from investing more in an operating subsidiary than the bank could *legally* pay in dividends, there are real *economic* limitations on a bank's ability**

**to pay dividends that do not limit the bank's ability to invest in a subsidiary.**

**A dividend payment effects a real reduction in the bank's economic and GAAP-reported capital and assets and, thus, is carefully reviewed by the bank's counterparties and other creditors. If the dividend payment reduces the bank's capital below what the market feels is appropriate to support its activities, the payment -- even if permitted by law — will cause the bank's borrowing costs to increase or reduce the bank's ability to obtain private funds at all. Data in fact indicate that over the past 25 years the cost of uninsured funds for the largest banks has tended to increase as the bank's capital ratio has fallen.**

**Thus, it is not in the interest of a holding company to use bank dividends to finance nonbank affiliates because the resulting decline in bank capital would increase the bank's funding costs on *all* of its uninsured liabilities. Data indicate that these additional costs more than outweigh the small benefit that may be achieved by indirectly using subsidized funds to partially fund an affiliate. This process serves as an effective check on a bank's ability to pay dividends, and explains why banks do not pay out the full amount of dividends they are permitted to distribute under law and why bank holding companies have traditionally not used bank dividends to capitalize nonbank affiliates.**

**An equity investment in an operating subsidiary, however, does <u>not</u> reduce the bank's consolidated total capital or assets under GAAP—it results only in a transfer *within* the consolidated bank. Thus, unlike in the affiliate context, there is no real economic limitation on a bank's ability to transfer subsidized funds to an operating subsidiary. In fact, a bank would have a strong incentive to invest the *maximum* amount permitted by law in its operating subsidiary to maximize the subsidiary's funding advantage vis-a-vis its independent competitors. Under**

**Treasury's proposal, this maximum would not be restricted by the parent bank's general dividend limit—it would only require OCC *approval* for the bank to invest *more* than the bank's retained net income for the previous *3 years*.**

## 6. Would generally accepted accounting principles lead banks to prop up troubled subsidiaries?

**As discussed above, generally accepted accounting principles require that any losses incurred by an operating subsidiary be fully reflected in the consolidated financial statements of the parent bank. These GAAP-based financial statements are relied on by the financial counterparties that engage in transactions with the parent bank (e.g. foreign exchange, large CD, and derivative counterparties) or that provide funding and liquidity to the parent bank (e.g. other banks). This fact and the direct management link between a parent and a subsidiary give banks a particularly strong incentive to provide financial assistance to a troubled subsidiary. Banks have provided, and likely will continue to provide, financial assistance to troubled subsidiaries not because they are legally obligated to do so, but because the problems at an operating subsidiary directly affect the bank's operations, funding and funding costs.**

**Losses incurred by a holding company affiliate are not directly reflected in the financial statements of an affiliated bank. Furthermore, the management of a holding company affiliate generally reports directly to the management of the holding company. Thus, although losses at an affiliate may indirectly affect an affiliated bank, the more direct linkages between a bank and its operating subsidiary give the bank greater market and reputational incentives to support a an operating subsidiary of the bank.**

**7. Are some proposed financial activities so inherently risky as to be inappropriate for subsidiaries?**

**The Federal Reserve strongly supports permitting banking organizations to affiliate with companies engaged in securities, insurance, and other financial activities. These activities, like traditional banking activities, involve risk to the organization conducting the activity. Some financial activities - such as merchant banking activities and underwriting property and casualty insurance – are more volatile than other types of financial activities.**

**The critical question is not whether these activities are inherently risky, but how best to protect the federal safety net from the risks that are involved with newly authorized financial activities. The Federal Reserve, for the reasons discussed above, strongly believes that the federal safety net is best protected by permitting new affiliations to occur through the holding company structure, and not through operating subsidiaries of banks. The holding company structure provides better, albeit not perfect, insulation for the federal safety net from the risks involved with securities underwriting, insurance underwriting, merchant banking and other new principal activities.**

**Financial modernization also presents another risk: the risk of transference of the subsidy inherent in the federal safety net to the newly authorized activities. For sound public policy reasons, Congress has chosen to limit the federal safety net, and its attendant moral hazard, to banks because of their unique role in our society. The Federal Reserve firmly believes that the subsidy is more readily transferred to a subsidiary of a bank than to its affiliates, and the holding company structure creates the best framework for limiting this leakage.**

**8. <u>Do American banks have experience conducting nonbanking activities through subsidiaries</u>?**

**Congress has specifically authorized banks to own Edge Act corporations, which are permitted to conduct a banking business outside the United States. Treasury contends that subsidiaries of national banks should be permitted to engage in a broad range of principal activities *in the United States* because Edge Act subsidiaries of banks have engaged in certain principal activities *overseas* in a safe and sound manner.**

**Only a handful of U.S. banks engage to a significant extent in activities overseas through Edge Act subsidiaries. In addition, the Edge Act subsidiaries of U.S. banks engage almost exclusively in *commercial banking* activities that the banks could conduct directly in the United States. In this regard, only 9 U.S. banking organizations account for more than 95 percent of the assets of all Edge Act and other foreign subsidiaries of all U.S. banking organizations. *Less than 2 percent* of the assets of the Edge Act and other foreign subsidiaries of these nine banking organizations is attributable to activities that a bank cannot conduct directly, such as trading in equity securities. Furthermore, the bank-ineligible securities activities of these Edge Act subsidiaries are subject to various size limitations and other supervisory limits.**

**Thus, there is very limited supervisory experience with Edge Act subsidiaries engaging overseas in the types of volatile activities -- such as merchant banking -- that Treasury would allow <u>all</u> national banks to conduct in the United States. The limited exception provided Edge Act subsidiaries overseas does <u>not</u> justify overturning the general principle that has served Congress and the American taxpayer well for decades.**

**Furthermore, Congress explicitly authorized the creation of Edge Act subsidiaries to allow U.S. banks to compete equally in foreign banking markets where the laws may permit local banks that are supported by a foreign government's safety net to engage in broader**

range of activities than banks in the United States. The same principle that justified the creation of Edge Act subsidiaries -- providing a level competitive playing field -- does not justify authorizing operating subsidiaries to conduct a broad range of principal activities in the United States. Permitting the operating subsidiary structure in the United States would place U.S. securities and insurance firms that chose to remain independent of banks at a competitive disadvantage, thereby creating an unlevel playing field in the United States.

## 9. Did the thrift debacle result from allowing new financial activities in subsidiaries?

As the Treasury correctly points out, the thrift debacle had several causes. Unfortunately, Treasury's proposal would replicate certain of the mistakes that contributed to the costly savings and loan bailout.

In the 1980s, thrifts were permitted to engage indirectly through "service corporations" in risky principal activities, including real estate investment and development. The losses incurred by these service corporation subsidiaries contributed significantly to the costs of the bailout absorbed by the American taxpayer. Despite this experience, Treasury would now permit national banks to engage through an operating subsidiary in potentially volatile principal activities (such as merchant banking) that Congress has forbidden national banks to conduct directly.

In addition, the thrift crisis was complicated and extended by the use of special regulatory accounting principles that differed from GAAP. These regulatory accounting devices made thrifts appear—at least to the regulators—to be in better financial condition than they were in fact. Treasury's proposal, however, would create a similar regulatory accounting device through its proposed "capital deduction" procedure. This new regulatory accounting device would make a parent bank appear to have more capital and earnings than the bank may in fact have under CAAP.

**10. Do bank holding companies face higher borrowing costs than their banks?**

**The debt of bank holding companies generally has a lower credit rating than the debt issued by the holding companies' subsidiary banks, which tends to indicate that banks benefit from a subsidy due to their access to the federal safety net. In fact, for the 35 largest bank holding companies where comparable data is available, the debt rating of the holding company is *always* lower than the debt rating of the holding company's subsidiary bank. Since banks have higher debt ratings than their parent holding companies, they can raise funds at a lower rate than their parent holding companies.**

**The funding cost differential between banks and bank holding companies, moreover, is significant and appears to increase in periods of market stress—just as one would expect because the value of the subsidy increases during periods of financial turmoil. Even today, when economic times are good and the value of the subsidy should be relatively low, banks can raise debt capital, on average, at a cost that is 10 to 12 basis points lower than bank holding companies. This translates into a material advantage in those markets—such as the market for investment grade business loans—where gross profit margins may be only 20 to 30 basis points.**

**11. Is allowing new financial activities in subsidiaries consistent with functional regulation?**

**According to Treasury, the operating subsidiary structure is fully consistent with functional regulation because the SEC and state insurance authorities would continue to have full supervisory authority over a broker-dealer or insurance company, respectively, that is an operating subsidiary of a bank.**

**Treasury's arguments again miss the point. No one contends that the SEC and state insurance regulators would not, or should not, continue to have regulatory responsibility for broker-dealers or insurance companies, wherever such companies are held in**

**a corporation's structure. The real issue is how best to minimize conflicts between the functional regulation of securities and insurance activities, on the one hand, and regulation designed to protect the safety and soundness of depository institutions on the other hand.**

**The Federal Reserve, the SEC, and the securities and insurance industries all agree that the holding company framework provides the better vehicle for minimizing conflicts between functional and bank regulation. That is because the holding company framework better insulates the bank—which is the subject of all bank regulation—from the functionally regulated activities conducted by an affiliate. The current bills would further enhance these strengths by imposing reasonable limits on the Board's ability to examine, obtain reports from, impose capital requirements on, or take enforcement action against a functionally regulated nonbank affiliate of a financial holding company. These modifications would reduce overlapping examinations and the potential for conflicting capital requirements, and enhance coordination between the Board and functional regulators.**

**The OCC has opposed the imposition of the exact same restrictions contained in the current bills on its authority over an operating subsidiary. The OCC argues – perhaps correctly – that it must have full and unfettered regulatory authority over an operating subsidiary because the subsidiary is directly owned by an insured bank. The simple fact that the OCC insists on having complete dominion over the regulation of all operating subsidiaries – including the authority to take actions against the subsidiary under the prompt corrective actions provisions of the Federal Deposit Insurance Act – demonstrates the incompatibility of the operating subsidiary approach with true functional regulation.**

## 12. What about the risk of a future Congress loosening applicable safeguards?

**Many of the safeguards that Treasury has proposed to protect a parent bank from its operating subsidiaries (e.g. capital deduction) must be imposed by legislative or administrative action and, thus, could be weakened or eliminated in the future.**

**On the other hand, many of the benefits associated with holding company affiliates (e.g. separation of the affiliate's and bank's financial statements) are inherent to the holding company structure and cannot be loosened by legislative or administrative action.**

Mr. OXLEY. Without objection, and all of the members' statements will be made part of the record should they choose to do that.

The gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman.

It has now become increasingly clear that consumers are today at great risk on having their privacy totally compromised as the affiliations occurring in the marketplace and sanctified under this bill allows banks, brokers, and insurance companies to compile a detailed digital dossier of a consumer's most sensitive health and medical records, their credit cards, checking account transactions, their bank balances and loans, and their life and medical insurance information.

If we fail to act now, we will soon be facing big brother banking, financial institutions that can snoop into our lifestyles, our finances, other health records, our most personal family secrets. Now the financial services industry likes to tell us all about the wonderful synergies that will result when our personal secrets are sold and transferred to affiliates.

Let us just take a look into the future at what some of those synergies actually mean for our consumers. The next time you get cold called by a stockbroker, will he tell you, hey, I see that you have been buying Ritalin for your daughter. You know, there are a lot of kids on Ritalin these days for attention deficit disorder and the company that makes this stuff is about to have its stock go right through the roof; but right now, it is undervalued. So we are recommending to our customers that they buy now.

And oh, I see that you have been buying Depends for your 85-year-old mother-in-law who lives at home with you. Well, our health sector analysts have projected continued growth in the incontinence market as the baby boomers reach their golden years. So now is really the time to get in on the stock of the companies that make those products.

Speaking of companies whose products are selling like hot cakes, I guess that I don't need to tell you how much that Viagra drug has taken off if you know what I mean.

Next day when you and your wife drop by to visit your friendly banker seeking a mortgage for the dream home that you just made an offer on, does he sympathetically shake his head as he reviews his computer data base saying he is so sorry to see that your wife has recently been under treatment for breast cancer. But the bank is just going to have to require a larger down payment and higher interest rates to reflect the increased risk they would dare if they were to grant this mortgage application given the fact that you will be relying on both of your incomes to make the mortgage payments.

And oh, by the way, we see that you have been charging quite a tab down at Joe's tavern over the last 2 months which I guess is understandable in light of your daughter's ADD, your mother-in-law's incontinence problem, and your wife's breast cancer treatments. But we are just somewhat concerned about the impact of your recently increased drinking habits on your continued ability to pay back this mortgage that you are asking us to grant you.

And when you drop by your insurance agent a few days later to take out a new life insurance policy, will he, after a few clicks of the mouse on his computer, look over to you and ask, so, can you tell me what all those recent charges are for sky-diving lessons?

Well, if we allow all of this to be mixed into one company, each one of these people will have access to your file whether or not they have any basis to have access to it.

Now, your friendly banker or broker or insurer in that one company wouldn't be foolish enough to actually reveal to you that they have gathered all of this sensitive information about you because they know that if they ever did, you would reach right across the desk and throttle them for their insolence in prying into your personal affairs and talking about your daughter, your wife, your mother in those terms. But they do have the file right in front of them even though you didn't go to them, that broker or that insurance agent or any other part of that affiliate for those services.

Under current law, there is nothing, absolutely nothing to prevent them from taking your family secrets and selling or transferring them to their affiliates all in the name of synergies. H.R. 10 does very little to stop the principal harm done by those much touted synergies, the taking of an individual's most precious private property right, their right to privacy.

We are going to form a Congressional privacy caucus. We need one. As all of these technologies converge, as all of these financial institutions converge, we need a Congressional privacy caucus to ensure that we have an ongoing monitoring of these issues. Every citizen has a right to knowledge of the information that is being gathered about them, notice that the information is going to be reused for purposes other than that which they originally intended, and the right to say no, they don't want this information used for any other purpose.

I hope that as we move forward on the markup of this legislation that we can ensure that these privacy rights of every American are indeed protected.

I thank you, Mr. Chairman, and I yield back the balance.

[The prepared statement of Hon. Edward J. Markey follows:]

PREPARED STATEMENT OF HON. EDWARD J. MARKEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Thank you, Mr. Chairman. One of the most critically important domestic policy issues coming before the Congress this session is what is going to happen to the consumer's most personal information, including their financial records, or their health and insurance information when banks, brokerage firms, and insurance companies all merge with one another under the financial services modernization legislation, H.R. 10.

It has now become increasingly clear that consumers are today at great risk of having their privacy totally compromised as the affiliations occurring in the marketplace and sanctified under this bill allow banks, brokers, and insurance companies to compile a detailed digital dossier of a consumer's most sensitive health and medical records, their credit card and checking account transactions, their bank balances and loans, and their life and medical insurance information. If we fail to act now, we will soon be facing **Big Brother Banking**—financial institutions that can snoop into our lifestyles, our finances, our health records, our most personal family secrets. Now, the financial services industry likes to tell us all about the wonderful "synergies" that will result when our personal secrets are sold or transferred to affiliates.

But let's just take a look into the future at what some of these "synergies" actually could mean for consumers. The next time you get cold-called by a stock broker, will he tell you, "Hey, I see here that you've been buying Ritalin for your daughter. Well, you know, there are a lot of kids on Ritalin these days for Attention Deficit Disorder, and the company that makes this stuff is about to have its stock go right through the roof. But right now, it's undervalued and so we're recommending to our customers that they buy now.

"Oh, and I see that you've been buying Depends for your 85-year old mother-in-law, who lives at home with you. Well, our health sector analysts are projecting continued growth in the incontinence market as the Baby Boomers reach their Golden Years, so now is really the time to get in on the stock of the companies that make these products. And speaking of companies whose products are selling like hotcakes, I guess I don't need to tell YOU how much that Viagra drug is taking off—if you know what I mean?"

And, the next day, when you and your wife drop by to visit your friendly banker seeking a mortgage for the dream home you've just made an offer on, does he sympathetically shake his head as he reviews his computer database, saying that he's so sorry to see that your wife has recently been under treatment for breast cancer, but "the bank is just going to have to require a larger downpayment and higher interest rate to reflect the increased risk it would bear if it were to grant this mortgage application, given the fact that you will be relying on both of your incomes to make the mortgage payments."

"Oh, and by the way, we see that you've been charging quite a tab down at Joe's Tavern over the last two months, which I guess is understandable in light of your daughter's ADD, your mother-in-law's incontinence problem, and your wife's cancer treatments. But we're just somewhat concerned about the impact of your recently increased drinking habits on your continued ability to pay back this mortgage you're asking us to grant you."

And when you drop by you insurance agent a few days later to take out a new life insurance policy, will he, after a few clicks of the mouse on his computer, look over to you and ask, "So, can you tell me what all these recent charges are for Skydiving Lessons?" "And I also see that you've recently written several checks for psychiatric counseling and you've also submitted claims for a Prozac prescription—what's that all about?" "Now, I am sorry to have to ask this, but you know—it's company policy. I mean, between your kid's ADD, your mother-in-law's incontinence, your wife's breast cancer, your recently increased drinking, your impotence, and, well, this new skydiving thing—well, our management might say that we shouldn't really insure you at all. I mean, let's face it, given all you've been going through, you are definitely *one big suicide risk*."

Now, of course, your friendly banker, broker, or insurer won't be foolish enough to actually reveal to you that they've gathered all this sensitive information about you, because they know that if they ever did you'd probably reach right across the desk and throttle them for their insolence in prying into your personal affairs. But, under current law, there is nothing to prevent them from taking your family secrets and selling or transferring them to their affiliates—all in the name of "synergies." And H.R. 10 does very little to stop the principal harm done by these much touted "synergies"—the taking of an individual's most precious private property right, their right to privacy.

In order to provide meaningful privacy protections, H.R. 10 needs to provide consumers with three things: Knowledge of what information is being collected about them; Notice before information is transferred to affiliates for purposes other than the original purpose for which it was provided, and a right to say No. I intend to offer amendments to this legislation which would provide consumers with Knowledge, Notice and Know, and I urge my colleagues to support this effort. In addition, I would like to notify the Members that I am today establishing a Congressional Privacy Caucus to serve as a clearinghouse for information on privacy matters and educate and organize Members with an interest in these critical issues, so that we can prevent the digital disutopia that I have just described from coming into being. I urge my colleagues to join me in this endeavor.

Mr. OXLEY. The gentleman yields back. The Chair now recognizes the vice president of the subcommittee, the gentleman from Louisiana, Mr. Tauzin.

Mr. TAUZIN. Thank you, Mr. Chairman.

I commend you for moving H.R. 10 again this year in an attempt to settle this incredibly complex and contentious set of issues. Just last week, Alan Greenspan, chairman of the Federal Reserve

Board, shared with us his concerns regarding H.R. 10 as it was reported out of the banking committee.

I am pleased to see my colleague from Louisiana who serves on that committee here. I wanted to say up front that I think Mr. Greenspan's concerns about the op-sub model proposed by the banking committee are shared by this member. As reported out of H.R. 10 as it came out of banking it would enable banks to transfer safety net subsidies to their operating subsidiaries engaged in financial activities not conducted directly in the banks.

Mr. Greenspan indicated his concern, I share it, that this would place traditional securities and insurance firms at a competitive disadvantage as it clearly would not have the access to the payment system that would be affordable indeed to banks engaging in these activities. Ultimately, I disagree with the notion that the securities or insurance firm should have access to a payment system just because it is an operating subsidiary of a bank. In fact, I can't see a good reason why any securities, insurance, and nonbanking entity should be afforded access to the payment system.

To try to put it in perspective here, banks have always been allowed to receive Federal safety net subsidies for one reason, because we believe that it is important to preserve the safety and soundness of the banking system in which Americans deposit their money for safekeeping. It makes sense. Depositing money in a bank should be, as much as possible, a riskless activity. And the payment system exists to ensure against or eliminate as many of those risks as possible when that money is deposited.

By contrast, it is counterintuitive, in fact it is ridiculous to say that an investor is going to expect any loss she might incur as a result of investing in an inherently risky capital market should be insured by the taxpayers through the Federal Government that insures these safety net deposits. Fundamentally then, it doesn't make sense for the Federal Government to insure against capital losses, and I can see no justification whatsoever for enabling subop investments and securities firms to access Federal safety nets subsidies.

That access would indeed result in competitive disadvantages, and I think would subsidize the capital investment activities on behalf of the investing customers. I understand that Secretary Rubin will favor the sub-op model, and I am anxious to hear if he can address those concerns. Ultimately, there is an additional concern that I have with H.R. 10 that I want to hear briefly.

I am concerned about the way that the insurance provisions are drafted. In my view, the bill in its current state seems to strip the States of their much needed authority to regulate the sale of insurance and protect insurance customers. In lieu of affording the States the requisite authority to properly regulate insurance, the bill appears to give the comptroller and the office of thrifts division a great deal of regulatory discretion to control these activities.

I just had some recent experience with the FCC that I think we all should remember. The FCC recently, through court action, deprived our States of their authority to local telephone rates based on economies of scale and local costs. Just as local special considerations and insurance has generally been regulated on a State and local basis, because of that, I have grave concerns about a policy that would move more and more authority to a Federal system of regulation and the uncertainties of changes in that Federal regulatory scheme from time to time.

That provision of H.R. 10 deeply concerns me. After all, the terms of the insurance policies are usually based on many local considerations to which Federal regulators are not at all sensitive. Again, Mr. Chairman, I am anxious to hear my good friend, especially my friend from Louisiana, but I also look forward to hearing Secretary Rubin's defense of what I consider to be some very bad policy when it comes to sharing the Federal safety net to risky capital investments. I yield back the balance of my time.

Mr. OXLEY. The gentleman yields back.

The gentleman now recognizes the gentleman from Michigan, the ranking member of the full committee, Mr. Dingell.

Mr. DINGELL. Mr. Chairman, I thank you for your courtesy and I thank you for the hearing.

Mr. Chairman, I will not belabor the points I made in my opening statement at last week's hearing. That record is, I think, a good one; and I am pleased to have made the opening statement and received the courtesy of the Chair on that matter.

I will reiterate one thing. I am strongly opposed to H.R. 10 in its current form. I am willing to work with my colleagues to improve it. However, unless it is significantly changed, I will regretfully be opposed to it at every stage of the legislative process with great vigor.

On behalf of the minority, I will need to note a serious procedural and substantive issue for the record. Last week we were informed by the majority staff that we could not hear from consumer group witnesses at today's hearing because there would be three panels of administration and industry witnesses and thus no time or room to accommodate the minority's request.

While I understand that time is dear, I would note that having a full and complete record is extremely important and having the views of consumers on this matter is something which is very important both to a proper hearing of the matter and also to a proper hearing record, as well as to give the committee the information on all viewpoints with regard to the legislation. I feel very strongly that we do need in this committee a strong record on key consumer issues, including privacy and the community reinvestment act. Therefore, it would be my hope that we could hear these witnesses at a time soon and that we could do a good job of achieving a proper and a full record.

I would note that two of my colleagues from the banking committee, Republican members, are being heard this morning. They were added at the last minute. That is fine. I have no objection to that and certainly there is no ill will either toward these members or toward having them heard. But we do believe that there should be an opportunity for the committee to hear from consumer witnesses and that we should make the necessary room and opportunity for them to be heard.

I would also note that the Treasury Department testimony arrived last evening after most members of the staff had left for the day. I respectfully request then that the record be kept open for the submission of written questions for the Secretary after we have had adequate opportunity to review his written statement and the issues that that statement raises.

I would note that the Chair has been providing good leadership in our consideration of this matter, and I thank you for recognizing me for my comments.

Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman yields back. Without objection, any questions to the Secretary in writing would be in order. Without objection it is so ordered.

Mr. OXLEY. The gentleman from Kentucky, Mr. Whitfield.

Mr. WHITFIELD. Thank you very much, Mr. Chairman. Thank you, Mr. Chairman, for recognizing me.

I wanted to welcome today to this hearing George Nichols who is the Commissioner of Insurance from the State of Kentucky. I know he has testified before this committee before. He is a real expert in this area. He is considered one of the most effective insurance commissioners we have had in Kentucky for some time and his peers at the National Association of Insurance Commissioners respect him so much that they named him the chairman of their special committee on financial services modernization.

So, Mr. Commissioner, we look forward to your testimony as well as that of the other distinguished witnesses this morning.

I yield back the balance of my time.

Mr. OXLEY. The gentleman yields back.

The gentleman from Minnesota, Mr. Luther. No opening statement?

The gentleman from Iowa, Dr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman.

I think it would not have been unreasonable for a lobbyist when I started in 1995 to have said I expect that you will see a vote on war and a vote on an impeachment of the President before you will ever see Glass-Steagell changed.

Well, it is possible that we are seeing light at the end of the tunnel, and the reason for that is that I think there is a consensus that the form of Glass-Steagell would provide for better services for consumers and would also help our financial services industry in the United States compete better globally. Des Moines has a very strong financial services and insurance industry, and so I have been very interested in this issue.

Why am I optimistic? Well, there was a big bipartisan vote that came out of banking, and I appreciate Mr. Baker and Mrs. Roukema for being here today. I am hearing that leadership on both sides of the aisle in both the House and the Senate would like to see something happen this year as well as the administration. That doesn't mean that there aren't some problems and some bumps along the way that we will have to look at. It has already been mentioned that the operating subsidiary issue, the financial medical privacy issue, CRA—but I feel that there is a coalition that is there that has come together based on work that we did in the last Congress that is delicate but is in agreement on most of the major things as it relates to insurance, securities, banking, and consumer protections.

And I am very hopeful, Mr. Chairman, that maybe this year we will actually get the job done. Maybe the stars will come into alignment. It takes an awful lot of work by a lot of people, and I commend you for your effort on this.

I also want to note that Mr. Arnold Schultz is here today from Grundy Center which is very close to Des Moines. We will appreciate his testimony.

Thank you, Mr. Chairman.

Mr. OXLEY. The gentleman yields back.

The gentleman from Illinois, Mr. Shimkus? Do you have an opening statement? None.

The gentleman from New York, Mr. Fossella. Mr. Bilbray, the gentleman from California.

Mr. Gillmor, the gentleman from Ohio.

Mr. GILLMOR. Mr. Chairman, I don't have an opening statement. I just want to welcome a fellow "buckeye" who is going to be on our last panel, W. Craig Zimpher, with Nationwide Insurance who I first knew when he worked in then Governor Rhodes' office and has had a distinguished career both in government and the private sector, and we look forward to hearing his testimony.

Mr. OXLEY. I thank the gentleman. And finally the gentleman from Maryland, Mr. Ehrlich.

No further opening statements, we will now turn to our distinguished Members panel. Let me introduce the first witness, the gentleman from Louisiana, Mr. Baker.

**STATEMENT OF HON. RICHARD H. BAKER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA**

Mr. BAKER. Thank you, Mr. Chairman. I certainly appreciate the courtesy that you have extended and that of the committee to allow me to appear here this morning with Ms. Roukema and to present a perspective from the House Banking Committee on this controversial subject.

The world is changing irrevocably in manners that few understand and even less can accurately predict. No doubt there are many companies that can lend you a mortgage, but there is one out there that can also do that and sell you a casket as well under current law.

The pressure is on, whether from uniquely chartered special purpose institutions, such as unitary thrift, a section 20 affiliate, or a foreign bank. The traditional institution has competitors with market advantages governmentally created.

Just one example. Since 1990, the Fed has issued approval for 18 foreign banks to own subsidiaries that engage in the underwriting of securities in the United States. This is not insignificant as the aggregate asset size of these foreign institutions exceeds $450 billion. The Fed has acknowledged that a foreign bank may establish a subsidiary while a U.S. bank may not.

On another point somewhat unrelated but of equal curiosity, under the Bank Holding Company Act, a bank may own up to 24.9 percent of nonvoting stock in a United States corporation, but at the same time that same bank may own up to 40 percent of nonvoting stock of a foreign corporation. I never have understood nor had it explained to me why a larger share of ownership in a foreign corporation is safer than a smaller share of ownership in a domestic corporation.

Clearly there is a patchwork of regulatory standards and statutes that create current market inequities. I note, Mr. Towns, in your opening statement your concern for having a uniform playing field in which all participants are treated equally. The regrettable observation is, today, we have irregularities that create market inequities already. But to add another level of complexity to that decisionmaking process, I would note that there are nonregulated financial service organizations that do provide a full range of financial services without similar regulatory responsibilities.

This means that competitors of regulated financial institutions have a real cost advantage in the delivery of the same financial products. For instance, Ford Motor Company can offer a money market account which is, in all respects, a checking account as well as investment counseling, insurance products, radios, and bumpers.

Is this bad? Consumers don't think so. Profits are at record levels, stock valuations are at record levels. But they don't pay deposit insurance premiums. Consumers don't care. The Federal Reserve monitoring is not there. Consumers don't care. They don't comply with CRA. Consumers don't care. Neither the OTS, the FDIC, the OCC, or the Treasury inspect the books. Customers just don't care.

There is good reason why the customers don't worry about the lack of government intrusion. As Fed Governor Ferguson best stated on February 25 of this year, and I note after the Long-Term Capital failure, "perhaps the most fundamental principle that must guide us is that private market participants are the first line of defense against excessive private and public risk in the financial system."

I would note that it was the market that first advised the regulators of Long-Term's significant problems, not the regulatory system. Despite the regulatory failure in the LTCM problems, the system almost always works in the best interest of the taxpayer and the consumer.

Can we assure there will never be failures? Certainly not. The markets do treat failure very harshly, but can we assure that there will never be any loss to the deposit insurance fund no matter whether we have the affiliate or the subsidiary structure? Absolutely not.

But the Secretary of the Treasury and all four past and present FDIC chairpersons, the current and three preceding, two Republicans and two Democrats, agree that the op-sub provisions make market sense and consumer sense. In fact, the preceding FDIC chairmen argue that forcing activities into an affiliate actually exposes insured banks to greater risks than that of the operating subsidiary.

So what are we to do? Ultimately, the consumer and taxpayer should be our focus. Government policy should not determine profitability. Government regulations should not determine winners and losers. In America, management should discuss in their boardroom how to best use their shareholders' investment to efficiently serve customers.

The best service at the lowest price serves investors and consumers well. But leaving business managers to structure their business as they see fit should not only be permissible but encouraged. The Fed would acknowledge that for the complex international financial corporation that is permissible under current law, the best risk analysis comes from the corporations' own internal risk-management analysis.

Can we appropriately conclude that we can best determine business structure when we can't fully understand even the business activities that we are attempting to regulate? Governor Meyer, in a speech of March 2 of this year said, "if we excluded banks from financial modernization in order to avoid safety net and subsidy transference over a wider area, banks would simply take smaller shares of the total financial markets' pie as their less-protected and subsidized competitors expanded."

I doubt that banks would wither away, but they would surely become less important. Let me say it in my own way. Imagine for a moment your last name is Kennedy, not the Massachusetts kind but the Clinton, Louisiana, kind, and you are sitting behind the desk as the CEO of Feliciana Bank and Trust in Louisiana, a $44.2 million institution. While you look down the street, and it is a short street, you look to the automobile dealership where you used to finance six, maybe eight automobiles a month. Now G.E. Capital finances those. You look up the street to the sheriff's department and you see G.E. Capital financing the fleet-leasing program for that sheriff's department. As a matter of fact, everywhere you look in that town you find evidence of G.E. Capital, home mortgages, insurance, retail, finance, credit cards, computer services, appliance manufacturing, plastics, lighting and aircraft engines. By the way, they can advertise it all on their own network, NBC.

Now, do you think that Mr. Kennedy is really worried about affiliate versus subsidiary structure? You see, G.E. Capital is not subject to Federal regulation. Neither the FDIC, the OTC, the OCC, or CRA or any other financially regulatory constraint which Mr. Kennedy is subject to. This is just one example among many. So while we fervently debate the advisability of affiliate versus subsidiary, Mr. Kennedy wonders why A.G. Edwards, credit unions, and G. E. Capital and the like are able to do what he can't, make a profit without strangling government regulation.

Does the Federal Reserve really need to sit on Mr. Kennedy's board to protect America's economic interests? Would a subsidiary in Clinton, Louisiana, threaten national safety and soundness? I do not think so. Let the free enterprise system work. Let services and products meet consumers needs. Let regulators monitor professional conduct, and let Mr. Kennedy make his own business decisions whether those include a subsidiary or not. In this matter, financial markets will continue to innovate products and services whereby consumers will be protected and served in the best manner possible.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Richard H. Baker follows:]

PREPARED STATEMENT OF HON. RICHARD H. BAKER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

The world is changing, irrevocably, in manners that few understand, and even less can accurately, predict. Governor Meyer of the Federal Reserve captures this change well.

> High-speed computers and constant pressure to press the envelope of regulatory limits made possible everything from money market mutual funds to deriva-

tives; from loans once held permanently by a bank to securitization into a capital market instruments; from computer shopping for a mortgage to a higher yielding deposit at a virtual bank; from equity mutual funds from a bank or a broker to a checking account at your credit union; from a company that will lend you a mortgage to one that will do that and sell you a casket (yes a casket manufacturer owns an S&L); and I could go on.—*Gov. Laurence Meyer (March 12, 1999)*

The pressure is on, whether from uniquely charted, special purpose financial institutions, such as a unitary thrift, a Section 20 affiliate, or a foreign bank, the traditional institution has competitors with market advantages *governmentally* created. Just one example, since 1990, the Fed has issued approval for 18 foreign banks to own subsidiaries that engage in the underwriting of securities in the U.S. This is not insignificant as the aggregate asset size of these foreign institutions exceeds $450 billion. The Fed has acknowledged that a foreign bank may establish and fund a subsidiary, while a U.S. bank may not.Another anachronism of financial regulation includes current Fed practices. Under the Bank Holding Company Act, a bank may own up to 24.9% of non-voting stock in a U.S. corporation, but at the same time it may own up to 40% of a *foreign* corporation. I have never understood how a larger share of a foreign corporation is less risky than a smaller share of a U.S. corporation. And don't get me started on the subject of unitary thrifts except for one observation. The unitary thrift charter was created by Congress in 1967. Not only do these institutions engage in diversified financial activities, they engage in commercial activities as well. Although existing charter operations number in the hundreds, many more applicants are pending approval. More importantly, of all thrifts operating today, unitary thrifts control 70% of all thrift assets.

Despite this predominant market share, are regulators in pursuit of abusive market participants? No. Are consumer organizations demanding their closure? No. Are securities and insurance companies fighting to eliminate them? Not hardly. In fact, the only group outspoken in their demand for limits on the unitary thrifts are the banks. Why, because of the competitive advantage of their charter.

Clearly, there is a patchwork of regulatory standards and statutes that create current market inequities. But to add another level of complexity to our decision marking process non-regulated financial service organizations provide a full range of financial services without a similar regulatory responsibility. This means that non-regulated competitors of regulated financial institutions have a real cost advantage in the delivery of financial services.

For instance, many non-banks such as GMAC and Ford Motor Company offer a money market account, which is, in all respects a checking account, as well as investment counseling, insurance products, radios, and windshield wipers. Is this bad? Customers don't think so. Profits are at record levels, stock valuation is at record levels. But they don't pay deposit insurance premiums. Customers don't care. The Federal Reserve doesn't claim to monitor their conduct. Customers don't care. They don't comply with CRA. Customers don't care. Neither the OTS, the FDIC, the OCC, or the Treasury inspect the books. Customers don't care. And there is good reason why customers don't care about intrusive government regulation.

As Fed Governor Ferguson best stated on February 25 of this year, note after Long Term Capital's demise:

> Perhaps the most fundamental principal that must guide us is that private market participants are the first line of defense against excessive private and public risk in the financial system. Private borrowers, lenders, investors, institutions, traders, brokers, exchanges, and clearing systems all have huge stakes in containing their risks as individual agents and risk to the system as a whole. Private market participants can discourage excessive risk taking by choosing to do business with those firms that demonstrate sound risk management systems, and portfolios that balance appropriately risk and expected return.—*(Gov. Ferguson, Feb. 25, 1999)*

Despite the regulatory failure in the LTCM incident, the system almost always works in the interest of the taxpayer.

Can we assure there will never be failures? Certainly not. The markets do treat failure harshly! Can we assure there will never be any loss to the deposit insurance funds, no matter what structure we dictate? Absolutely not.

But I am assured by the Secretary of the Treasury, and all four FDIC chairpersons, (the current and three preceding—2 Republicans and 2 Democrats), agree that the op-sub provisions make market sense and consumer sense. In fact, the preceding FDIC chairmen argue that forcing activities into an affiliate actually exposes insured banks to greater risks than that of an operating subsidiary.

So what are we to do? Ultimately the consumer and the taxpayer should be our focus. Government policy should not determine profitability. Government regulation should not determine winners and losers. In America, management should hold discussions in the boardroom how to best use their shareholders investment to efficiently serve their customers. The best and most convenient service at the lowest price serves investor and consumer well. Permitting business managers to structure their business as they see fit should not only be permissible, it should be encouraged.

The Fed acknowledges, that for complex international financial institutions—all operating under existing law—the best risk analysis comes from the institutions own internal managerial risk assessment. Can we appropriately conclude that we can best determine business structure, when we don't fully understand the nature of the business activities we are attempting to regulate?

Let me say it another way. Imagine for a moment your last name is Kennedy—not the Massachusetts kind, but the Feliciana Louisiana kind, and you're sitting behind the desk of Clinton Bank and Trust, which is a *$44.2* million community bank. While we debate subsidiary versus affiliate, he looks down the street and sees, say for example, the local credit union or GE Capital which is financing the 6 or 8 cars a month he used to finance. He sees GE Capital down the street leasing an auto fleet to the Sheriff's department. GE Capital in fact can do home mortgages, insurance, retail finance, credit cards, computer service, appliance sales, plastics, lighting, and aircraft engines, and advertise it all on their network-NBC. All without bank holding company regulation. Do you think Mr. Kennedy is really worried about affiliates versus subsidiaries? You see GE Capital is *not* subject to Federal regulations, FDIC, OTC, OCC—and particularly CRA—or any other financial regulatory constraint, but Mr. Kennedy is subject.

Now this is just one example among many. So while we fervently debate the advisability of affiliate versus subsidiary, Mr. Kennedy wonders why credit unions, unitary thrifts like AG Edwards, GE Capital, and the like are able to do what he can't—make a profit without the strangling government regulation. Does the Federal Reserve really need to sit on Mr. Kennedy's board to protect America's economic interests? Would a subsidiary in Clinton, Louisiana threaten national safety and soundness? I do not think so.

Let's let free enterprise work. Let services and products meet consumer needs. Let regulators monitor professional conduct. And let Mr. Kennedy make his own business decision—whether a subsidiary or not.

Mr. OXLEY. Thank you, Mr. Baker.

We now turn to our distinguished lady from New Jersey. What are your druthers, Marge?

## STATEMENT OF HON. MARGE ROUKEMA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

Mrs. ROUKEMA. Well, my druthers would be, I think in the interest of your time and everyone's patience here, to just submit my testimony and give maybe a 2 minute summary so that it can be submitted. Because I, as chairwoman of the Financial Institution Subcommittee, have very strong feelings here on the subject of the holding company affiliate structure that are consistent with Chairman Greenspan's position. I know you, Mr. Chairman, have referenced the Greenspan position.

This is not about winners and losers, it is about fire walls and safety and soundness and the American taxpayers. In my full testimony, I reference the fact that if we don't learn from history, we are doomed to repeat the same mistakes and item by item referenced the savings and loan debacle as being a parallel that we would be inviting if we did not follow Mr. Greenspan's position.

This is not a turf battle. It is about having more than rhetoric relating to safety and soundness and those fire walls. I believe firmly, as my testimony will reflect in specific detail, that the holding company structure is absolutely essential to prevent conflicts of interest and the safety and soundness questions.

In addition, I must say that if you look at the Asian crisis, you will see that government interference in the financial institutions there brought about the Asian crisis. I am not talking as a Republican or as a Democrat. But if you have elected officials through the Treasury Department setting up arbitrary and discretionary requirements for financial institutions in the future, you are inviting political manipulation rather than objective standards for those purposes.

Finally, I would like to say that by all means I believe we need a bill this year. If we in the Congress do not get a bill this year, we are essentially saying that the regulators and the Court—we can't do our business and the regulators and the courts will fill in and redesign financial institutions and modernization without statutory authority because we would have abrogated our responsibility.

Again, Mr. Chairman, I believe that you will see that the testimony reflects completely from my own experience and my position as the chairwoman of what Chairman Greenspan has laid out to you and what you, Mr. Chairman, and Mr. Tauzin, vice chairman, have enunciateed in your opening statements.

[The prepared statement of Hon. Marge Roukema follows:]

PREPARED STATEMENT OF HON. MARGE ROUKEMA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW JERSEY

"We cannot escape history. We of this Congress and this administration will be remembered in spite of ourselves." Those words remain as true today as they were the day Abraham Lincoln uttered them in 1862 and they have special significance for Congress as we consider legislation that would comprehensively modernize our financial laws.

Financial modernization may not have the headline-grabbing power of air strikes in Serbia or school violence, or the potential to affect our daily lives like a proposed tax increase. But this legislation is critically important. If not "done right" it has the potential to drain hundreds of billions from America's financial system and from federal budget priorities such as preserving Social Security and improving education. This is not about winners and losers. By all means, we need a bill this year.

The pending financial modernization legislation is designed to replace outmoded laws—many of which were drafted during the Great Depression. The bill would tear down the out-of-date barriers that prohibit banks, securities firms, insurance companies and other financial service providers from affiliating with each other and entering each other's businesses. It would foster competition for financial services, permit financial organizations to offer consumers a wider array of products and services, and enhance the ability of U.S. banking and financial companies to compete more efficiently in the global market.

Congress has a special responsibility, however, to ensure that the newly authorized affiliations and activities occur within a framework that protects the safety and soundness of this nation's insured banks, the Federal deposit insurance funds and the American taxpayer. In fact, this decision regarding the how we construct an appropriate framework for authorizing new financial activities is likely the most important decision associated with financial modernization, and a misstep will have profound consequences for our financial system and the taxpayer.

We have been down this road before. The savings and loan debacle of the 1980s cost the Federal deposit insurance funds and, ultimately, the American taxpayer hundreds of billions of dollars. Indeed, the price tag grows every day as lingering lawsuits are settled.

These losses were caused in part because S&Ls were permitted to engage in risky activities directly or through subsidiaries -- incurring substantial losses. In some cases, these losses had a direct impact on the financial solvency of the parent thrift. Hundreds of federally insured thrifts had to be bailed out by the federal government, and ultimately, by us, the taxpayers.

Following the thrift taxpayer-financed bailout, Congress restricted the ability of insured state banks to engage through subsidiaries in such risky activities, such as underwriting property and casualty insurance or making equity investments in nonbanking entities. We also required the accounting practices of Federal banking agencies to "be uniform and consistent with generally accepted accounting principles."

Now we have to apply the standards of safety and soundness to financial modernization. Unfortunately, the painful lessons of the thrift debacle have faded with time and our enduring economic boom has tempered memories of what can happen, particularly to insured depository institutions, when the economy turns sour.

I believe the Treasury Department's own modernization proposal has the potential to repeat the costly mistakes of the thrift crisis. In particular, the Treasury Department has championed a proposal that would allow so-called "operating subsidiaries" of national banks to engage in some of the potentially risky activities that Congress has not allowed national banks to conduct directly. These activities include merchant banking activities, which would allow subsidiaries of national banks to acquire up to 100 percent of the equity of companies engaged in any type of financial or commercial activity,

Here we go again. Treasury's proposal would place the American taxpayer at risk. Losses at an operating subsidiary can occur quickly and can significantly exceed the bank's total capital and investment in the subsidiary. These losses must be fully and immediately reflected in the financial statements of the parent insured bank under generally accepted accounting principles and, thus, can have an immediate impact on the bank's solvency. The direct ownership and management link between an operating subsidiary and its parent bank also gives the bank a strong incentive to support a financially distressed operating subsidiary. These economic realities have not changed since the thrift crisis of the 1980s.

Treasury would address the risks inherent in the operating subsidiary structure through the creation of so-called regulatory "firewalls." But these firewalls would not fully protect an insured national bank, the Federal deposit insurance funds or the American taxpayer from losses incurred by an operating subsidiary. Experience with the thrift crisis proves that such artificial regulatory accounting devices are not effective because they cannot alter economic realities—losses at a subsidiary reduce the economic resources of the parent.

This is precisely why Congress must support the "holding company" framework. The holding company framework has an established track record of better insulating insured banks from the risks associated with new activities. An insured bank does not control a holding company affiliate. Instead, the bank is owned by the uninsured holding company. Losses incurred by a holding company affiliate are not directly reflected in the financial statements of an affiliated bank and are borne by the uninsured holding company—not the insured bank.

It is for these reasons that the financial modernization bills passed last year by the House and by the Senate Banking Committee rejected the operating subsidiary framework and required a holding company framework. Many who discount last year's action claim it is nothing but a turf battle. It is not. There are sound policy reasons to institute a prudent system of checks and balances.

There is one final risk that the operating subsidiary structure would present. It would invite the further politicization of banking and financial policy by greatly expanding the authority of the Treasury Department and, thus, the ability of any Administration—Democrat or Republican—to exert influence over banking organizations. For sound reasons, Congress has carefully divided responsibility for financial institution regulation and policy among the politically elected executive branch and independent regulatory agencies, such as the Federal Reserve Board.

We have the right regulatory structure now. Here I would point to Asia where the ongoing financial crisis was exacerbated by the outright corrupt relationship between the Asian governments and their respective financial industries.

The operating subsidiary structure would dangerously upset this careful balance and lead to the further politicization of financial policy. Banks play too important a role in our economy to allow banking policy to become further politicized.

The lessons of the financial collapse that led to Depression and the more recent Asian economic crisis should be "red flags" reminding Congress to do it job to protect the safety and soundness of the financial services sector. It does that by following the lead of Federal Chairman Alan Greenspan and by rejecting Treasury's dangerous "opsub" scheme.

Mr. OXLEY. Without objection, the full statement will be made part of the record as well as Mr. Baker's. We thank both of you for your testimony. The Chair would note that we do have a vote on the floor, and the committee will stand in recess for 15 minutes.

[Brief recess.]

Mr. OXLEY. The subcommittee will reconvene.

We are honored to have as our lead witness this morning the Honorable Robert Rubin, Secretary of the Treasury. Secretary Rubin, thank you for appearing before the committee today. We appreciate you taking the time to be with us, and we apologize for the usual floor votes and other distractions, but we are eagerly anticipating your participation and your testimony. With that, let me recognize you for whatever time you wish to spend with us.

**STATEMENT OF HON. ROBERT E. RUBIN, SECRETARY OF THE TREASURY, ACCOMPANIED BY RICHARD S. CARNELL, ASSISTANT SECRETARY OF THE TREASURY, DEPARTMENT OF THE TREASURY**

Mr. RUBIN. Thank you, Mr. Chairman. Let me start by thanking you for the opportunity to be here with you.

Mr. OXLEY. Is that microphone on?

Mr. RUBIN. I do not know the answer to that, sir. Is it better now? Would you rather I have it on or off?

Mr. OXLEY. We will take a vote on that.

Mr. RUBIN. I think I will put it on. Let me start again, if I may.

Mr. Chairman, we are delighted to be here. I appreciate the opportunity to present our views on H.R. 10, and financial modernization more generally. Let me begin, if I can, with a general comment that the United States financial services industry is stronger and more competitive in the global economy than at any time in many, many decades, including dominance in investment banking and a stronger position abroad in commercial banking than certainly at any time in my memory.

Moreover, financial modernizations are occurring through the marketplace, products are being developed in one sector that serve another sector and mergers are taking place. This is because of the lowering of regulatory barriers.

Financial modernization, I have no doubt, will continue in the absence of legislation. But, in our view, it is important to get legislation—if we can get good legislation—because with good legislation it can be done in a more orderly fashion. However, if it is going to be done through legislation, it needs to be done right.

Let me now turn to H.R. 10. The administration strongly supports H.R. 10, which, as you know, is supported by the Banking Committee with a vote of 51 to 8 on bipartisan basis. H.R. 10 takes the necessary actions to modernize our financial system with respect to Glass-Steagell and the Bank Holding Company Act and it takes two other steps that are of critical importance to the administration. It preserves the relevance of the Community Reinvestment Act and it permits financial service organizations to organize themselves in whatever way they feel best serves their business purposes and their customers.

What I would like to do is focus primarily on how H.R. 10 deals with these two issues in what we view to be the right fashion. Then I will briefly mention four other ways that we think H.R. 10 could be improved.

The first is preserving the relevance of the Community Reinvestment Act, which is a key tool in providing capital to distressed areas. We strongly support H.R. 10's requirement that any bank seeking to conduct new financial activities be required to achieve and maintain a satisfactory CRA rating.

In our view, to preserve the relevance of CRA at a time when the relative importance of bank mergers may decline and banks will focus to a greater degree on establishing new nonbank financial activities, the authority to engage in these new activities must be connected to satisfactory CRA performance.

The second administration priority is to allow banking organizations to choose a structure that best serves their customers.

Before getting into specifics on this point, let me make two general observations. The first is that the subsidiary option is a proven success, not a risky experiment, and one that every current and recent financial modernization bill, including the bill reported by this committee last year, would continue to allow in some form. For example, subsidiaries—U.S. banks currently engaged overseas in securities underwriting, merchant banking, and other nonbanking activities—these subsidiaries have over $250 billion in assets, and they would be allowed to continue under all recent versions of H.R. 10 including last year's bill. These subsidiaries, as you know, have been approved by the Federal Reserve Board and are supervised by the Federal Reserve Board.

Second, foreign banks are permitted to engage in securities through subsidiaries in the United States. These subsidiaries, which currently have roughly $450 billion in assets, would be allowed to continue under all recent versions of H.R. 10. And here, too, the subsidiaries have been approved by the Federal Reserve Board and are supervised by the Federal Reserve Board.

The second point is that allowing the choice of subsidiary or affiliate has received broad support. The choice of a subsidiary option. This is supported by the current chairman of the FDIC, which, as you know is the agency responsible for securing bank deposits, and her four predecessors, in total three Republicans and two Democrats, and by independent economists and other academics.

The FDIC chair has testified that subsidiaries are actually preferable to affiliates for purposes of safety and soundness. Of the 18 other countries composing the European Union and the G-10, none requires the use of separate bank holding company affiliates for underwriting and dealing in securities.

Now for specifics. Under H.R. 10, subsidiaries and affiliates are subject to safety and soundness safeguards that are absolutely identical. The bill contains the following rigorous safeguards. Subsidiaries of banks would be functionally regulated in exactly the same manner as affiliates of banks. The authority of the SEC, for example, over subsidiaries engaged in securities activities would be exactly the same as over affiliates engaged in those same activities.

Second, every dollar a bank invested in a subsidiary would be 100 percent deducted from the bank's regulatory capital, just as is the case for every dollar a bank pays as a dividend to its parent holding company for investment in an affiliate. The bank would have to be well-managed and well-capitalized before such an investment and on an ongoing basis with either a subsidiary or an affiliate. A bank could not invest any more in a subsidiary than it could pay as a dividend to its parent holding company for investment in an affiliate.

The rules governing loans from a bank to a subsidiary would be exactly the same as they are for loans from a bank to an affiliate. These safeguards are primarily addressed to safety and soundness; but they also resolve another potential concern, the possibility of a subsidiary gaining a competitive advantage by receiving subsidized funding from the parent bank.

While the idea of a bank having a net subsidy is debatable, these funding restrictions ensure that banks are no more able to transfer any subsidy to a subsidiary than to an affiliate. Now, it has been argued that even with these restrictions in place, the bank would still have an incentive to operate through a subsidiary because the bank's funding cost would be lower.

A bank may have such incentive, but that has nothing—zero—to do with the transfer of any subsidy that may exist. Rather, it is based on the interests of creditors, the same interests that have caused the current Chairman of the FDIC and the four former FDIC chairs, three Republicans and two Democrats, to state that the subsidiary is preferable to the affiliate with respect to safety and soundness. In other words, it is a better credit risk. It may be, I should say, it may be a better credit risk.

If a company has a valuable subsidiary, then the capital markets will reward that company with lower funding costs because, as I said a moment ago, the company is a better credit risk. Creditors prefer to see valuable assets lodged in a place where creditors can reach them if the company gets into financial trouble. The FDIC shares this preference, as it seizes the assets of a bank in the event it fails. A subsidiary meets this test; an affiliate does not. Thus market incentives in this area are rational and have nothing—zero—to do with any subsidy received by the bank.

One last point on subsidy. As I have said, if there is a subsidy, it could be equally transferred to an affiliate and a subsidiary. And if there is one, the evidence is that it is not significant enough to make a truly significant difference. If banks received a net subsidy significant enough to make a competitive difference, then presumably they would dominate the low margin—the very low margin—government securities market. They do not. The same is true with respect to mortgage banking subsidiaries of banks, which do not dominate that area either.

Thus we see no public policy reasons to deny the choice of a subsidiary. However, there are four important policy reasons to allow that choice.

First, financial services firms should, like other companies, have a choice of structuring themselves in the way that makes the most business sense—and that, in turn, should lead to the lowest costs and best service to their customers.

Second, the relationship between a subsidiary and its parent bank provides a safety and soundness advantage as compared to an affiliate, the subject that I have just discussed. And to repeat this once again, it is for that reason that the Chairman of the FDIC and the four preceding chairpersons have said that an op-sub is preferable to an affiliate with respect to safety and soundness.

Third, one of the elected administration's, any administration's, critical responsibilities is the formation of economic policy, for which it is held accountable. An important component of that economic policy for which it is held accountable is banking policy. For an administration to have an effective role in banking policy, it must have a strong nexus with the banking system. That in turn requires the maintenance of the effectiveness of a national bank charter. In this instance, I am talking about bank policy, not regulation. By law, the Secretary of the Treasury cannot get involved in case-specific regulatory matters.

We also believe that it is very important that the Federal Reserve Board maintain its strong connection with the banking system. Therefore, we have taken steps to help ensure that the Federal Reserve's jurisdiction is not weakened. Under H.R. 10, the Federal Reserve would continue to be the sole regulator of bank holding companies and their affiliates, and the largest banks would be required to operate through a bank holding company.

We strongly support H.R. 10, though in certain respects we believe it could be improved. Let me briefly touch on four of those.

We are concerned about the Federal Home Loan Bank System provisions of H.R. 10. A great deal of the subsidized debt raised by the system is used not to expand home ownership, but rather to fund arbitrage activities and short-term lending to benefit the system and its bank and thrift members.

As currently drafted, H.R. 10 takes no steps to ensure that the funds that the system raises will be used for the public purpose for which the system was established. Rather H.R. 10 would allow the system's regulator to cut the capital requirements of the system in half. We believe such a step to be very unwise.

We are also concerned about a provision of H.R. 10 that would allow greater affiliations between commercial firms and savings associations. We have serious concerns about mixing banking and commercial activities. Thus we are concerned that H.R. 10 would allow commercial firms to acquire any of the 600 thrifts currently owned by unitary thrift holding companies.

Finally, we continue to believe that any financial modernization bill must have adequate protection for consumers, and that there are improvements that could be made by this committee and approved by the full House, including provisions addressing securities sales regulation issues.

Let me conclude, Mr. Chairman, by saying that the financial modernization legislation can produce significant benefits, but the job must be done right. H.R. 10 has received broad industry and bipartisan Congressional support, and we believe its critical provisions should be preserved. We look forward to working with this committee and with Congress to move a bill forward that best serves the interests of the American people.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Robert E. Rubin follows:]

PREPARED STATEMENT OF HON. ROBERT E. RUBIN, SECRETARY OF TREASURY

Mr. Chairman, Members of the Subcommittee, I appreciate this opportunity to discuss the Administration's views on financial modernization, including H.R. 10, the Financial Services Act of 1999.

Mr. Chairman, as we approach financial modernization legislation, the Administration's overall objective has been to do what best serves the interests of consumers, businesses and communities, while protecting the safety and soundness of our financial system. We will support legislation that achieves those aims.

Let me begin by noting that the U.S. financial services industry is stronger and more competitive in the global market than at any time in many decades. The United States is dominant in global investment banking and highly competitive in other segments of financial services. U.S. commercial banks are today more competitive abroad than at any time I can remember. The problem our financial services firms face abroad is lack of access rather than lack of competitiveness.

Financial modernization is occurring already in the marketplace through innovation, technological advances, and the lowering of regulatory barriers. Banks and securities firms have been merging; banks are selling insurance products; and insurance companies are offering products that serve many of the same purposes as banking products—all of which increases competition and thus benefits consumers.

Financial modernization will continue in the absence of legislation, but it can, with good legislation, occur in a more orderly fashion. Treasury has long believed in the benefits of such legislation, but we have also been clear that if this is going to be done, it needs to be done right.

Let me turn now to H.R. 10. The Administration strongly supports H.R. 10, which was reported by the Banking Committee by a bipartisan 51-8 vote. H.R. 10 takes the fundamental actions necessary to modernize our financial system by repealing the Glass-Steagall Act's prohibitions on banks affiliating with securities firms and repealing the Bank Holding Company Act prohibitions on insurance underwriting. And it takes two other steps that are of critical importance to the Administration: it preserves the relevance of the Community Reinvestment Act, and it permits financial services firms to organize themselves in whatever way best serves their customers and their businesses.

Today, I would like to focus primarily on how H.R. 10 gets these two issues right. I will then discuss four ways that we believe that H.R. 10 could be improved.

The first issue is preserving the relevance of the Community Reinvestment Act (CRA). CRA encourages a bank to serve creditworthy borrowers throughout communities in which it operates. Since 1993, a greatly invigorated CRA has been a key tool in the effort to expand access to capital in economically distressed areas and to make loans to rebuild low and moderate-income communities.

We strongly support H.R. 10's requirement that any bank seeking to conduct new financial activities be required to achieve and maintain a satisfactory CRA record. If we wish to preserve the relevance of CRA at a time when the relative importance of bank mergers may decline and the establishment of non-bank financial activities will become increasingly important, the authority to engage in newly authorized activities must be connected to a satisfactory CRA performance. We strongly urge the Committee to retain this important provision and otherwise leave CRA intact.

The second Administration priority is to allow banking organizations to choose the structure that best serves their customers. Before getting into specifics, I would like to make two general points.

The first is that the subsidiary option is a proven success, not a risky experiment, and one that every current and recent financial modernization bill—including the bill reported by this Committee last year—would continue to allow in some form. For example:

- Subsidiaries of U.S. banks currently engage overseas in securities underwriting, merchant banking and other non-banking activities. These subsidiaries—which currently constitute $250 billion of assets—would be allowed to continue under all recent versions of H.R. 10, including last year's bill. These subsidiaries, I might add, have been approved by the Federal Reserve and are supervised by the Federal Reserve.
- Foreign banks are currently permitted to engage in securities underwriting through subsidiaries in the United States. These subsidiaries—which currently constitute $450 billion of assets—would be allowed to continue under all recent versions of H.R. 10. These subsidiaries, too, have been approved by the Federal Reserve and supervised by the Federal Reserve.
- Subsidiaries of state banks are currently authorized to engage in a broad range of non-bank activities permitted by their state charter, provided that the FDIC does not find these activities to pose a risk to the deposit insurance funds. Such non-bank activities would continue in some form under all recent bills.

The second point is that the idea of allowing the choice of subsidiary or affiliate has received broad support. The subsidiary option is supported not just by Treasury but also by the current Chairman of the FDIC, the agency responsible for insuring bank deposits, and her four predecessors—two Republicans and two Democrats—and by independent economists and other academics. The FDIC chair has testified that the subsidiary is actually preferable to an affiliate for purposes of safety and soundness. Of the 18 other countries composing the European Union and the G-10, none requires the use of separate bank holding company affiliates for underwriting and dealing in securities. Of those authorizing links between banking and insurance underwriting, all but one allow the choice of a subsidiary or an affiliate. By allowing a choice of structure, H.R. 10 is clearly in the mainstream of economic and legal thinking in this area.

Now, for the specifics. In H.R. 10, subsidiaries and affiliates are subject to safety and soundness safeguards that are absolutely identical. The bill contains the following rigorous safeguards:

- Subsidiaries of banks would be functionally regulated in exactly the same manner as affiliates of banks. The authority of the SEC, for example, over a subsidiary engaging in securities activities would be exactly the same as over an affiliate engaging in those same activities, and customers of that subsidiary would benefit from the same customer investor protections as customers of an affiliate.
- Every dollar a bank invests in a subsidiary would be deducted from the bank's regulatory capital, just as is the case with every dollar a bank pays as a dividend to its parent holding company for investment in an affiliate. A bank would have to be well-managed and well-capitalized before and after such investment is deducted from its capital and on an ongoing basis.

  The capital investment would remain on the bank's books for purposes of Generally Accepted Accounting Principles (GAAP), since all of the assets and liabilities of the subsidiary are consolidated with the bank for GAAP purposes. But that accounting consolidation does not affect safety and soundness in any way: as I noted, the bank must maintain capital at the highest level set by the banking regulators—the well capitalized level—even assuming the investment is a total loss, and the bank cannot lose more than its investments in and loans to the subsidiary, which are expressly limited by statute.
- A bank could not invest any more in a subsidiary than it could pay as a dividend to its parent holding company for investment in an affiliate.
- The rules governing loans from a bank to a subsidiary would be exactly the same as they are for a loan from a bank to an affiliate.

These safeguards are primarily addressed to safety and soundness, but they also resolve another potential concern: the possibility of a subsidiary gaining a competitive advantage by receiving subsidized funding from its parent bank. While the idea that a bank receives a net subsidy is debatable, these funding restrictions ensure that banks are no more able to transfer any such subsidy to a subsidiary than to an affiliate.

Now it has been argued that, even with these restrictions in place, the bank would still have an incentive to operate through a subsidiary because its funding costs would be lower. A bank may have such an incentive, but that incentive has nothing to do with the transfer of any subsidy that may exist. Rather, it is based on the interests of creditors—the same interests that have caused the current and three former FDIC Chairs to conclude that the subsidiary is preferable to the affiliate with respect to safety and soundness.

If a company has a valuable subsidiary, then the capital markets will reward that company with lower funding costs because it is a better credit risk. Creditors prefer to see valuable assets lodged in a place where creditors can reach them if the company defaults. The FDIC shares this preference, as it seizes the assets of a bank in the event it fails. A subsidiary meets this test, but an affiliate does not. Thus, market incentives in this area are rational—and have nothing to do with any subsidy received by the bank. It is difficult to understand why Congress would wish to disrupt these sound market incentives—incentives that also promote safety and soundness.

One last point on subsidy. As I have said, if there is a subsidy it could be equally transferred to an affiliate and a subsidiary. And if there is one, it is not significant enough to make a practical difference. If banks received a net subsidy significant enough to make a competitive difference, then presumably they would dominate the low-margin government securities market. They do not. Presumably, mortgage banking subsidiaries of banks, which currently operate without any of the funding restrictions imposed by H.R. 10, would dominate their non-bank competitors. They do not. I cannot help but conclude from our real world experience that the net subsidy is not that significant and, more importantly, that under the funding limitations of H.R. 10, any subsidy that a subsidiary would manage to extract from its parent bank would be inconsequential.

Thus, we see no public policy reasons to deny the choice of a subsidiary; however, there are four important policy reasons to allow that choice.

First, financial services firms should, like other companies, have the choice of structuring themselves in the way that makes the most business sense and this, in turn, should lead to better service and lower costs for their customers.

Second, the relationship between a subsidiary and its parent bank provides a safety and soundness advantage. As I have noted, firms that choose to operate new financial activities through subsidiaries are, in effect, keeping those assets available to the bank rather than transferring them outside the bank's reach. The bank's interest in the subsidiary could be sold if it ever needed to replenish its capital. If the bank were ever to fail, the FDIC could sell the bank's interest in the subsidiary in order to protect the bank's depositors and the deposit insurance fund.

Third, one of an elected Administration's critical responsibilities is the formation of economic policy, and an important component of that policy is banking policy. In order for the elected Administration to have an effective role in banking policy, it must have a strong connection with the banking system. That connection would be weakened if new financial activities were off limits to OCC supervision.

We also believe it is very important that the Federal Reserve Board maintain its strong connection with the banking system, and therefore we have taken steps to help ensure that the Federal Reserve's jurisdiction is not weakened. Under H.R. 10, the Federal Reserve would continue to be the sole regulator of bank holding companies and their affiliates, and the largest banks would be required to operate through a bank holding company. The Federal Reserve would also supervise subsidiaries of State member banks, and would continue to supervise overseas subsidiaries of national banks and U.S. subsidiaries of foreign banks. Insurance underwriting would be conducted solely in Federal Reserve-supervised bank holding company affiliates. And the Federal Reserve would have the authority to veto any new activity for a subsidiary—Fed-supervised or not—just as the Treasury would have the authority to veto any new activity for an affiliate.

While we strongly support the House Banking Committee bill, there remain certain aspects of the bill that concern us.

We are concerned about the Federal Home Loan Bank System provisions of H.R. 10. The FHLBank System is currently the largest issuer of debt in the world. Last year, it issued approximately $2.2 trillion in debt, and it currently has $350 billion in debt outstanding. As a government sponsored enterprise directed to foster home ownership, the System receives tax benefits, an exemption from SEC registration for its securities, and benefits from a market perception that the government stands behind the System, even though there is no legal obligation to do so. Yet a great deal of the government subsidized debt raised by the System is used, not to advance its home ownership purpose, but rather to fund arbitrage activities and short-term lending that benefit the System and its bank and thrift members. For those who care about the market-distorting effects of government subsidies on U.S. markets, the Federal Home Loan Bank System should be a substantial concern.

The System's arbitrage is not only an abuse of its government subsidy but also injects risk into a System that was designed—by requiring all loans to be collateralized by stable, low-risk mortgages—to have very little.

As currently drafted, H.R. 10 effects no reform of the System's arbitrage and takes no steps to ensure that the funds it raises will be used for a public purpose. Rather, H.R. 10 would allow the System's regulator to cut the capital requirements of the System in half. We believe such a step is very unwise.

We are also concerned about a provision of H.R. 10 that would allow greater affiliations between commercial firms and savings associations. We have serious concerns about mixing banking and commercial activities under any circumstances, and these concerns are heightened as we reflect on the financial crisis that has affected so many countries around the world over the past two years. Thus, we are concerned that H.R. 10 would allow commercial firms to acquire any of the over 600 thrifts currently owned by unitary thrift holding companies. Currently, only a few unitary thrifts are owned by non-financial firms—many are owned by insurance companies and securities companies, for example—but if H.R. 10 were to break down the barriers to affiliation among financial firms, then their need for owning thrifts would be substantially reduced. The logical buyers at that point would be non-financial firms.

We continue to believe that any financial modernization bill must have adequate protections for consumers. We believe that improvements should be made by this Committee and approved by the full House. Thus, we look forward to working with the Committee on provisions addressing sales of securities regulation issues.

Mr. Chairman, let me conclude by reiterating that financial modernization legislation can produce significant benefits, but the job must be done right. H.R. 10 has received broad industry and bipartisan Congressional support, and we believe its critical provisions should be preserved.

We in the Administration look forward to working with you and others in Congress to move the bill forward and improve it where necessary in order to produce legislation that truly benefits consumers, businesses and communities, while protecting the safety and soundness of our financial system. Thank you very much.

Mr. OXLEY. Thank you, Mr. Secretary. We again appreciate your willingness to come here to testify and to answer some questions. Let the Chair begin with some questions.

This is perhaps inevitable because there was so much discussion about operating subsidiaries both by Chairman Greenspan last week and then you in your testimony today.

So let me begin with the obvious. You have indicated you believe that the provisions in the bill H.R. 10, as passed by the Banking Committee, effectively curtail the transfer of the subsidy that exists for banks to their operating subsidiaries. Would the provisions of H.R. 10 requiring deduction of investments and operating subsidiaries apply only to regulatory capital of the bank and not necessarily the operating capital?

Mr. RUBIN. Well, what the legislation would do is require a deduction from the regulatory capital. In terms of GAAP accounting, they would still be consolidated. But as you know, Mr. Chairman, if it turns out there were losses in the subsidiary, then the bank, when it sells the subsidiary or liquidates the subsidiary, whatever the case may be, for GAAP purposes it would recapture those losses. They would be in effect recaptured at the bank level. But for regulatory capital purposes, the deduction would be 100 percent.

Mr. OXLEY. Chairman Greenspan testified to this committee on two different occasions that the Fed had done an extensive study and indicated that banks using the operating subsidiaries concept would enjoy a 10 to 12 basis point advantage over other financial institutions.

You obviously disagree, but I am curious as to why such a wide disparity of opinion between two well-respected individuals such as yourself and Chairman Greenspan.

Mr. RUBIN. Could I correct one oversight. I apologize, Mr. Chairman, I have forgotten to introduce our Assistant Secretary, Rick Carnell, who is absolutely delighted to respond to questions as well.

Mr. OXLEY. Welcome, Mr. Carnell.

Mr. RUBIN. I apologize to Rick for that.

I lived in capital markets, as you know, Mr. Chairman, for 26 years before I entered the world of—I don't know how to describe the world that I am in now. I was going to say something, but I decided not to.

If there is a funding advantage, and I think, by the way, this may cut both ways. Let me give you a full answer, if I may, because it is a somewhat complicated question. It is one that I actually know something about.

If there is a funding advantage to a bank in setting up a subsidiary, it has nothing to do with transfer of subsidy. That is identical. But if you are a creditor of a bank and the bank takes a certain portion of its capital and puts it into the subsidiary to conduct securities business or whatever it may be, securities underwriting, those assets then remain subject to the creditors of the bank if the bank gets in trouble without having to get bank board approval or any such thing.

If the bank gets in trouble, the creditors can simply seize all of the assets. So the bank is actually a better credit risk. The same reason the FDIC says the subsidiary is preferable for safety and soundness, it is also better for credit risk. There are many instances if they put the—or at least in some instances, if they put the assets in the subsidiary rather than putting them in the affiliate, because if so, then the creditors can't grab them.

Now, on the other hand—how much of a funding advantage that would be I don't know, Mr. Chairman.

On the other hand, there may be other banks that would have just the opposite incentive, because they may have a holding company, which is where a lot of the financing gets done, that is doing financing at unattractive rates because the creditors are concerned that the flow of funds from a subsidiary could be interrupted by a bank regulator. So what they might like to do, what the creditors of the holding company would like to see, is a larger portion of the assets be in the affiliate. So in that case, that might actually be an incentive for the bank to take its capital and put it in the affiliate to engage in the new activities. So it is a very complicated subject cut either way.

But in the cases in which there is a funding advantage by putting assets into the subsidiary, conducting activities in the subsidiary, this has zero—nothing—to do with passing along a subsidy; it has everything to do with simply being a better credit risk.

Mr. OXLEY. The Chairman said that he, along with the other members of the Board of Governors, had made an extensive study and indicated some numbers that you could actually get ahold of. That is, he indicated that it was a 10 to 12 basis point advantage.

Mr. RUBIN. Mr. Chairman, if there is, it is simply because it is a better credit risk because that is how they operate. But let me ask Mr. Carnell to respond.

Mr. CARNELL. If I could just put it in context and then respond to the specific point about the differences.

The typical bank holding company has a tremendous reliance on its subsidiary banks for its assets and its earnings. The banks are most of the holding company's assets. And the holding company is typically completely dependent on those banks for money with which to pay its own debt. The reason that holding companies pay more than their banks to borrow money is that creditors price in the risk that—if the bank gets into trouble—the bank regulators or even the prompt corrective action statute will cutoff the flow of dividends from the bank to the holding company. That is the key to the pricing difference.

Chairman Helfer in her 1997 testimony before the Banking Committee spoke specifically about this point. The FDIC staff did a study where they talked to the rating agencies about why the banks and the holding companies had different credit ratings which reflects this different cost of capital, the different costs of funds here. And the answer that the rating agencies gave was that there was a greater risk of this interruption of dividends.

Let me point to another risk, in addition to the risk of interruption of dividends, and that is that if there were to be any failure of the bank, the creditors of the holding companies are going to wait in line last, they are going to wait in line after the FDIC and the depositors of the bank, they are going to wait in line, so they are really in the same position as stockholders of the bank, because they don't get anything unless the holding company, as a stockholder of the bank, gets something. So it reflects the structural weakness of the holding company rather than any transmission of subsidy.

Mr. RUBIN. Very good.

Mr. OXLEY. The Chair's time has expired.

The gentleman from New York, Mr. Towns.

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

Let me begin by saying, can we be guaranteed—well, I won't use the word guaranteed, but "assured" of competitive equality if we adopt an operating subsidiary provision?

Mr. RUBIN. I think, Mr. Towns, that you can be assured of absolute competitive equality, except to the extent that—which is the issue we were just discussing—except to the extent that the bank is actually a better credit risk and safer and sounder, which obviously is to the benefit of the taxpayers, because the assets have been put in a place where they can be reached by the FDIC and the creditors. So I think there is zero difference with respect to transfer of a subsidy. Zero. But to the extent that creating the subsidiary structure actually makes the bank a better credit risk, then that is in the interests of the taxpayers and might create some funding advantage for the bank.

Mr. TOWNS. Can we maintain functional regulations of securities and insurance activities under an operating subsidiary structure?

Mr. RUBIN. We have provided—or I shouldn't say we have provided, I apologize. H.R. 10 provides that functional regulation of the op-sub is to be identical to functional regulation of the affiliate. Now, we did not actually put—as you know, H.R. 10 does not put insurance underwriting in the op-sub, but with respect to securities underwriting and merchant banking—which would be done there—functional regulation would be absolutely identical, and this is specifically so provided in H.R. 10.

Mr. TOWNS. What else other than the comments that you have made, do we need to do, do you feel, to really fix this bill?

Mr. RUBIN. I think——

Mr. TOWNS. You know we have been trying to do this for 65 years.

Mr. RUBIN. The Congress has been trying to do it for a while, but not everything happens immediately.

Mr. TOWNS. You were not here all 65 years.

Mr. RUBIN. That is a long time, I agree. I think you are on the verge of a good bill, Mr. Towns, I really do. I think the confluence of forces that have come together have come very close to producing a good bill. I would urge, this is my view, at least, that we take a look at the Federal Home Loan Bank provisions in the sense that I mentioned. FHLOB serves a very important purpose, but I think that the fact that there is so much focus on arbitrage and overnight loans is an issue that ought to be dealt with. There are some consumer protection issues that I think should be taken care of. We very much share the SEC's concerns about certain issues with respect to functional regulation that we would like to work with the

SEC and the committee on to improve, but I think you are close to a very good bill.

Mr. TOWNS. Thank you very much, Mr. Chairman. I yield back.

Mr. OXLEY. The gentleman yields back.

The gentleman from Illinois, Mr. Shimkus. I am sorry, the Vice Chairman from the State of Louisiana, Mr. Tauzin.

Mr. TAUZIN. Mr. Secretary, how can you say that there is no competitive disadvantage, that the competition is equal, except? "Except" means it is not equal.

I mean, if Mr. Greenspan is correct, weighing in all of these factors of greater creditor position and cheaper capital as against the possibility of a bank regulator stepping in because of some problems at the bank, weighing in all of those features, you have a 10 to 12 basis point advantage, and if you are giving the banks op-sub access to the payment system that other securities and insurance firms don't have, how can you say that the competition is equal?

Mr. RUBIN. Well, the op-sub would not have access to the payment system, and any benefit that the bank gets by access to the payment system can be transferred equally to the op-sub or to the affiliate.

I don't know what advantage any particular institution would have with respect to its overall funding by using an op-sub, but one thing I am sure of is that each of these cases is going to be different. I have no doubt, since most of the funding for these institutions is done at the holding company level, that there will be many instances that the institution will actually think its economic advantage lies in putting its assets into the affiliate.

But unfortunately—I shouldn't say unfortunately—the holding company is in a weaker position for funding, and if assets can be put outside of the reach of the bank regulators, that is better from the point of view of the holding company and the holding company's funding rates.

In the instances where the subsidiary does create an advantage, it is simply a better credit risk. It is safer and sounder for the taxpayers.

Mr. TAUZIN. You said in some instances the bank is a better creditor. You obviously would make room for the fact that in some instances it is not.

Mr. RUBIN. No. Oh, no, no. All I was saying is that if there is a funding advantage, it is solely—100 percent—solely because the bank is a better credit risk due to the fact that the assets are someplace that can be reached by the bank's creditors.

Mr. TAUZIN. Isn't that going to be different from bank to bank? I assume if you have a bank that is in an excellent position, it may indeed enjoy a heck of an advantage with a op-sub provision in this bill. If a bank is in a more tenuous position where in fact there may be fear of Federal banking regulators disrupting the flow of dividends, then that may be—that may not be such a good idea to go with the——

Mr. RUBIN. No, I think it actually cuts the other way, Mr. Tauzin. If you have a very, very strong bank, then the creditors aren't going to be concerned about the possibility of the failure of the bank. Therefore, keeping the assets within reach of the creditors isn't going to matter. But it may be, in fact it could well be, that the creditors——

Mr. TAUZIN. It may well be that——

Mr. RUBIN. Wait a minute. The creditors of that institution could be concerned about the holding company and might like to see the holding company strengthened, in which case the cost of money actually is benefited by taking the assets and putting them into the affiliate.

Mr. TAUZIN. I grant you that. I grant you it may be—I see that. But the point is it is going to be different, depending upon the position of the bank, and in some cases the bank, I think, is going to have a very clear advantage over a nonbank insurance or securities firm. And the question we are going to have to face in this committee is whether or not, as Mr. Towns alluded to, whether or not that is really fair competition or we are creating an old, traditional, unlevel playing field again.

Mr. RUBIN. Oh, I don't agree with that. I think what you have got is that where a bank is a better credit risk—and it can be a better credit risk for an enormous number of reasons—then it should be able to borrow more cheaply. That is how the credit markets work. There are all kinds of reasons why it might be a better credit risk, and one of them might be that it has taken a bunch of its assets and decided to do securities underwriting or dealing or whatever through a subsidiary and kept those assets subject to the claims of its creditors.

Mr. TAUZIN. I know my time has certainly about expired, but I would like very much, Mr. Secretary, if you would specifically address the 10 to 12 point basis points study and indicate for us, perhaps in writing, why you think it is flawed in any respect. Because if that is a real number that we have our hands on what Mr. Greenspan has supplied to us that is still sitting out there unchallenged, except in theory, without a specific refutation, the concerns are real.

Mr. RUBIN. I would be delighted to respond, we would be happy to respond. But one thing I can assure you of, Mr. Tauzin, is that if there is an advantage—and I suspect every institution will be different. I know, I used to do this for a living. If there is a difference, it is solely for the same reason that all other companies have different rates as amongst themselves: because of credit differences.

Mr. TAUZIN. That is the way it should be. It should not be because of language in this bill. That is what concerns me.

Mr. RUBIN. That is the point, I agree. This bill should not restrict a banking institution from finding the way that makes it the most creditworthy borrower and therefore having the best rate, and that is in the taxpayers' interest, and that is why the Chairman of the FDIC says there should be choice, to enable banks to do that which will—that structurally, make them safest and soundest. That is exactly the point.

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

The gentleman from Michigan, Mr. Dingell.

Mr. DINGELL. Mr. Chairman, I certainly want to welcome my old friend Mr. Rubin back to the committee. We always enjoy his visits here and find them enormously valuable and informative. I would like to welcome my good friend back.

Mr. RUBIN. Thank you, Mr. Dingell.

Mr. DINGELL. I have been very much impressed, Mr. Rubin——

Mr. RUBIN. I can't quite hear you.

Mr. DINGELL. I have been very much impressed with the comments you made about how allowing a bank to have an operating sub which would do all of these things would be a benefit to the bank, would be of benefit to the bank in terms of its liquidity, in terms of its earnings, in terms of its credit risk, and a number of other things.

I am curious, I am curious—the bill also gives, however, to the bank the ability to do these things in a wholly owned affiliate, but none of the advances and advantages appear to apply to the affiliate, and I am just curious; why would a bank choose to utilize the affiliates if there are such huge advantages to the bank by going through the operating subsidiary?

Mr. RUBIN. I didn't mean to imply, Mr. Dingell, that in all or even in most instances a subsidiary would be preferable. I think there would be many instances in which a bank holding company, which is where most of the financing is done for these institutions, will determine that it is preferable to take the assets and put them into the affiliate, because the problem that the bank holding companies have is that, in effect, the creditors of the bank holding companies come behind the creditors of the bank. I am just telling you things you know. So what the creditors of the bank holding company like to see are assets that lie outside of the reach of the bank regulators. So I actually think that in many instances, the affiliate would have the advantage, not the op-sub, in terms——

Mr. DINGELL. That would be particularly true where you had a weak bank, and it would be particularly true where you had a holding company that was apprehensive about the weakness of the bank, its credit ratings, and also about the fact that that bank might go under.

Mr. RUBIN. Well, you know, it is funny. I think it could actually cut both ways, because if you have a weak bank and the holding company is worried about the weak bank, they have competing considerations. But it seems to me by giving them their choice and allowing them to do what is best for them, I think they will probably do what is best for the taxpayers and the FDIC. But if they have a weak bank, Mr. Dingell, it may well be that they will decide the thing they have to do is to take those assets and keep them where it most reassures the creditors of the bank, and that would be to put them in the op-sub.

On the other hand, they might say, no, we want to make sure that our holding company is in the best position possible, and therefore put them in the affiliate. I think every business situation is going to be different.

Mr. DINGELL. Well, now, here we have——

Mr. RUBIN. I might say that if the bank is actually weak, then you can't have a sub in the first place. There is a capital requirement to have these new activities, as you know.

Mr. DINGELL. Here you note that, in the case of operating subsidiaries, that to keep these banks—or rather to keep the assets of these kinds of facilities available at the bank rather than transferring them out of the bank's reach, the bank's interest in the subsidiary could be sold if it needed to replenish its capital. If the bank were to fail, the FDIC could sell the bank's interest in the op-sub in order to protect the bank's depositors and the deposit insurance fund; isn't that so?

Mr. RUBIN. Correct.

Mr. DINGELL. So now this gets down to raising several questions. This is a great deal for banks, but how is it fair to the competition with nonbank competitors?

Mr. RUBIN. Well, I think that in terms of the nonbank competitors in the securities businesses, Mr. Dingell, they will themselves have all sorts of ways that they raise money. The way the system basically works is that each competitor organizes—I used to do this when I ran these places—organizes itself in the way to most effectively raise money. We had all sorts of subsidiaries in order to raise money most effectively, and I assume that is what a bank would do.

Mr. DINGELL. How does it create a level playing field, and how will your firewalls be real if your statements about keeping these assets in the hands of banks are also true?

Mr. RUBIN. Well, you have a level playing field with respect to transfer of subsidy. There is no difference— zero difference—with respect to transferring the subsidy. With respect to allowing institutions to organize themselves in a way that makes them most attractive to creditors, your level playing field is that every institution that is involved in the competitive arena will presumably organize itself so as to effectively raise money.

Mr. DINGELL. How about an entity that chooses to remain simply a financial institution which is not a bank, a Wall Street broker? This puts enormous pressure, for example, on a national or regional broker to simply either sell out to or be bought by or to buy a bank, so that it would derive these benefits. So you are essentially driving the systems toward a peculiar kind of homogeneity.

Mr. RUBIN. I don't think so, Mr. Dingell, for two reasons. No. 1, I don't think the evidence suggests that the funding advantage is substantial enough to have an effect, or to have a meaningful effect on the business results of these organizations. But much more importantly, I think that what you have right now is different organizations that compete with each other, each trying to raise money in whatever way is most effective for them. And all you are saying here is that we are not going to allow the banks to take advantage of the subsidy, zero. We are not going to allow them to take advantage of their subsidy, but we are going to have full competition. That is the idea of financial modernization.

And for full competition that has no advantage to the subsidy, these institutions can find some way of raising money more cheaply and offering their customers a lower-cost service. That is what competition is all about.

Mr. DINGELL. Isn't it also true, however, that there are huge advantages——

Mr. RUBIN. That there are what?

Mr. DINGELL. Isn't it also true that there are huge advantages, both to the bank and to the operating subsidiary in terms of lower capital costs, lower cost of money, greater efficiencies by keeping the brokerage business or the insurance business in the operating sub?

Mr. RUBIN. Well, the insurance business can't be in the operating sub, because H.R. 10 wouldn't allow that. If there are advantages in financing, Mr. Dingell, then those advantages, as I said a moment ago, have nothing to do with subsidy, and it really is the American economic system at work, which is institutions finding ways to more effectively raise money. It is for the same reason when I was part of an investment banking firm——

Mr. DINGELL. So there is an advantage there. By the way, I would note that the insurance underwriting is in the operating sub.

Mr. RUBIN. No. That would be the affiliate.

Mr. DINGELL. But the sales are.

Mr. RUBIN. The sales can be.

Mr. DINGELL. The sales can be, and that is, of course, to me the most troublesome part of the business.

Mr. RUBIN. There may be an advantage in funding, Mr. Dingell. If there is, that, in effect, is why we are doing financial modernization all together, which is to absolutely preclude any unfair use of the subsidy, and beyond that, to encourage greater competition. If we weren't going to do that, then it seems to me we shouldn't be in financial modernization all together.

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

Mr. DINGELL. I thank you, Mr. Chairman.

Mr. OXLEY. The gentleman from Iowa, Mr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman. Thank you, Mr. Secretary, for coming. I have four questions on operating subs, so I guess about a minute, 15 seconds for each one of those. We will see if we can get through these.

Mr. Secretary, the Treasury Department in the 1980's opposed expanded powers for operating subs. Why has the Treasury changed its view?

Mr. RUBIN. That was a totally different set of proposals with respect to operating subs. They did not have the safeguards that we have in this proposal. Just a different proposal.

Mr. GANSKE. All right. The Treasury has criticized Japan for having extensive subsidies and conflicts of interests in their financial system and has encouraged the Japanese to adopt a holding company structure for their banking system, I believe. If that is true, why?

Mr. RUBIN. No, we didn't actually recommend a holding company. We have been critical of certain practices in the Japanese banking system—and I think there are very serious issues that need to be addressed—but they have nothing to do with the op-sub versus affiliate question. In fact, in Japan, as you probably know, banks have the choice now of an op-sub or an affiliate, except in certain respects with respect to insurance, but we never had anything to do with that issue. They have a combination of banking and commerce, and I think there have been a lot of issues there that at least should be focused on, in our judgment.

Mr. GANSKE. I think it is fair to say that the Treasury Department has been concerned about the interconnectedness in the Japanese economy; is that not true?

Mr. RUBIN. Yes, but that had nothing to do with the question of whether a financial institution conducted its nonbanking financial activities in the op-sub or the affiliate. It had to do with the keiretsu, the interlinking, if you will, of banking and commerce.

Mr. GANSKE. So what you are saying is that under—if you have certain safeguards, your position is that op-subs are okay?

Mr. RUBIN. Our position is that with the safeguards in H.R. 10, op-subs are absolutely identical to affiliates.

Mr. GANSKE. Okay. Well, you indicate that there haven't been any problems with op-subs. I understand that NationsBank settled claims of $50 million for defrauded investors with securities sold by an op-sub. Do you have the facts of that case, and what are the banking regulators doing about that?

Mr. RUBIN. Let me make a general comment and ask Mr. Carnell to respond, if I may. I have no doubt that from time to time, in any sort of organization, there are going to be issues. The organization that I ran had issues from time to time, and we had to deal with them. I don't think that in itself speaks to the question of op-sub versus affiliate. In fact, I apologize for not remembering the name of it, but there was a bank with an affiliate that through mortgage banking activities failed in 1976 because of the activities between the affiliate and the bank. So this can happen under any structure.

Mr. CARNELL. The NationsBank securities firm was an SEC-registered broker-dealer. The OCC and the SEC worked together in dealing with the abuses there, and all of this was done completely within the jurisdiction of the SEC.

Mr. GANSKE. All right. Well, here is my crucial question, because I don't want to see this financial services bill flounder on this op-subs thing. I hope that we can find some compromise between the administration and the different parties on this. You point out that the Commerce Committee print from last Congress provided for limited operating subsidiaries. These op-subs were limited to agency activity to address Chairman Greenspan's concern about giving away taxpayer money.

My question is, would you be willing to support agency-only op-subs as the compromise to try to keep this moving along?

Mr. RUBIN. The answer to that is no, but that was not my point about the H.R. 10 of last year. I apologize. My point was that the foreign subsidiaries of U.S. banks, and the U.S. subsidiaries of foreign banks, can do the kinds of activities that we are talking about, and they are both subject to Fed approval and Fed regulation. That was my point, not the provision you were talking about.

Mr. GANSKE. And so—if you would clarify for me again what is your position at this time on what we had in our print last year, limiting op-subs to agency activity.

Mr. RUBIN. That in our judgment is not responsive to our belief that banks should have choice for the reasons that I have said. That would not be a satisfactory provision. My point about last year's bill was that you all did actually approve a bill that involves very substantial securities dealing and underwriting activities by subsidiaries of banks. That was my only point.

Mr. GANSKE. Mr. Chairman, let me just ask one follow-up question, with your permission.

Mr. Secretary, how do we get this agreement on this? How are you and Mr. Greenspan and Mr. Levitt going to come together on this?

Mr. RUBIN. Well, let me say that the Fed and the Treasury have an extraordinarily good working relationship, and I think it has been of tremendous benefit to this country. I think the probability of this country being able to provide the leadership it did in connection with the financial crises of the last 2 years would have been substantially reduced if we did not have the excellent working relationship we have. This is a matter where we simply disagree.

But you have a bill that has passed, 51-8, so there was obviously strong bipartisan support in the House Banking Committee. And that is a bill that, in our judgment at least, should be the basis, with some minor matters that need to be dealt with, should be the way in which financial modernization is dealt with.

Mr. GANSKE. Thank you.

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

The gentleman from Michigan, Mr. Stupak.

Mr. STUPAK. Thank you, Mr. Chairman.

Mr. Secretary, in just listening to testimony, when we talk about operating subsidy, I believe we are talking about access to the discount window and the Federal guarantee to insure the bank assets. Do you disagree with that?

Mr. RUBIN. I do. We are not talking about the operating sub having any access to the window, or any guarantee of assets. The operating sub would have none of that.

Mr. STUPAK. But the bank has the access which makes the capital then cheaper, does it not, if the bank has access to the discount window and the guarantee?

Mr. RUBIN. The bank has the access. That may make their capital somewhat cheaper, although that, as you know, is a matter that is somewhat disputed. But the subsidy that is thereby created can then only be transferred to the subsidiary in accordance with the provisions of H.R. 10. And under those provisions, the affiliate and the subsidiary are exactly identical—100 percent identical—with respect to the ability to benefit from the subsidy. A zero difference.

Mr. STUPAK. All right. Let me ask you this. In your statement, you maintain that a bank would not transfer the subsidy it receives through the access to the payment window and deposit insurance to a subsidiary anymore than an affiliate, because it would have to provide loans on the same terms.

Mr. RUBIN. Correct.

Mr. STUPAK. It is my understanding that Chairman Greenspan was not primarily concerned about the loans, but the fact that the capital banks invest in subs would be subsidized, and in case of the affiliate, the bank would not invest in the affiliate, only the parent who does not derive a subsidy.

Now, so you don't dispute the notion that the access to the discount window and the Federal guarantee to insure bank assets decreases the cost of their capital, do you?

Mr. RUBIN. No. What I disagree with is the other parts of the statement that you made. There is a very lively debate amongst people who are expert in this area as to whether or not there is an actual subsidy in the bank, because as you know, the bank——

Mr. STUPAK. But it is not an actual subsidy, right? I mean, it is the access to the discount window and the Federal guarantee.

Mr. RUBIN. You have Federal guarantee, you have access to the discount window, both of which are benefits to the bank, but the bank also takes on other responsibilities. For example, CRA. I can just tell you if you read the literature and you talk to people in this world, they will tell you that there is a very lively dispute as to whether there is a subsidy, whether or not that subsidy exists. But I am not engaging in that debate at the moment. I am saying whether or not that subsidy exists is irrelevant with respect to this op-sub affiliate debate because the ability to take that subsidy and put it in one or the other is exactly the same.

Now, for the reasons that we discussed with others—including, I think, Mr. Dingell—a bank for all kinds of economic reasons may choose either the op-sub or the affiliate as the place to put its capital. I think there are some instances where I think they feel the affiliate gives them the greatest overall competitive advantage, and there are some that are going to consider that the op-sub gives them the greatest competitive advantage, but that has zero to do with the subsidy.

Mr. STUPAK. If it is exactly the same, as you said, then are you saying, then, that Goldman Sachs and Citicorp can obtain loans or issue debt at the same terms?

Mr. RUBIN. Citicorp, the holding company, or Citicorp, the bank?

Mr. STUPAK. The bank.

Mr. RUBIN. No, the bank may have a subsidy. That isn't the issue, Mr. Stupak. The question is, if they have a subsidy, and it is not so clear they have a subsidy—let me say, we competed with Citibank, wonderful institution, great institution, but we competed with them very effectively when I was in the securities business. But in any event, it suggests to me that if there is a subsidy, it isn't very large, where a large subsidy would be a determinative factor. In fact, the investment banks were extremely competitive.

But leaving that aside, if there is a subsidy, it is equally transferable to the affiliate and to the subsidy. The subsidiary has no more advantage than the affiliate; it can be equally transferred to both. There are certain instances in which an institution will feel that its overall funding is advantaged by putting it in the affiliate, and there are other instances where they feel it would be an advantage by putting it in the subsidiary. That has nothing to go with the question of whether there is a subsidy.

Mr. STUPAK. But the answer then to my question based on your answer is, no, that they can't do it on the same terms; correct?

Mr. RUBIN. Can't do what?

Mr. STUPAK. Issue debt on the same terms, Citicorp or Goldman Sachs. They can't issue on the same terms.

Mr. RUBIN. Actually, we can respond to you in writing, Mr. Stupak, but I am not so sure you are right about that. What kind of debt are you talking about? Is it overnight debt or 1 week debt or 1 month debt?

Mr. STUPAK. Well, as you formulate your answer, take the transcript and read it back and I think you will find your answer was no. So therefore,——

Mr. RUBIN. Well——

Mr. STUPAK. Well, just humor me and read it back before you answer my question if you are going to put it in writing, okay?

Mr. RUBIN. Mr. Stupak, even if you are right—and I think it is a much more complicated question than lends itself to a simple answer—it doesn't matter. Because if Citibank can get an advantage in borrowing, if there is a subsidy, then the question is, can Citibank transfer that subsidy any more readily to an op-sub than to an affiliate? And the answer to that is 100 percent no.

Mr. STUPAK. But they invest in their op-sub, right?

Mr. RUBIN. But they invest in the affiliate. What they do is, as you know, they move it up to the parent and then the parent takes that—if it is subsidized—subsidized capital and invests it in the affiliate. The same thing. Exact same thing.

Mr. STUPAK. All right. You mentioned that the foreign banks can engage in securities activities. Was Divo Securities an operating sub?

Mr. RUBIN. Was Daiwa securities? I actually don't know. You mean their operations here? They were subject to Fed supervision. I don't know whether it was a sub or not. Do you know? I don't know. We can get back to you.

I don't think it would make any difference, really. I think that is irrelevant to this argument, but I don't know whether it was a subsidiary or some other form, I don't know. My guess is since that was a banking activity, my guess is it was not a subsidiary, but I don't know.

Mr. STUPAK. I don't know either. I thought I would ask.

Chairman Greenspan stated in his testimony that Treasury had consistently opposed the operating subsidy in previous administrations. Why has this Treasury changed that prior policy.

Mr. RUBIN. Because what we did was to change the proposal. The op-sub that H.R. 10 contains is very substantially different than the proposal that the Treasury used to oppose.

Mr. STUPAK. Okay. You indicated that State banks are allowed to engage in a broad range of activities subject to their State charters and agreed to by the FDIC. How many States have allowed securities underwriting by State banks, and how many banks has the FDIC allowed to underwrite securities?

Mr. RUBIN. I do not know the answer to that. Do you?

Mr. CARNELL. Many States allow securities underwriting.

Mr. STUPAK. How many is many?

Mr. CARNELL. I don't know the number. We can get back to you for the record, but a substantial number of States allow underwriting in securities of State banks. The actual number of banks that have come to the FDIC over the 13 years in which the FDIC has allowed this is not large. It is a handful right now. There have been no problems at those banks, by the way.

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

The gentleman from Illinois, Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman.

It is good to have you, Mr. Secretary. I have great respect for your knowledge and experience, along with the Fed Chairman. So if we have two credible proponents of two opposing views on financial modernization, other factors may—you know, the public may be addressing other concerns.

So let me ask a question that hasn't been asked yet, and I don't mean it to be disparaging of the administration, but if the public wants to ensure that our financial institutions are devoid of political influence regardless of who is in power in the executive branch, why would they, the public as a whole, safety and soundness, why would they side with your position versus the Fed Chairman's?

Mr. RUBIN. I think that is a good question. What the public does when they elect an administration is they basically give to that administration the responsibility and the accountability, for that matter, for economic policy; and economic policy very much includes banking policy.

I think the critical distinction—and I think you are getting to a good point, Mr. Shimkus—the critical distinction, it seems to me, is between economic policy, banking policy—where the Secretary is and, I think, should be deeply involved—and regulatory matters where it seems to me the Secretary should not be involved. And it is a violation of Federal law for the Secretary to be involved in case-specific regulatory matters. And by that I presume——

Mr. SHIMKUS. I thought you were going to give me something else.

Mr. RUBIN. I don't know this, but I presume that it was made a violation of law precisely to protect the public against the concerns that you just mentioned.

Mr. SHIMKUS. During my short time as a member of the subcommittee, the big battles between the bank holding company and the operating sub, that is how I like to—my terminology that I am comfortable with saying—under the operating sub which you support, the FDIC insurance—you are saying that there will be firewalls so that the FDIC insurance will not be at risk based upon the activities of the other elements in the operating sub, the insurance or the securities instances. But can you put a price on the full faith and credit of the Federal Government? You can't quantify that financially.

Mr. RUBIN. Well, what I am saying, Mr. Shimkus, and what the Chairman of the FDIC is saying, is that the taxpayers' funds are better protected by having the nonbank financial activities in the subsidiary than in the affiliate. The problem for the taxpayers—the FDIC, as you say—lies if the bank gets in trouble. And if the bank gets in trouble, the FDIC can liquidate the subsidiary and take the proceeds and use them to deal with the problems of the bank. If the activities are in the affiliate, then the FDIC cannot automatically reach those assets—in fact they can't—and liquidate them.

Mr. SHIMKUS. But many of us are saying there is more risk taking the other view. If in essence the FDIC is—which you can't quantify the benefits to the operating sub of the other elements in the insurance and also——

Mr. RUBIN. No, but there is no way that the problems in the op-sub—I see your point—can adversely affect the bank, because as you know, under American corporate law——

Mr. SHIMKUS. I am not a lawyer, so I don't know.

Mr. RUBIN. The parent is not responsible for the liabilities of the subsidiary, so the problems of the sub won't affect the bank. But conversely, if the bank gets in trouble, then the FDIC can reach the subsidiary. This is the reason that the current FDIC Chairman and four predecessors—three Republicans and two Democrats—have said they prefer for safety and soundness purposes the op-sub. They are actually looking at exactly what you are looking at, safety and soundness, and they are saying the op-sub is preferable for precisely these reasons.

Mr. SHIMKUS. That is all I have, Mr. Chairman. Thank you.

Thank you, Mr. Secretary.

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

Mr. MARKEY. Thank you, Mr. Chairman, very much. Welcome, Mr. Secretary.

The subject I want to address if I could is the issue of privacy. I believe that every American has a right to knowledge that information is being gathered about them, notice that the information is going to be reused for purposes other than that which they had originally intended, and the legal right to say no with penalties against any entity which reuses that information: financial services, health care, any information technology. Fundamental right.

Do you believe that a person's privacy is a property right? Does someone have the right to their own person, their own information, their own history? Is that a property right?

Mr. RUBIN. Could I give a two-part answer, Mr. Markey? When you stated the general principle, I was thinking to myself, I agree with you. When you stated it as a property right—I certainly agree with the general principle. You know, a property right is a very specific legal term with a lot of ramifications—and I would have to think about that. But I certainly agree with the principle.

Mr. MARKEY. We spend a lot of time in Congress trying to give individuals rights to physical property.

Mr. RUBIN. I am not disagreeing with you. It is just something I need to think about. It is an interesting way to put it. It would not have occurred to me to think about it quite that way.

Mr. MARKEY. In the bill H.R. 10, as it emerged from the Banking Committee, the financial privacy language covers only banks and thrifts, but not broker dealers, not investment companies, not investment advisors or insurance companies. None of them are covered in the H.R. 10 privacy language.

Do you think all of those institutions should be covered by any privacy language which we pass, or should it only be the banks and thrifts?

Mr. RUBIN. Well, as you know, Mr. Markey, the President announced yesterday an initiative to try to substantially improve privacy, and I think that if you have—and I hope this is responsive to your question—that if you have a number of these different activities in the same institution, then the sharing of that information amongst the—I think this actually is responsive—amongst the components of that conglomerate, if you will—or for that matter the selling of the information—is something that the individuals should receive notice of and then should have the opportunity to prevent.

Mr. MARKEY. Across all of the institutions?

Mr. RUBIN. Yes, I think that is right.

Mr. MARKEY. Okay, good. Linda is nodding yes.

Mr. RUBIN. Well, Linda may agree. But I think she is right in this instance, which is not always the case.

Mr. MARKEY. The issue is—in my experience it has been that is that Linda is always right.

So here is the issue. The broker, having access to checks, would know that your daughter was being treated with Ritalin for ADD, that your wife was being treated for breast cancer—the banker, the mortgage banker—that your wife had breast cancer, so he wouldn't have any other way of knowing, except for these—for access to your checks.

The insurance agent in the same firm would know of the stress of your daughter and the stress of your wife, and that your mother is on Depends, and you have her at home. So he would know the extra stress that you were under that otherwise he wouldn't have any access to because he has your checks. So at the end of the day, shouldn't you have a right to say no?

Mr. RUBIN. The answer to that question is yes, in my judgment.

Mr. MARKEY. That is great.

Mr. RUBIN. By the way, I think that was really the core of the President's announcement yesterday.

Mr. MARKEY. I know that, and I am just trying to get it out.

Mr. RUBIN. So Linda agrees with the President as well.

Mr. MARKEY. I have been looking to Linda for 20 years.

Now, the legislation that passed the Banking Committee also limited this small segment of the financial services universe of banks and thrifts to merely requiring that a banker tell the customer what the institution's privacy policy is with respect to disclosure to other third parties, other than agents of the depository institution.

The amendment that I will make in the committee is to make sure it is not just other depository institutions, but to every other affiliate of that institution that has that responsibility, and the administration agrees with that position.

Mr. RUBIN. I think that sounds right, yes.

Mr. GANSKE. Would the gentleman yield?

Mr. MARKEY. I will be glad to yield.

Mr. GANSKE. And with the chairman's discretion, would—I ask unanimous consent for 1 additional minute.

Mr. OXLEY. One additional minute.

Mr. GANSKE. I am sympathetic to the gentleman's concern about privacy, both in financial services and in health care, but the privacy issue is a very, very difficult one that relates to Internet, to all sorts of complicated issues. I would sort of liken trying to solve this, that problem with the financial services, to the gentleman putting a basketball in each hand and trying to make both shots at the same time, or having two baseballs pitched at you and trying to hit both of them at the same time out of the park.

I pledge to work with the gentleman on these issues. I am concerned about trying to marry a very complicated issue to an already very complicated issue, and I don't know if the gentleman has a response to that.

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

Mr. MARKEY. I ask the chairman for 1 additional minute.

Mr. OXLEY. One additional minute. Briefly, please.

Mr. MARKEY. We have two phenomena here. We have this rapid technological revolution which is affecting every industry. It forces convergence in the financial industry, yes, but it also makes it possible for these data miners to use this electronic capacity to be able to glean information about each of us.

So there is a Dickensian quality to it. It is the best of wires and the worst of wires simultaneously. It makes it possible to create all of this wonderful progress in financial services being put in one place, but it also makes it possible for unscrupulous individuals to monitor our private secrets of our lives.

So for a woman who, in order to get an insurance policy, has to go in to get a medical exam and there is knowledge here that she has breast cancer, it is a very sensitive subject——

Mr. OXLEY. The gentleman's time has expired once again.

Mr. MARKEY. If I may, just 30 seconds, with your indulgence, I don't think that that person should have waived her rights to have that information now transferred over to her broker dealer, over to her mortgage banker. It should not be affecting every other part of her life without her permission. Otherwise I think, whether it be ADD or it be breast cancer or it be any other issue, we will put a chilling effect upon people trying to gain access to the medical services which they need, for fear that it will be spread all over time because one institution in town is now able to spread it. And that is why I think it has to be merged into one ball and I would like to work with the gentleman.

Mr. OXLEY. I would remind the members, this is a hearing and not a markup. There will be plenty of time for give and take, and I am sure the Secretary would appreciate getting back to the issue at hand. I would also say, knowing my friend from Massachusetts, the chances of him with two basketballs scoring is far higher than passing either one of those basketballs.

I recognize the gentleman from New York.

Mr. FOSSELLA. Thank you, Mr. Chairman.

I stepped out for a few minutes but, Mr. Secretary, I am just curious. At the end of the day, you raised some red flags in what may happen on this bill. Is there anything that you can see where you would urge the President to veto this legislation, given some of the amendments that are under consideration?

Mr. RUBIN. Any situation in which I would urge it to be vetoed? He has issued a veto letter, as you know. The letter focused on CRA, and as he said yesterday again in his statement, it is imperative that the CRA remain relevant in the world that is now developing. The veto letter included the failure of the Senate banking bill to provide choice between an op-sub and an affiliate, and it involved consumer issues. And then he is concerned about banking and commerce issues.

Mr. FOSSELLA. And that is going to be the party line from here on in; is that it?

Mr. RUBIN. Excuse me?

Mr. FOSSELLA. That is the party line from here on out?

Mr. RUBIN. It is not a party line. That is a veto letter that came from the President himself, it was not senior advisors, and it reflected the deeply held policy views of the President and the administration.

Mr. FOSSELLA. Thank you very much.

Mr. RUBIN. Okay.

Mr. OXLEY. Does the gentleman yield back?

Mr. FOSSELLA. I yield back.

Mr. OXLEY. The Chair now recognizes the gentlewoman from Colorado.

Ms. DEGETTE. Thank you, Mr. Chairman.

Mr. OXLEY. If the gentlewoman would just suspend. The Chair would announce there is a 15-minute vote on the floor and then a 5-minute vote. We would love to be able to get through the panel and get the Secretary on his way if that is at all possible, so let's give that a shot.

The gentlewoman from Colorado.

Ms. DEGETTE. I won't have any basketball discussions, Mr. Chairman.

Just very briefly, Mr. Secretary, to take a sort of a different angle at this, in your prepared testimony you say that you continue to believe that any financial modernization bill must have adequate protections for consumers, and you point out that you are hoping that this committee will add additional protections over the bill that came out of the Banking Committee.

Are you talking specifically there about the Federal Home Loan Bank system, and the other issue on affiliations between commercial firms and savings associations, or are there additional consumer protections you would like to see?

Mr. RUBIN. I was referring there primarily to try to work with the SEC in order to better enable them to perform their functional regulation. The SEC has concerns and I think they are well taken.

Ms. DEGETTE. I do too.

Mr. RUBIN. As you know, this bill was designed to eliminate the exemption from the SEC of these various securities activities conducted in banks. At the same time, then, there are all sorts of exceptions to the exemptions, and they could be read so broadly as to establish the exemption. That is the concern that the SEC has. We share that concern, and what we would like to do, if there is a way that it can practically be done, is to work with the SEC on these issues. That was my primary reference.

Ms. DEGETTE. Do you think there is a way that it can practically be done?

Mr. RUBIN. I don't fully know the answer to that. We have worked with the SEC extensively, we would like to continue to work with them, but these are very complicated issues. All I can tell you is that we very strongly share their concerns and we would like to be constructive in resolving them if there are ways to do that.

Ms. DEGETTE. You have had ongoing discussions, I guess, and you haven't been able to come up with any ideas so far?

Mr. RUBIN. Well, we certainly have had ongoing discussions, and I think it would probably be fair to say that there were a lot of ideas, and the question is, will any of them work and be practical and legislatable and so forth.

Ms. DEGETTE. Mr. Chairman, in the interest of getting in the other questions, I yield back.

Mr. OXLEY. The gentleman from Wisconsin is next, Mr. Barrett.

Mr. BARRETT. I appreciate your comments and the comments the administration has made with regard to CRA. My question regards central city. I represent a district with a large central city, and I am grasping to see in either approach what is here to benefit the central city and what is going to improve investments in our central cities. Can you make the case as to why your approach is better than Mr. Greenspan's approach?

Mr. RUBIN. Well, as you know, because we have discussed these issues before, I also care deeply about what is happening in inner cities and I think that what is happening there is going to greatly affect what is happening in the rest of our country. I don't know that the op-sub affiliate debate particularly affects what happens in the inner cities, although I must say, having said that, to the extent that there are minority, small minority-owned banks—actually, I hadn't thought about it until this moment—but to the extent there are small, minority-owned banks that want to get into these new financial activities in some measure—and it seems to me it might well be advisable to do that in some measure and then affiliate with other larger institutions and so forth—what they should be allowed to do as long as there is no reason not to allow them, and I believe there is zero reason not to allow them, is to find the form of organization that is most efficient for them. And I suspect that for small banks of the kind I have just described, the op-sub probably would be a less expensive way of structuring themselves to engage in these activities.

Mr. BARRETT. Which approach would have more CRA penetration?

Mr. RUBIN. If there is a difference, then it seems to me that it may be—I mean, we are totally committed to CRA, as you know, but if there is a difference, it may be that by virtue of the fact that the sub is an asset of the bank and preserves these assets within the bank as opposed to putting them in the affiliate, that that might be beneficial or advantageous with respect to CRA.

Mr. BARRETT. Okay. Thank you.

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

The gentleman from Illinois, Mr. Rush.

Mr. RUSH. Thank you, Mr. Chairman.

Secretary Rubin, in the interests of time—well, first of all, Mr. Chairman, I do have a number of questions, but I ask for unanimous consent to ask that you——

Mr. OXLEY. That has already been provided for, yes.

Mr. RUSH. All right. Secretary Rubin, H.R. 10, as reported out of the Banking Committee, carves out and essentially protects title insurance from competition under the act. Will you discuss the resulting benefits or detriments of such a carve-out?

Mr. RUBIN. Let me ask Mr. Carnell to do that, if I may, Mr. Rush.

Mr. CARNELL. We think, Mr. Rush, that more competition is desirable here, and that singling out this or another line of financial services business for special protection from competition does not make sense. So we think these provisions are discriminatory, and that something that puts different providers on a real equal footing and lets them compete would be good for consumers.

Mr. RUSH. Thank you, Mr. Chairman. I yield back.

Mr. OXLEY. Thank you. The final questioner, the gentleman from New York, Mr. Engel.

Mr. ENGEL. Thank you, Mr. Chairman.

I too have a number of questions which I will submit in the interests of time.

I just wanted to ask the Secretary, in his prepared testimony he mentioned the Federal Home Loan Bank system and his concerns with that. I am wondering if you could elaborate on them. Obviously, the Federal Home Loan Bank system has been effective in assisting Americans to obtain homeownership. I wonder if you could elaborate on your concerns. You mentioned particularly its arbitrage and short-term lending activities.

Mr. RUBIN. We are very much in favor of the Federal Home Loan Bank System serving its legislatively determined public purpose, which, as you say, is housing. And there are people who think it should be expanded to provide more resources to communities and community banking and various community purposes. That seems to us a sensible judgment for Congress to make.

Our concern is the use of the FHLB's taxpayer subsidy for purposes other than those determined by Congress. Arbitrage activity is not a benefit to housing and it is not a benefit to communities, if that is a purpose Congress should determine. And neither is overnight lending. That was the point of my comment.

Mr. ENGEL. I just want to say I agree with you, and I have some other questions which I will submit. Thank you very much.

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

Mr. Secretary, we appreciate your willingness to be with us this morning and, as usual, your excellent testimony is appreciated and we thank you very much.

With that, the subcommittee stands in recess until 1 p.m.

[Brief recess.]

Mr. OXLEY. The subcommittee will reconvene, on time, and we welcome our third panel of today. If they will come forward. We are honored today to have two distinguished gentlemen. The first witness is Commissioner George Nichols, III, the chairman of the committee on financial services modernization with the National Association of Insurance Commissioners, and our old friend, the Honorable Arthur Levitt, chairman of the Securities and Exchange Commission.

Gentleman, welcome to both of you. We appreciate your coming before the committee on this important issue. You have testified on this issue before this committee in the past. We hope fervently that this is the last time that we will ask you to participate on a hearing on financial services modernization and that you can join us at some future date for a bill signing and everything will be fine and we will get on with the rest of our lives.

So with that, let us begin with Commissioner Nichols.

**STATEMENTS OF GEORGE NICHOLS, III, CHAIRMAN, COMMITTEE ON FINANCIAL SERVICES MODERNIZATION, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS; AND HON. ARTHUR LEVITT, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION**

Mr. NICHOLS. Thank you, Mr. Chairman. My name is George Nichols, and I am the commissioner of insurance in the Commonwealth of Kentucky; and I serve as vice president of the National Association of Insurance Commissioners and chairman of the special committee on financial services. We are honored to be here today to talk about this important issue——

Mr. OXLEY. Excuse me. Is your mike on?

Mr. NICHOLS. Hello? I thought it was.

Mr. OXLEY. No. It is that switch down at the bottom. If you could, just pull it a little bit closer. The acoustics are tough in this room.

Mr. NICHOLS. My name is George Nichols. I am the Commissioner of Insurance in the Commonwealth of Kentucky. I am representing the National Association of Insurance Commissioners, which I serve as vice president and chairman of the special committee on financial modernization. We are honored to be here today.

We want to talk about insurance consumers who are a huge factor in the H.R. 10 equation. Their interests must not be sacrificed in the name of financial modernization services. Insurance is a unique product which is purchased to protect people during times of their lives when they are most vulnerable.

Figures compiled by our association show that families can spend easily upwards of $3,000 for auto, home, and life insurance. If you take into consideration health insurance and they buy it individually, that amount could double, including additional property that they own or additional cars. Seen regularly, those are the only protection for America's insurance consumers.

Nationwide we employ some 10,000 people and spend $750 million annually to be the watchful eyes and helpful hands of consumers regarding insurance problems. There is no Federal agency for regulating the business of insurance. If Congress prevents the States from supervising insurance adequately, this vital function will go undone.

Furthermore, the cost of insurance of any regulatory failures of insurance companies would directly affect policy holders, claimants, State guarantee funds, and the taxpayers. As passed by the House Committee on Banking and Financial Services, H.R. 10 is basically hostile to consumers and the States. The bill needlessly sweeps away State consumer protection authority.

H.R. 10's broad preemption of State insurance laws is clearly shown on a chart that we have prepared for each of the members. We have compiled it relating to the specific statutes for your given State. State regulators and the NAIC strongly oppose the Banking Committee version of H.R. 10.

To correct these deficiencies, we are submitting specific amendments to the Commerce Committee that will preserve our central authority to the following areas: affiliations. The NAIC amendments preserve the power of State regulators to fully review proposed affiliations involving banks, just as we do with any other firm that would acquire an insurer. This is sensible since we are the only regulators who protect the rights of policyholders and claimants.

Insurance business activities. The NAIC amendments make it clear that States can regulate all insurance functions of all business entities including banks. Our amendments cover important aspects of insurance operations that H.R. 10 fails to address such as reinsurance, investments, and claims handling.

Nondiscrimination. The NAIC amendments make it clear that State laws cannot overtly discriminate against banks or indirectly be used to prevent them from engaging in business activities provided for under H.R. 10.

Equal standing in the court. The NAIC amendments give State regulators equal standing in the court with the Federal regulators for all disputes arising over matters relating to H.R. 10.

The NAIC amendments make minimum changes to the existing language and structure of the bill. Adopting them will not interfere at all with the bill's financial modernization goals. The NAIC is also proposing new amendments to H.R. 10 that will give us extra tools to quickly achieve the uniformity and efficiency of State insurance regulation and supervision.

Our amendments would use Federal law to help State insurance departments to accomplish the following goals: (1) establish a streamlined and uniform process for licensing nonresident agents; (2) remove State barriers to nonresident licensing, including countersignature requirements; (3) establish a streamlined and uniform process for licensing of insurance companies; and, (4) grant legal protection to city and NAIC and State regulators to information sharing data base activities and enforcement matters involving Interstate Commerce.

Mr. Chairman, H.R. 10 is now at a crossroads. Congress must make a clear choice to protect insurance consumers. If Congress adopts the NAIC's consumer protection amendments, the bill can proceed with the confidence that policyholders and claimants will remain fairly protected by the States. If Congress fails to adopt these amendments, the critical interests of insurance consumers and State governments will be sacrificed.

There is one last fact that Congress should consider. In 1997, insurance products generated 4 million consumer inquiries and complaints. If Congress takes away our power to handle these complaints, who in the Federal Government will? State insurance regulators and the NAIC want to continue keeping misguided fraudulent insurance providers from damaging consumers, banks, and insurance companies. We ask that Congress come in and help us protect consumers by fixing H.R. 10 in order to preserve the authority of States they need to get the job done.

That concludes my prepared remarks, Mr. Chairman. I would also like to offer a few personal thoughts in the importance of the H.R. 10 debate in view of the tragic storm and losses to the people in Oklahoma and Kansas.

We recognize the devastation that has affected those two States. Right now those two States both have strong advocates in their commissioners of insurance. Both States are setting up satellite offices in the locations of the devastation to make sure that insurance companies are doing the jobs that they need to do, to coordinate the response, to make sure that claims are handled in a proper manner, and that they can move as quickly as possible to try to help the people in those two areas move toward back being whole again.

We are asking this committee to work with us to assure that we do not lose the authority that we have to be the advocate on behalf of consumers with this financial service.

Thank you very much, sir.

Mr. OXLEY. Thank you, Mr. Nichols.

[The prepared statement of George Nichols III follows:]

PREPARED STATEMENT OF COMMISSIONER GEORGE NICHOLS III, CHAIRMAN, COMMITTEE ON FINANCIAL SERVICES MODERNIZATION, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

*Introduction*

My name is George Nichols, and I serve as Commissioner of Insurance in Kentucky. I also serve as Vice President of the National Association of Insurance Commissioners (NAIC) and Chairman of the NAIC's Special Committee on Financial Services Modernization. The NAIC established this Special Committee in 1996 to assist State insurance regulators as they continue to meet the demands of the Nation's rapidly evolving market for financial products.

Today, I would like to make three points regarding HR 10 and financial services modernization.

- First, the interests of insurance consumers in the United States must not be sacrificed in the name of modernizing financial services.
- Second, State insurance regulators strongly oppose the version of HR 10 passed by the House Committee on Banking and Financial Services because the bill sweeps away State authority to protect insurance consumers. We will use every means available to alert the public, Congress, and State officials that HR 10 is currently anti-consumer and anti-State government.
- Third, the NAIC is providing the Committee on Commerce with specific amendments that fix the serious regulatory deficiencies in HR 10. The NAIC's amendments will also achieve the goals of uniform licensing procedures for insurers and agents, as well as national enforcement of State and Federal laws that protect insurance consumers.

*Insurance Consumers Are a Huge Factor in the HR 10 Equation*

HR 10 has been working its way through Congress with strong backing from important segments of the banking, insurance, and securities industries. The commercial firms pushing the bill argue that new Federal legislation is needed to enable them to develop and market better products, as well as to allow them to compete more fairly in a global economy. NAIC members also support modernizing financial laws. We recognize there are potential business benefits to consumers in our respective States.

However, Congress must also consider the welfare of consumers from the standpoint of making sure that their insurance is safe and their claims are paid. To our knowledge, the millions of people who buy insurance for their homes, cars, health, and financial security are not even aware that Congress is considering HR 10. We do not believe the public will be complacent about HR 10's negative impact on insurance supervision when people learn that it prevents State regulators from monitoring insurer solvency and handling customer complaints.

Paying for insurance products is one of the largest consumer expenditures of any kind for most Americans. Figures compiled by the NAIC show that an average family can easily spend a combined total of $3,000 each year for auto, home, life, and health insurance coverage. This substantial expenditure is typically much higher for families with several members, more than one car, or additional property.

Collectively, the insurance premiums paid by American consumers in 1997 amounted to $116 billion for auto coverage, $29 billion for homeowners policies, $107 billion for life insurance, and $216 billion for health coverage. Almost half a trillion dollars goes toward buying annual personal insurance coverage, a unique product which is purchased to protect people during the times in their lives when they are most vulnerable.

Consumers clearly have an enormous financial and emotional stake in assuring that the promises made by insurance providers are kept.

*State Regulators Are the Only Protection for Insurance Consumers*

As regulators of insurance, State governments are responsible for making sure the expectations of American consumers are met regarding financial safety and fair treatment by insurance providers. State insurance commissioners are the public officials who are appointed or elected to perform this consumer protection function. Nationwide, we employ 10,000 regulatory personnel and spend $750 million annually to be the watchful eyes and helping hands on consumer insurance problems.

Here are three key factors to keep in mind when considering HR 10 or other Federal legislation affecting State insurance authority—

1. There is no Federal agency for regulating the business of insurance. If the Federal government prevents the States from supervising insurance adequately, this vital consumer protection function won't get done at all.
2. Individual States and their citizens bear the costs associated with regulating insurance providers, including the costs of any insolvencies that occur. State governments thus have a powerful incentive to do the job well, and the record shows they have done so.
3. Overly broad language and imprecise drafting in Federal laws can easily undermine essential State consumer protection laws which apply to ALL insurance providers. The resulting costs to State governments, taxpayers, policyholders, and claimants can be enormous.

Some people have framed the debate over financial modernization as a conflict between Federal and State regulation, or between the banking and insurance regulatory systems. The real issue, however, is whether insurance-related activities of financial services companies will be regulated at all if Federal law prevents the States from doing the job.

The Federal Reserve Board, the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) have each said they do not intend to regulate insurance. If State governments are prevented from doing it, who will?

*HR 10 Prevents State Insurance Regulators from Protecting Consumers*

NAIC pointed out the following serious flaws in HR 10 during NAIC President and Connecticut Insurance Commissioner George Reider's testimony before the House Banking and Financial Services Committee on February 11, 1999.

- HR 10 flatly prohibits States from regulating the insurance activities of banks, except for certain sales practices. There is no justification for giving banks an exemption from proper regulations that apply to other insurance providers.
- HR 10 prohibits States from doing anything that might "prevent or restrict" banks from affiliating with traditional insurers or engaging in insurance activities other than sales. This exceedingly broad standard undercuts ALL State supervisory authority because every regulation restricts business activity to some degree. HR 10's total preemption of State consumer protection powers goes far beyond current law, and casts a dangerous cloud over the legitimacy of State authority in countless situations having nothing to do with easing financial integration for commercial interests. It could also throw into question the regulatory cooperation between State insurance regulators and Federal banking agencies being achieved under current law.
- HR 10 uses an "adverse impact" test to determine if State laws or regulations are preempted because they discriminate against banks. This unrealistic standard fails to recognize that banks are government-insured institutions which are fundamentally different from other insurance providers. Sound laws and regulations that are neutral on their face and neutral in their intent would still be subject to preemption under such a standard.
- HR 10 does not guarantee that State regulators will always have equal standing in Federal court for disputes which may arise with Federal regulators.

Frankly, we are quite disappointed and concerned that the House Banking and Financial Services Committee chose not to fix these and other problems pointed out by NAIC. We were told that all parties affected by HR 10 will suffer a certain amount of pain, but nobody has informed insurance consumers that they are among the groups who will suffer when State laws and regulations are preempted.

*Real Examples of HR 10's Harmful Impact*

1. Connecticut was involved last year in the regulatory approval process for the merger between Travelers Insurance and Citibank. Operating under State law, Commissioner Reider and his staff reviewed the proposed business plan and a complete filing of corporate financial and operating data before making a final decision that the merger should be approved. He met his responsibility to fully

review the merger on behalf of the public, and the matter was handled expeditiously with no complaints from the companies making the application. Under HR 10, however, he would automatically be prevented from conducting a proper regulatory review of such a large and influential merger affecting insurance consumers in his State.

2. After extensive input from citizen groups, the State insurance department, and Blue Cross/Blue Shield managers, North Carolina's legislature decided that the $2 billion value of the Blue Cross/Blue Shield plan should be put into a trust for the benefit of the public if it is ever sold to private interests. If a bank or bank-affiliated insurer were involved in such a sale, this State law—passed to address local concerns having nothing to do with Federal banking laws—would be preempted because HR 10 dictates that no State law may prevent or restrict a bank from affiliating with an insurer.
3. Pennsylvania enacted a law in 1996 to correct widespread sales and solicitation abuses found during the State's regulatory examinations of companies marketing life insurance products and annuities. The law sets limitations and minimum standards for illustrations used in marketing such products. It also addresses unfair financial planning practices, and prohibits unqualified agents from holding themselves out as financial planners. Under HR 10, Pennsylvania stands to lose this important tool with respect to the solicitation and sale of life and annuity products by financial institutions, even though the need for the law has been established by State regulators.
4. On a broader level, the NAIC is preparing a specific home-state chart for each Member of this Subcommittee showing more than 30 basic insurance laws that HR 10 is likely to preempt if it is not amended. These charts identify State statutes covering such critical areas as examinations, audits, reinsurance, capitalization, valuation, investments, liquidations, guarantee funds, agent licensing, and holding company supervision. NAIC will deliver these graphic illustration charts to the Subcommittee Members when completed.

*Current Progress by State Regulators Depends Upon Maintaining Our Authority*

HR 10 threatens the substantial progress now being made by State insurance regulators using our existing authority. While Congress and industry have been talking about modernizing financial services regulation, we have been developing and implementing real changes that promote uniformity and efficiency. The process is working because State insurance authority is well defined and accepted under the McCarran-Ferguson Act.

The NAIC is joining with Federal and State banking agencies to develop agreements for cooperating and exchanging information on regulatory matters. In addition, special training classes are being designed by NAIC to help Federal regulators perform their duties better. All-day meetings among top technical experts at the Federal Reserve Board, OTS, OCC, and State insurance departments are also occurring. Participants in these hands-on exchanges have all agreed that they are exactly what is needed to make functional regulation work.

Under HR 10, the extent of State insurance authority will surely be questioned and tested, not only by banks and their affiliates, but also by traditional insurers that have been complying with present laws for many years. Federal and State regulators may start to question whether the cooperation arrangements we have made with them remain legal. It makes no sense for Congress to undermine State regulatory reforms being accomplished today under existing laws.

*NAIC's Amendments Preserve Essential State Consumer Protection Authority*

The version of HR 10 passed by the House Banking Committee is very harmful to insurance consumers. To correct its deficiencies, the NAIC is submitting specific amendments to the Commerce Committee that will make HR 10 palatable in the following essential areas—

- Affiliations—The NAIC amendments preserve the power of State regulators to fully review proposed affiliations between banks and insurers, just as we do with any other firm acquiring an insurer. This is sensible, since we are the only regulators who protect the rights of policyholders and claimants. It is also fair, since State guarantee funds are required to pay for any insolvencies which may result from bank-related affiliations.
- Insurance Sales and General Business Activities—The NAIC amendments make it clear that States can regulate the insurance functions of all business entities, including banks. Our amendments cover all aspects of insurance operations, including reinsurance, investments, claims handling, and managing general agents.

- Non-Discrimination—The NAIC agrees that State laws and regulations should not unfairly discriminate against banks on insurance matters, but we also recognize it would be foolish to ignore the fact that they are government-insured deposit institutions which are fundamentally different from other insurance providers. Our amendments make it clear that State laws cannot overtly discriminate against banks or indirectly be used to prevent them from engaging in businesses permitted by HR 10.
- Equal Standing in Court—The NAIC amendments give State regulators equal standing in court with Federal regulators for all disputes arising over matters relating to HR 10. There is no good reason to grant special deference to Federal regulators simply because a matter occurred before September 1998.

The NAIC's consumer protection amendments are Attachment I to this testimony. We carefully crafted the amendments to make minimal changes to the existing language and structure of HR 10. Adopting our amendments will not interfere at all with the financial modernization goals which the bill's sponsors hope to achieve.

*NAIC's New Amendments Achieve Uniform Licensing and National Enforcement*

The NAIC has clearly heard the demands in Congress and industry for more uniformity and efficiency in State insurance supervision. Since NAIC has promoted these same objectives for many years with incomplete success, we now believe it is appropriate to ask Congress for new amendments to HR 10 that will use Federal law to let State regulators get the job done. With these tools, we can overcome the obstacles that have hindered our progress.

The primary benefit of adding these amendments to HR 10 is to achieve the goals of uniform regulatory procedures and national enforcement quickly by using the existing system of State regulation. The extra costs and delays of establishing a NARAB organization could thus be avoided, while also preserving the legal certainty of licensing and enforcement under State and Federal law.

Banking and insurer groups advocating broad preemption of State law in HR 10 say that uniformity and efficiency are major reasons to justify such radical action. However, the NAIC's amendments will achieve the same goals without gutting basic State consumer protection powers.

We propose that the Commerce Committee adopt specific amendments to direct and authorize State insurance departments and the NAIC to accomplish the following goals—

1. Establish a streamlined and uniform non-resident agent licensing process.
2. Remove State law barriers to non-resident licensing, including counter-signature requirements, by a certain date.
3. Establish a streamlined, uniform, and expedited process for insurance company admissions.
4. Authorize the use of social security numbers for licensing purposes, for the producer database, and for use by the Insurance Regulatory Information Network (IRIN).
5. Grant exemptions from the Fair Credit Reporting Act for IRIN, the NAIC, and State insurance departments regarding regulatory licensing activities and related databases.
6. Provide State insurance regulators and NAIC with access to the national criminal history database (NCIC) for regulatory purposes and for checking criminal histories as required by the Federal Insurance Fraud Prevention Act.
7. Grant Federal immunity from liability for NAIC and IRIN database activities.
8. Protect the confidentiality of regulatory communications between among NAIC, State regulators, and Federal agencies.
9. Facilitate the use of regulatory databases, including digital signatures, acceptance of credit cards, and electronic funds transfers.
10. Grant immunity for insurance companies that report agent terminations for cause to State regulators.

A brief description of these amendments is Attachment II to this testimony.

*Conclusion—Congress Must Make a Choice to Protect Insurance Consumers*

HR 10 is now at a crossroads. If Congress adopts the NAIC's consumer protection and uniform licensing and enforcement amendments, the bill can proceed with confidence that insurance policyholders and claimants will remain fairly protected by the States. If Congress fails to adopt these amendments, the critical interests of insurance consumers and State governments will be sacrificed. There must be no misunderstanding about what is at stake, and no illusion by anyone that insurance consumers will somehow be protected if State regulators are removed from the process.

There is one last fact that Congress should consider. In 1997, insurance products generated 3.2 million consumer inquiries and 392,000 actual complaints made to

State regulators. If Congress takes away our powers to handle these complaints, we will be forced to turn consumers away. Who in the Federal government will take care of them?

State insurance regulators and the NAIC want to continue keeping unsound or rogue insurance operations from damaging consumers, banks, and insurance companies. Doing that job will also protect Federal and State governments from unnecessary financial exposures caused by weak and insolvent institutions. We ask the Commerce Committee to help us help consumers by fixing HR 10 in order to preserve the authority States need to get the job done.

ATTACHMENT I

NAIC'S CONSUMER PROTECTION AMENDMENTS TO HR 10

**1. Section 104. Operation of State Law.**
**(a) Affiliations.—**

*Starting on page 37, delete the entire subsection, and replace with the following:*

(1) In General.—Except as provided in paragraph (2), no State may, by statute, regulation, order, interpretation, or other action, prevent or restrict the affiliations authorized or permitted by this Act and the amendments made by this Act.

(2) Insurance.—With respect to affiliations between insured depository institutions, or any subsidiary or affiliate thereof, and persons or entities engaged in the business of insurance, paragraph (1) does not prohibit any State from collecting, reviewing, and taking actions on applications required by the State and other documents or reports the State deems necessary concerning proposed acquisitions of control or the change or continuation of control of any entity engaged in the business of insurance and domiciled in that State, if the State actions do not violate the nondiscrimination requirements of subsection (c).

*Analysis:*

- This language enables the States to enforce their insurance holding company acts, provided such acts do not discriminate against banks. It is critical that the States retain this authority because no one else will review these affiliations for the purpose of protecting insurance consumers. Note that the Federal Reserve retains the authority to review all bank affiliations with bank holding companies.
- This language is substantially similar to the section 104 affiliations language in Senator Gramm's Financial Services Modernization Act.

**2. Section 104. Operation of State Law.**
**(b) Activities.—**

**In General.—**

*Delete the following phrase from subsection 104(b)(1), page 44, lines 12 and 13:*

"as provided in paragraph (3) and except".

*On page 44, line 17, delete "*restrict*" and insert "*significantly interfere with the ability of".

*At the end of subsection (b)(1), on page 44, line 22, insert the following:*

"where the State action discriminates against an insured depository institution or wholesale financial institution based on its status as an insured depository institution or wholesale financial institution, any subsidiary or affiliate thereof, or any person or entity based on its status of affiliation with an insured depository institution, contrary to the nondiscrimination requirements of subsection (c)."

**(3) Insurance Activities Other than Sales.—**

*Delete subsection 104(b)(3) in its entirety, page 55, lines 3-22.*

*Analysis:*

- These changes do not impact the Section 104(b)(2) Sales language in any way.
- These changes are necessary to enable the States to regulate the non-sales insurance activities of banks, bank affiliates and bank subsidiaries, provided such State action does not discriminate against banks. This change is necessary to preserve State authority to regulate non-sales insurance activities in which banks are currently engaged, such as credit-related activities.

**3. Section 104. Operation of State Law.**
**(b) Activities.—**

**(2) Insurance Sales.—**

*Delete subsection 104(b)(2)(C)(i) OCC Deference in its entirety, page 53, lines 20-25 and page 54, lines 1-3.*

*Renumber subparagraph (ii) on page 54, line 4, as subparagraph (i).*

*Renumber subparagraph (iii) on page 54, line 13, as subparagraph (ii).*

*Renumber subparagraph (iv) on page 54, line 21, as subparagraph (iii).*

*Analysis:*

- This change is needed to ensure that equal deference is accorded to State insurance regulators regarding the interpretation of all State sales laws.

**4. Section 104. Operation of State Law.**
**(c) Nondiscrimination.—**

*In subparagraph (c), on page 58, line 4, insert "affiliations or" after "insurance".*

*In subparagraph (c)(1), on page 58, line 12, insert "based on their insured status" after "thereof".*

*Delete subparagraph 104(c)(2), page 58, lines 17-25.*

*Renumber subparagraph (3) on page 59, line 1, as subparagraph (2).*

*Renumber subparagraph (4) on page 59, line 6, as subparagraph (3).*

*Analysis:*

- The change to subparagraph (c) is necessary to clarify that affiliations of insured depository institutions authorized under the act are subject to the nondiscrimination requirements of this subsection.
- The change to subparagraph (c)(1) is necessary to clarify that laws that differentiate by their terms between insured depository institutions and other entities are impermissible only if the differentiation is based upon the insured status of those institutions.
- Deletion of subparagraph (c)(2) is necessary to remove the effects test, which would make it impossible to make or enforce insurance laws and regulations. A law or regulation will always impact entities differently for reasons that are wholly unrelated to whether the entities in question are banks.
- These changes leave in the bill strong requirements ensuring that States cannot discriminate against banks.

**5. Section 104. Operation of State Law.**
**(d) Limitation.—**

*On page 59, line 13, insert* "(i)" *after the word* "affect" *and before the word* "the".

*On page 59, line 19, insert the following at the end of the paragraph:*

> ; and (ii) State laws, regulations, orders, interpretations, or other actions of general applicability relating to the governance of corporations, partnerships, limited liability companies, or other business associations incorporated or formed under the laws of that State or domiciled in that State, or the applicability of the antitrust laws of any State or any State law that is similar to the antitrust laws if such laws, regulations, interpretations, orders, or other actions are not inconsistent with the purposes of this Act to authorize or permit certain affiliations and to remove barriers to such affiliations.

*Analysis:*

- This language was originally in subparagraph (a). This change is necessary so that this subparagraph, which preserves State corporate laws of general applicability and State antitrust laws, modifies both subsection (a) Affiliations and subsection (b) Activities.
- The language has been changed slightly to conform to Senator Gramm's Financial Services Modernization Act. By these changes, the language of subsection (d) is made identical to Senator Gramm's Financial Services Modernization Act.

**6. Section 111.—Streamlining Financial Holding Company Supervision.**

*Page 76, line 11, delete* "in compliance with applicable" *and insert* "subject to".

*Analysis:*

- This technical change is needed to ensure that the States retain authority to enforce their capital requirements. As the provision is currently written, the Federal Reserve would be able to step in as soon as a company falls out of compliance with applicable capital requirements, but before the State has had an opportunity to enforce its applicable laws and regulations with respect to such capital requirements.

**7. Section 124.—Functional Regulation.**

*Page 128, line 14, delete* "Agency".*Page 129, line 3, delete* "Agency" *from the heading of subparagraph (b).*

*Page 129, lines 3-4, delete* "insurance agency or brokerage that is a subsidiary of an insured depository institution" *and insert* "insured depository institution subsidiary that is engaged in insurance activities".

*Page 129, line 7, delete* "insurance agency or brokerage" *and insert* "entity engaged in insurance activities".

*Analysis:*

- These changes are necessary to ensure that all insurance activities of bank operating subsidiaries are functionally regulated.
- As the bill is currently written, this provision is limited to insurance agency and brokerage activities. These changes are necessary because HR 10 permits bank operating subsidiaries to engage in credit-related activities as well as agent/broker activities. Such activities should be functionally regulated.
- By this change, the provisions of HR 10 that apply to insurance affiliates of bank holding companies (including, for example, report, examination and capital requirements) also apply to bank operating subsidiaries that are engaged in insurance activities.

**8. Section 303.—Functional Regulation of Insurance.**

*Page 332, line 11, delete* "sales".

*Analysis:*

- This technical change is needed to ensure that the bill clearly provides that all insurance activities are functionally regulated by the States.
- This change makes this provision identical to the language in the Bryan amendment to Senator Gramm's Financial Services Modernization Act, which was adopted by the Senate Committee on Banking, Housing, and Urban Affairs on March 4, 1999.

ATTACHMENT II

HR 10—SUMMARY OF NAIC'S PROPOSED AMENDMENTS RELATED TO UNIFORM LICENSING AND ENFORCEMENT

**1) Establish a streamlined and uniform non-resident agent licensing process.**

The objective of this amendment is a uniform non-resident agent licensing process, but not a single licensing decision. States would use a common form, which could be submitted electronically and distributed to those states where the applicant wants to be licensed. However, each state would retain the ability and discretion to decide whether to license or not license an agent, based upon uniform procedures. Uniform procedures would be developed by the states collectively through the NAIC. Standards would focus on consumer protection.

**2) Remove state law barriers to non-resident licensing, including countersignature requirements, by a specific date.**

Federal preemption of counter signature laws has been in and out of the HR 10 discussions. Many states have repealed these laws over the last few years. Only 8 or 9 states still retain these requirements.

**3) Establish a streamlined, uniform, and expedited process for insurance company admissions.**

Similar to non-resident agent licensing, there would be a uniform process for insurance company admissions, but not a single licensing point. States would retain the ability and discretion to decide whether or not to admit a company, based upon uniform procedures. The states themselves would collectively establish uniform procedures through the NAIC. Applications could be submitted electronically to a single point for distribution to states where licensure is requested.

**4) Authorize the use of social security numbers for licensing purposes, for the producer data base, and for use by IRIN.**

The use of social security numbers (SSN's) is restricted under the Federal Privacy Act of 1974. Most states have found ways to supply social security numbers for the producer data base, but a few states still have significant problems. Use of SSN's is the minimum element needed for properly identifying agents. A specific clarification in federal law would resolve any problems relating to use of SSN's for insurance regulatory purposes.

**5) Exemptions from the Fair Credit Reporting Act for IRIN, the NAIC, and state insurance departments regarding regulatory licensing activities and related databases.**

Recent amendments to the Fair Credit Act extended its provisions to databases not typically a part of the credit rating process. These amendments apply to databases used for both credit rating and employment purposes. Expansive interpretations by the Fair Trade Commission have extended the Act even to situations involving administrative licensing. The Act, if it were determined to apply to IRIN, would impose extensive notice and appeal requirements, just as if IRIN were a credit bureau. The solution to these problems is simple—state insurance regulatory activities should be specifically exempted from the Act.

**6) Nationwide access for insurance regulators to the national criminal history database (NCIC) for regulatory purposes; and use of IRIN/NAIC to access the database so that insurance companies can obtain criminal histories in order to meet their responsibilities under the Insurance Fraud Prevention Act.**

State licensing, fraud, and enforcement staff have long sought access to the criminal history databases maintained by the FBI (usually referred to as NCIC access). The Department of Justice supplies criminal history information to the American Bankers Association so banks can run checks on employees, and also supplies the information to the securities and commodities trading industries. However, the Justice Department has not been willing to extend such authority to state insurance regulators, despite years of discussions.

Only a few states are currently able to access NCIC. In the remainder, enforcement personnel have no practical way to check the possible criminal background of an individual, even when they suspect a serious violation of law.

Under the Federal Insurance Fraud Prevention Act (18 USC 1033), a person with a felony conviction involving dishonesty or breach of trust is barred from the business of insurance unless they have a specific exemption from a state insurance regulator. Insurance companies also have a duty not to employ convicted felons, but there is no reasonable means for them to check the criminal records of job applicants and employees.

Statistics from the few states which are able to run criminal history checks show that between 10 and 15 percent of agent applicants conceal criminal convictions on their applications. Giving authority to the NAIC to obtain criminal records checks would provide a mechanism for regulators and insurance companies to comply with their legal obligations. The industry generally, as well as the IRIN Board, support this goal.

**7) Immunity for IRIN/NAIC in database related activities.**

The major regulatory databases for insurance, including the financial solvency database, the disciplinary actions listings (RIRS), the Special Activities Database, and the Complaint Data System, are all maintained by the NAIC. Key licensing data is supplied by the states to the producer database, which is part of IRIN.

Although NAIC and IRIN act on behalf of State governmental entities, they have no direct tort immunity from suit. This exposes IRIN and NAIC to potential legal actions. A number of states do grant immunity to the NAIC, but this does not cover all potential suits; a plaintiff could simply file in a different state. Federal immunity would help protect NAIC assets, and permit NAIC and IRIN funds to be spent for their intended purposes, not on lawsuits. Immunity would extend to the NAIC as an entity, as well as its members, officers, and employees.

**8) Confidentiality protections for confidential regulatory communications with Federal agencies.**

Federal law should clearly state that confidential information can be exchanged between state insurance regulators and Federal agencies. Such protections may also extend to communications with international regulators.

**9) Measures to facilitate regulatory database uses, including digital signature and acceptance of credit cards or other electronic funds transfers.**

Implementation of efficient electronic processing faces many hurdles, including various state requirements on how payments can be made, and what form of signatures will be accepted. Many of these requirements are in state laws or regulations outside the control of the insurance departments.

In some states, for example, no payments via credit cards can be made. Some require payment with each transaction, even if there are multiple transactions per day with one entity. Other states will bill periodically. Technology exists to use both electronic funds transfers and digital signatures, which would make many transactions more feasible and cost-effective.

**10) Immunity for insurance companies that report agent terminations for cause, to ensure that more complete data is reported.**

Insurers have long sought this immunity, and regulators support the idea because it means earlier identification of problem agents. Companies simply will not report terminations for cause without strong immunity, because an agent may sue them for defamation. There could be a process where agents reported by insurers are notified, so that they could contest a company's claim for database purposes.

Consumer Complaints and Inquiries by State in the United States

| State | 1994 Consumer Complaints | 1994 Consumer Inquiries | 1995 Consumer Complaints | 1995 Consumer Inquiries | 1996 Consumer Complaints | 1996 Consumer Inquiries | 1997 Consumer Complaints | 1997 Consumer Inquiries |
|---|---|---|---|---|---|---|---|---|
| Alabama | 2,129 | 569 | 542 | 1,522 | 328 | 3,804 | 193 | 2,784 |
| Alaska | 546 | 24 | 634 | 3 | 555 | 3,600 | 559 | 202 |
| American Samoa | N/A | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| Arizona | 6,608 | 77,711 | 7,757 | 90,767 | 7,076 | 97,215 | 6,034 | 101,559 |
| Arkansas | 3,428 | 16,389 | 3,081 | 16,937 | 3,552 | 31,851 | 2,981 | 27,759 |
| California | 43,672 | 623,181 | 34,480 | 574,435 | 30,716 | 550,394 | 28,269 | 453,764 |
| Colorado | 7,715 | 560 | 7,409 | 846 | 7,626 | 55,077 | 8,041 | 51,678 |
| Connecticut | 6,405 | 77,000 | 5,905 | 78,600 | 6,519 | 79,220 | 10,311 | 41,000 |
| Delaware | 7,490 | 10,158 | 6,326 | 10,398 | 6,798 | 8,925 | 6,985 | 9,260 |
| Dist. of Columbia | 22,650 | 10,216 | 837 | 0 | 908 | 1,300 | 856 | 1,769 |
| Florida | 41,505 | 482,273 | 42,480 | 475,731 | 45,255 | 398,777 | 42,340 | 318,620 |
| Georgia | 36,194 | 105,071 | 18,335 | 67,894 | 15,448 | 79,373 | 12,290 | 77,396 |
| Guam | 41 | 220 | 50 | 250 | N/A | N/A | N/A | N/A |
| Hawaii | 1,100 | 10,400 | 1,200 | 10,400 | 1,900 | 10,700 | 1,950 | 10,800 |
| Idaho | 1,468 | 14,320 | 1,290 | 12,913 | 1,303 | 12,650 | 1,507 | 16,722 |
| Illinois | 12,597 | 70,000 | 11,587 | 70,000 | 13,081 | 70,000 | 14,081 | 70,000 |
| Indiana | 4,491 | 53,028 | 4,108 | 84,911 | 4,987 | 94,871 | 5,278 | 106,265 |
| Iowa | 2,999 | 23,342 | 2,812 | 23,378 | 2,569 | 23,608 | 2,525 | 22,171 |
| Kansas | 5,063 | 6,068 | 5,336 | 4,158 | 5,319 | 1,354 | 5,781 | 1,477 |
| Kentucky | 5,686 | N/A | 5,399 | N/A | 6,685 | N/A | 6,756 | N/A |
| Louisiana | 3,271 | 1,071 | 2,898 | 2,084 | 3,081 | 2,278 | 4,099 | 2,796 |
| Maine | 1,673 | N/A | 1,639 | N/A | 1,483 | 11,460 | 1,333 | 14,553 |
| Maryland | 18,929 | 245 | 12,556 | 156 | 19,172 | N/A | 18,461 | 2,083 |
| Massachusetts | 4,491 | 1,388 | 3,806 | 67,512 | 3,686 | 77,429 | 3,375 | 63,784 |
| Michigan | 4,843 | 255 | 4,347 | 1,209 | 5,185 | 1,333 | 4,993 | 1,075 |
| Minnesota | 5,910 | 68,384 | 4,934 | 43,965 | 4,543 | 38,363 | 3,792 | 43,647 |
| Mississippi | 7,000 | 10,000 | 7,000 | 10,000 | 7,000 | 10,000 | 7,000 | 10,000 |
| Missouri | 5,003 | 58,738 | 4,556 | 57,748 | 4,623 | 70,591 | 4,735 | 78,102 |
| Montana | 1,521 | 741 | 1,527 | 801 | 1,574 | 818 | 1,927 | 968 |
| Nebraska | 3,293 | N/A | 3,136 | N/A | 2,823 | N/A | 2,733 | N/A |
| Nevada | 1,765 | 60,634 | 1,608 | 47,787 | 1,817 | 44,033 | 2,377 | 60,125 |
| New Hampshire | 1,208 | 12,583 | 1,186 | 16,075 | 1,833 | 20,529 | 1,418 | 19,597 |
| New Jersey | 12,972 | 1,711 | 11,775 | 1,800 | 14,078 | 2,088 | 14,012 | 1,976 |
| New Mexico | 1,700 | 2,150 | 1,470 | 2,500 | 1,603 | 7,830 | 1,700 | 8,000 |
| New York | 42,211 | 565,584 | 44,883 | 600,000 | 41,520 | 600,000 | 45,824 | 600,000 |
| North Carolina | 9,669 | 113,339 | 8,400 | 98,419 | 9,468 | 112,948 | 10,100 | 132,286 |
| North Dakota | 667 | 9,969 | 643 | 9,485 | 701 | 11,691 | 795 | 13,476 |

Consumer Complaints and Inquiries by State in the United States—Continued

| State | 1994 Consumer Complaints | 1994 Consumer Inquiries | 1995 Consumer Complaints | 1995 Consumer Inquiries | 1996 Consumer Complaints | 1996 Consumer Inquiries | 1997 Consumer Complaints | 1997 Consumer Inquiries |
|---|---|---|---|---|---|---|---|---|
| Ohio | 7,079 | 467 | 6,907 | 440 | 7,172 | 568 | 8,105 | 356 |
| Oklahoma | 5,806 | N/A | 5,874 | 55,105 | 6,371 | 61,051 | 6,236 | 59,667 |
| Oregon | 4,791 | 29,853 | 4,458 | 28,977 | 4,803 | 32,836 | 4,748 | 27,706 |
| Pennsylvania | 24,463 | 74,000 | 24,509 | 260,000 | 22,048 | 275,491 | 21,305 | 178,695 |
| Puerto Rico | 717 | N/A | N/A | N/A | N/A | N/A | N/A | N/A |
| Rhode Island | 959 | N/A | 939 | N/A | 794 | N/A | 806 | N/A |
| South Carolina | 3,312 | 58,540 | 3,002 | 47,445 | 3,943 | 47,258 | 4,093 | 51,560 |
| South Dakota | 1,275 | 2,631 | 1,218 | 2,327 | 1,429 | 2,740 | 1,438 | 4,707 |
| Tennessee | 3,382 | 141 | 3,063 | 25,612 | 4,020 | 29,624 | 4,013 | 33,077 |
| Texas | 26,846 | 290,804 | 18,125 | 300,092 | 17,625 | 298,754 | 24,958 | 348,709 |
| U.S. Virgin Islands | 58 | 22 | 300 | 425 | 425 | 615 | N/A | N/A |
| Utah | 930 | 30,439 | 853 | 29,995 | 952 | 33,283 | 1,056 | 36,267 |
| Vermont | 893 | 360 | 854 | 281 | 900 | 300 | 840 | 1,652 |
| Virginia | 8,460 | N/A | 8,260 | N/A | 8,350 | N/A | 8,227 | N/A |
| Washington | 7,334 | 97,052 | 6,826 | 123,000 | 8,620 | 124,545 | 7,923 | 114,299 |
| West Virginia | 2,338 | 47,781 | 2,651 | 41,283 | 3,135 | 51,128 | 2,695 | 44,106 |
| Wisconsin | 9,188 | 56,144 | 8,381 | 45,000 | 9,135 | 44,046 | 9,169 | 44,528 |
| Wyoming | 823 | N/A | 613 | 5,200 | 475 | 5,276 | 524 | 3,456 |
| **Totals** | **446,567** | **3,175,556** | **372,765** | **3,447,866** | **385,012** | **3,541,625** | **391,547** | **3,314,479** |
| **Total Complaints 1994-1997** | | | | | | | | **1,595,891** |
| **Total Inquiries 1994-1997** | | | | | | | | **13,479,526** |

Mr. OXLEY. We now turn to our distinguished Chairman of the Securities and Exchange Commission, Arthur Levitt. Welcome.

## STATEMENT OF HON. ARTHUR LEVITT

Mr. LEVITT. Chairman Oxley, Congressman Towns, members of the subcommittee, I appreciate the opportunity to testify today regarding H.R. 10. Let me begin, Mr. Chairman, by saying that I look forward to continuing to work closely with you and the rest of the subcommittee to ensure that any financial modernization bill is in the best interests of the Nation's investors and protects the integrity of our dynamic securities markets.

The Commission has long supported the goal of modernizing the laws that govern our financial services industry. For this reason, the SEC worked closely during the last Congress with the committee to help craft legislation that would modernize the legal structure for financial services, while at the same time preserving principles that are fundamental to oversight—effective oversight—of U.S. securities markets.

After very difficult and trying negotiations, and compromise on all sides, the Commission was able to lend some support to the version of H.R. 10 that was passed by the full House in May 1998. Although the House-passed version was not perfect from our perspective, it did appear to recognize the fundamental importance of investor protection as banks and securities firms move toward greater closer affiliations.

However, subsequent negotiations substantially diluted the securities provisions contained within H.R. 10 and eroded the basic principles that the Commission believes are absolutely critical to maintaining securities markets that are strong, vibrant, and healthy. Accordingly, the Commission strongly opposes the version of H.R. 10 that is now before you. I would note for the record that we similarly oppose Senate Bill 900 which is currently being considered.

H.R. 10 as it stands now simply contains too many loopholes. While everyone is talking about preserving so-called functional regulation, functional regulation is made a mockery of by this proposal. Too many products are exempted from securities regulation. The scope of these loopholes, which are ambiguously drafted, creates even greater problems and uncertainties in the future.

For example, under H.R. 10, two investors, one in a bank and one in a brokerage firm, could buy the exact same security but receive two very different levels of protection. The bank investor would not be protected by the SEC's failure to supervise doctrine, securities licensing procedures; securities arbitration remedies; and, perhaps most importantly, the Commission's extremely effective enforcement program. The brokerage industry would. The brokerage investor would.

The bank investor might or might not be able to make claims against the bank for unsuitable investments. The brokerage investor would. The bank investor would probably not even know this state of affairs existed. At best, this is inconsistent. At worse, and I think a lot more likely, this is down right dangerous.

By repealing Glass-Steagell, while largely maintaining the bank's exemptions from Federal securities laws, H.R. 10 would expand the flawed system of bifurcated regulation that currently exists. The bank exemptions were in part premised on the very existence of the safeguards that Glass-Steagell had erected between commercial and investment banking. We should not contemplate removing that separation of activity without also removing outdated exceptions.

I have believed for a long, long time that if banks were to gain full access to the securities industry, they must also be prepared to assume the great responsibilities that come with that privilege. Working within a regulatory framework painstakingly developed over 65 years, the securities industry and the SEC have instilled nothing less than a culture, a culture that places the interests of investors above all others.

Banking regulation is not and cannot be a substitute for sound securities regulation. I don't have to tell you that our markets continue to be the envy of the world. We have moved from a Nation of savers to a Nation of investors. American families today put more of their savings in mutual funds than in insured bank accounts.

It is crucial to ensure that we have a framework that maintains the strength, discipline, and vitality of our securities markets. That framework must allow the Commission, as the Nation's primary securities regulator, to continue to fulfill its mission to protect investors and to safeguard our market's integrity.

The purpose of my testimony is not really to comment on each and every one of the provisions of H.R. 10. I probably couldn't do that if I wanted to. Our written testimony contains much greater detail regarding those parts of the bill that the Commission finds most troublesome. However, overall, the Commission has come to the conclusion that H.R. 10 runs the risk of dramatically undermining investor protection as well as the integrity of our capital markets.

I believe that America's investors deserve a single high standard of protection. The current version of H.R. 10, however, simply fails to meet that critical standard. In addition, I share the financial services industry's call for a need to rationalize a system that tends to favor banking entities over brokerages. Again, I believe this bill fails to meet that basic threshold of fairness.

There are more investors in our markets today than ever before. Every day they choose from an increasingly wider array of both products and providers, but they should not have to give up basic safeguards in the process.

I urge the subcommittee to work toward a regulatory framework that really fits today's marketplace without compromising our Nation's historic commitment to protecting investors and preserving market integrity. The Commission would look forward to working closely with the Commerce Committee to help craft legislation that would bring about these important goals. Thank you.

[The prepared statement of Arthur Levitt follows:]

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

Chairman Oxley, Congressman Towns, and Members of the Subcommittee: I appreciate the opportunity to testify on behalf of the Securities and Exchange Commission ("SEC" or "Commission") regarding H.R. 10. I am pleased to appear before this Subcommittee again to present the Commission's views on the important issue of modernizing the nation's financial services industries. We look forward to working closely again with this Subcommittee and with the full Commerce Committee to ensure that the best interests of the nation's investors and the integrity of our securities markets are protected.

I. OVERVIEW

The Commission has long supported the primary goal of H.R. 10—modernizing the legal framework governing financial services.

For this reason, the Commission and its staff worked closely during the last Congress with the Commerce Committee to help craft legislation that would modernize the legal structure for financial services while at the same time preserving principles that are fundamental to effective oversight of the U.S. securities markets. Our securities markets today are strong, vibrant, and healthy. They are relied on by both individual investors, who are increasingly putting their savings in stocks, bonds, and mutual funds,[1] and by American businesses that need to raise capital.[2] The success of our securities markets is based on the high level of public confidence inspired by a strong system of investor protection, and on the entrepreneurial and innovative efforts of securities firms. As the nation's primary securities regulator, it is critical that the Commission be able to continue to fulfill its mandate of investor protection and to safeguard the integrity, fairness, transparency, and liquidity of U.S. securities markets.

Although the Commission had reservations, it supported the version of H.R. 10 that was passed by the full House of Representatives in May 1998. However, I must firmly state that subsequent negotiations substantially eroded the basic principles that the Commission believes are critical to maintaining securities markets that are strong, vibrant, and healthy. This critical erosion of basic principles is continued in the version of H.R. 10 now before you. The Commission, therefore, is strongly opposed to the version of H.R. 10 that the House Banking Committee reported and that the Commerce Committee is now considering.

As the Commission has testified before, its support of a financial modernization bill was contingent on maintaining the "delicate balance inherent in [the House-

[1] As of December 1998, mutual fund assets totaled $5.5 trillion. Investment Company Institute, *Trends in Mutual Fund Investing: December 1998* (Jan. 28, 1999).

[2] In 1998, businesses raised a record $1.8 trillion from investors, $1.31 trillion in 1997, and $967 billion in 1996. (These figures include firm commitment public offerings and private placements and do not include best efforts underwritings.) Securities Data Corporation.

passed version of] H.R. 10."[3] Unfortunately, the version of H.R. 10 currently before the Commerce Committee no longer represents that balance. H.R. 10 now creates too many loopholes in securities regulation—too many products are carved out, and too many activities are exempted. These loopholes would prevent the Commission from effectively monitoring and protecting U.S. markets and investors. Moreover, the scope of those loopholes, which are ambiguously drafted, may create even greater problems and uncertainties in the future. The Commission cannot ensure the integrity of U.S. markets if it is only able to supervise a portion of the participants in those markets. Neither can it ensure fair and orderly markets if market participants operate by different sets of rules and investors receive different levels of protection.

Although the Commission has a long list of concerns with the bill in its current form, we would like to limit ourselves at this times to pointing out a number of provisions contained in the House Banking Committee bill that are particularly troublesome for the Commission. These sections would severely impact the ability of the Commission to protect investors and the integrity of our markets. As discussed more fully in the Appendix to this testimony, the Commission is particularly concerned about issues that arise under the following sections of the bill:

- *New/Hybrid Products*—The current provision would permit any bank to automatically stay Commission action (potentially for years) if the Commission determined, through rulemaking, that a new product was a security and warranted the protections of securities regulation.
- *Derivatives*—The current provision exempting "any swap agreement" is so broadly drafted that it could include nearly all securities activities, including securities-based derivatives. It would also permit sales to any type of investor, regardless of the investor's financial sophistication, without securities sales practice regulation.
- *Trust Activities*—While the Commission recognizes the importance of traditional bank trust activities, the current provision is so broadly drafted that bank trust departments could take a "salesman's stake" in securities transactions without complying with basic securities law protections.
- *Private* Placements—The original private placement exception was designed for small banks without broker-dealer affiliates that conduct limited securities business. The current provision, however, would allow all but the very largest banks to conduct this business—which is a very significant portion of the securities market—outside of the Exchange Act regulatory scheme.

Perhaps it would be useful at this time to step back and outline the broader points the Commission feels should be addressed by any financial modernization bill. It is crucial that there be consistent regulation of securities activities engaged in by all types of entities. The Commission must retain supervisory and regulatory authority over the U.S. securities markets and continue to determine how securities activities are defined. Our markets are vibrant because they are fair, and because investors rely on the protections that are offered them under federal securities laws.

With that goal in mind, the Commission would like to work with the Commerce Committee and the Congress to include the following critical safeguards in any financial modernization legislation:

- Maintain aggressive SEC policing and oversight of all securities activities;
- Safeguard customers and markets by enabling the SEC to set net capital rules for all securities businesses;
- Protect investors by applying the SEC sales practice rules to all securities activities;
- Protect mutual fund investors with uniform adviser regulations and conflict-of-interest rules; and
- Enhance global competitiveness through broker-dealer holding companies.

These objectives are not novel; they have been central themes to all of the Commission's testimony to date. The Commission is eager to work with the Congress and the Commerce Committee to again achieve an appropriate balance in H.R. 10, without compromising these important principles.

## II. BACKGROUND ON THE SECURITIES ACTIVITIES OF THE BANKING INDUSTRY

Before discussing the Commission's objectives in detail, I would like to summarize the key points that the Commission has consistently raised in considering Glass-Steagall reform.

[3] Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 10, the "Financial Services Act of 1998," Before the Senate Comm. on Banking, Housing, and Urban Affairs (June 25, 1998), at 2.

The Commission has been the nation's primary securities regulator for 65 years. As such, it is the most experienced and best equipped to regulate securities activities, regardless of who conducts those activities. The Commission's statutory mandate focuses on investor protection, the maintenance of fair and orderly markets, and full disclosure. Moreover, securities regulation encourages innovation on the part of securities firms, subject to securities capital requirements that are tailored to support risk-taking activities. Significantly, securities regulation—unlike banking regulation—does not protect broker-dealers from failure. It relies on market discipline, rather than a federal safety net, with an additional capital cushion and customer segregation requirements to insulate customers and the markets from the losses of broker-dealer firms. Moreover, protection of customer funds has been further assured by the Securities Investor Protection Corporation ("SIPC").[4]

The Commerce Committee is well aware of the many securities activities in which the banking industry now engages. While these market developments have provided banks with greater flexibility and new areas for innovation, they have also left U.S. markets and investors potentially at risk. Because banks continue to have a blanket exemption from most federal securities laws, their securities activities have been governed in a hodge-podge manner by banking statutes and regulations that have not kept pace with market practices or needs for investor protection. As you know, banking regulation properly focuses on preserving the safety and soundness of banking institutions and their deposits, and preventing the failure of banks. But, because market integrity and investor protection are not principal concerns of banking regulation, the Commission believes that banking regulation is not an adequate substitute for securities regulation.

In order for banks to be fully liberated from the outdated Glass-Steagall Act restrictions on their ability to conduct securities activities, banks must be willing to take on the responsibility for full compliance with U.S. securities laws, with which all other securities market participants must comply. In terms of sound public policy, Congress should impose such full responsibility on banks.

## III. COMMISSION OBJECTIVES FOR FINANCIAL MODERNIZATION

I will now turn to a more detailed discussion of the fundamental securities principles that the Commission believes are necessary elements of a truly effective financial modernization bill.

### *A. Aggressive SEC Policing and Oversight of All Securities Activities*

Public confidence in our securities markets hinges on their integrity. As the Supreme Court recently stated: "an animating purpose of the Exchange Act . . . [is] to insure honest securities markets and thereby promote investor confidence."[5] The Commission has an active enforcement division, whose first priority is to investigate and prosecute securities fraud. The banking regulators, on the other hand, are required to focus their efforts on protecting the safety and soundness of banks, not considering the interests of defrauded investors. As a former Commission Chairman said in recent Congressional testimony, detecting securities fraud is a full-time job, and it is a far cry from formulating monetary policy.[6]

To continue its effective policing and oversight of the markets, the Commission must be able to monitor all securities activities through regular examinations and inspections, which includes access to all books and records involving securities activities. This is currently not the case. For example, during recent examinations of bank mutual funds, Commission examiners have had difficulty gaining access to key documents concerning the securities advisory activities of banks.[7] The Commission

[4] SIPC is a non-profit membership corporation created by the Securities Investor Protection Act of 1970. SIPC membership is required of nearly all registered broker-dealers, and SIPC is funded by annual assessments on its members. If a broker-dealer were to fail and have insufficient assets to satisfy the claims of its customers, SIPC funds would be used to pay the broker-dealer's customers (up to $100,000 in cash, and $500,000 in total claims, per customer).

[5] *United States v. O'Hagan,* 521 U.S. 642, 117 S.Ct. 2199, 2210 (1997).

[6] *See* Testimony of Richard C. Breeden, President, Richard C. Breeden & Co., Before the Subcomm. on Finance and Hazardous Materials, House Comm. on Commerce (May 14, 1997).

[7] The Commission and the federal bank regulatory agencies have worked to enhance coordination of their examination and inspection programs. *See* Testimony of Lori Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, Concerning the Securities and Exchange Commission's Examination Oversight of Securities Firms Affiliated with Banks, Before the Subcomm. on Financial Institutions and Consumer Credit, House Comm. on Banking and Financial Services (Oct. 8, 1997). Despite these initiatives, however, the Commission continues to have difficulty obtaining access to all appropriate books and records.

cannot vigorously protect the integrity of U.S. markets and adequately protect investors with one hand tied behind its back.

*B. SEC Financial Responsibility Rules for All Securities Businesses*

Securities positions can be highly volatile. The Commission's capital requirements recognize this fact and are, with respect to protection from market risk, more rigorous than those imposed by bank regulators. Market exposures and volatility are risks that the net capital rule was designed to address, unlike bank capital requirements, which focus more on credit exposure. Thus, the Commission's net capital rule better protects the liquidity of any entity engaging in often volatile securities transactions.

In addition to promoting firm liquidity, the Commission's net capital rule is a critical tool to protect investors and securities markets because the Commission also uses the net capital rule to address abusive or problematic practices in the market. For example, with respect to penny stock market makers, the Commission can limit their activity by raising capital requirements for market-making activities. In addition, the Commission can expand on the margin rules with respect to particularly risky stocks by increasing capital charges. Finally, the net capital rule's 100-percent capital charge for illiquid securities serves to constrain the market for securities that have no liquidity or transparency. Without the ability to uniformly apply its net capital rule, the Commission's ability to oversee and influence U.S. securities markets is severely inhibited.

In addition to detailed net capital requirements that require broker-dealers to set aside additional capital for their securities positions, the Commission's customer segregation rule prohibits the commingling of customer assets with firm assets. Thus, customer funds and securities are segregated from firm assets and are well-insulated from any potential losses that may occur due to a broker-dealer's proprietary activities. Furthermore, federal securities law, unlike federal banking law, requires intermediaries to maintain a detailed stock record that tracks the location and status of any securities held on behalf of customers. For example, broker-dealers must "close for inventory" every quarter and count and verify the location of all securities positions. Because banks are not subject to such explicit requirements, the interests of customers in their securities positions may not be fully protected.

Because the Commission's financial responsibility requirements are so effective at insulating customers from the risk-taking activities of broker-dealers, the back-up protection provided by SIPC is seldomly used. Although there have been broker-dealer failures, there have been no significant draws on SIPC, and there have been no draws on public funds. In fact, because of the few number of draws on SIPC funds, SIPC has been able to satisfy the claims of broker-dealer customers solely from its interest earnings and has never had to use its member firm assessments to protect customers. This is in sharp contrast to the many, often extensive, draws on the bank insurance funds to protect depositors in failed banks.

We must continue to protect our markets from systemic risk by ensuring that there is enough capital to support the market risk that is inherent in securities transactions. In addition, we must ensure that customer funds and securities are fully protected by enforceable requirements to segregate customer assets from firm assets. To satisfy its quest for effective financial modernization, Congress should permit the Commission to set financial responsibility requirements for all securities activities, in order to better protect investors and U.S. markets.

*C. SEC Sales Practice Rules Applied to All Securities Activities*

All investors deserve the same protections regardless of where they choose to purchase their securities. Unfortunately, gaps in the current bifurcated regulatory scheme leave investors at risk. For example, broker-dealers are subject to a number of key *enforceable* requirements to which banks are not, including requirements to:

- recommend only suitable investments;
- arbitrate disputes with customers;
- ensure that only fully licensed and qualified personnel sell securities to customers;
- disclose to investors, through the NASD, the disciplinary history of employees; and
- adequately supervise all employees.[8]

[8] The federal bank regulatory agencies have issued guidelines that address some bank sales practice issues. *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" (Feb. 15, 1994). These guidelines are advisory and therefore not legally binding, and they may not be legally enforceable by bank regulators.

Investors are generally not aware of these gaps in regulation and the risks that such gaps create.

In addition, federal banking statutes do not provide customers a private right of action for meritorious claims, and banking regulators do not routinely fully disclose the details of any and all enforcement and disciplinary actions against banks to put customers on alert. Although some customer protections have been suggested by the bank regulators, they are less comprehensive than the federal securities laws and serve to perpetuate the disparities between the bank and securities regulatory schemes.[9]

Some have suggested a system of parallel securities regulation by the banking regulators. However, the Commission notes that the 12(i) model for regulation of bank issuer reporting has not achieved the objectives of the federal securities laws and, in fact, the Treasury Department's 1997 financial modernization proposal suggested eliminating section 12(i). Under section 12(i) of the Securities Exchange Act,[10] banking regulators are required to adopt rules "substantially similar" to the Commission's rules within 60 days after the Commission's publication of its final rules. Notably, one commentator has stated that "final action by the [banking] regulators in promulgating 'substantially similar' 1934 Act rules has been delayed in some cases over five years after pertinent SEC amendments have been issued."[11] In addition, the 12(i) model perpetuates a complex scheme of disparate rules offering different protections for investors and markets and different levels of enforcement efforts.

I would like to briefly discuss two recent Commission enforcement actions that highlight the need for more universal application of strict sales practices rules to all entities engaged in securities activities.

In the first case, the Commission is alleging that the portfolio manager of two money market mutual funds sponsored by a bank (i) caused the funds to purchase volatile derivative instruments, (ii) fraudulently transferred the derivatives at inflated values between the mutual funds to some of the bank's various trust accounts to cover up the mutual funds' losses, and (iii) ultimately caused the funds to "break the buck." The Commission investigated and has initiated enforcement action against the mutual funds' portfolio manager.[12] However, because of the current bank exemptions from federal securities law, the Commission was unable to bring charges against the bank or its personnel for failing to adequately supervise the fund manager. Under these facts, the Commission ordinarily would have brought charges against any of its regulated entities for similar misconduct, and the Commission considers its ability to bring "failure to supervise" claims to be critical to investor protection. Securities fraud of this type—where transactions occur both in mutual funds and in bank trust accounts—illustrates the need for securities regulators to have access to books and records involving all securities activities conducted by banks.

In the second case, employees of a bank and its broker-dealer subsidiary blurred the distinction between the two entities and their respective products during sales presentations to customers and in marketing materials.[13] In addition, the broker-dealer's employees mischaracterized certain products as conservative investments when, in fact, they were highly leveraged funds that invested in interest-rate-sensitive derivatives. These actions resulted in customers, many of whom were elderly and thought they were purchasing investments in stable government bond funds, making unsuitable purchases of high-risk funds. The case is also evidence of how difficult it is to protect investors when securities regulation is split between exempted banks and their related securities firms. When there are multiple regulators with different goals, the regulatory environment can be easily muddled, leaving investors at risk.

The Commission believes that the protections provided by the high, uniform standard of the federal securities laws should benefit *all* investors purchasing securities.

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[9] H.R. 10 does contain a provision (section 204) that requires each banking agency to adopt sales practice rules. These rules would not be as extensive as securities sales practice rules, and in some cases may vary from Commission rules. Moreover, section 204 states that the banking agency rules could apply to registered broker-dealer subsidiaries or affiliates of banks, which would create regulatory overlap and confusion. The Commission strongly objects to this approach.

[10] 15 U.S.C. 78l(i).

[11] Michael P. Malloy, *The 12(i)'ed Monster: Administration of the Securities Exchange Act of 1934 by the Federal Bank Regulatory Agencies,* 19 Hofstra L. Rev. 269, 285 (1990).

[12] *See In the Matter of Michael P. Traba,* File No. 3-9788, Release No. 33-7617 (Dec. 10, 1998).

[13] *In the Matter of NationsSecurities and NationsBank, N.A.,* Release No. 33-7532 (May 4, 1998).

*D. Uniform Mutual Fund Adviser Regulation and Conflict-of-Interest Rules*

Mutual fund investors should always receive the protection of the federal securities laws. Accordingly, all parties that provide investment advice to mutual funds should be subject to the same oversight, including Commission inspections and examinations. In addition, any type of entity that is affiliated with a mutual fund should be subject to the strict conflict-of-interest provisions of the federal securities laws. For these reasons, the Commission supports provisions that would address the increasing involvement of banks in the mutual fund business and reduce potential conflicts of interest. Fortunately, the House Banking Committee version of H.R. 10 contains the same important mutual fund provisions that we supported in the House-passed version of H.R. 10.

Banks that act as investment advisers currently enjoy an exemption from the registration and other requirements of the Investment Advisers Act of 1940. As a result, bank investment advisers are not subject to the substantive requirements applicable to registered investment advisers, including: (i) regulation of advertising, solicitation, and receipt of performance fees; (ii) establishing procedures to prevent misuse of non-public information; (iii) books and records and employee supervision requirements; (iv) the general anti-fraud provisions; and (v) statutory disqualification from performing certain services for a mutual fund if the adviser violates the law. All but (v), which came to our attention in a recent matter, are already included in the bill before the Commerce Committee.

In addition, as banks increasingly advise mutual funds, the Commission grows more concerned that its examiners do not have ready access to information regarding bank advisory activities that could affect bank-advised mutual funds. Such access is necessary in order to detect front-running, abusive trading by portfolio managers, and conflicts of interest (involving, for example, soft-dollar arrangements, allocation of orders, and personal securities transactions by fund managers). As part of its review for conflicts of interest with respect to a bank mutual fund adviser's activities, Commission examiners must be able to compare trading activity in a mutual fund portfolio to that in the bank's trust accounts. As discussed above, the Commission has had difficulty obtaining full access to all relevant information when reviewing the securities activities of banks that advise mutual funds.[14] The Commission must be able to review records relating to *all* securities activities relating to mutual fund advisers, just as it does for all other non-bank fund advisers.

The Commission is also concerned about the unique conflicts of interest resulting from increased bank involvement in the mutual fund business. Currently, the Investment Company Act of 1940 places restrictions on certain transactions between investment companies and their affiliates. These restrictions were crafted, however, at a time when Congress could not have anticipated the dramatic change in the scope of bank securities activities. Specifically, the Commission is concerned about conflicts of interest that may arise from:

- bank lending to affiliated mutual funds, possibly on unfavorable terms, to the detriment of fund investors;
- bank holding company personnel serving on the boards of directors of affiliated mutual funds;
- personnel of an entity that lends to, or distributes shares of, a mutual fund also serving on the fund's board; and
- bank trust departments that hold shares in an affiliated mutual fund in a trustee or fiduciary capacity and that have the power to vote such shares.

Legislation that targets such conflicts of interest is necessary. Banks that lend to, advise, and/or sell mutual funds should be subject to rules governing conflicts of interest that arise when banks act in multiple capacities. The Commission supports the provisions of H.R. 10 that address these conflicts of interest.

Finally, the Commission advocates adding a new section to H.R. 10 in order to protect mutual fund investors from banks that engage in misconduct. Currently, the Investment Company Act statutorily disqualifies certain types of entities (such as brokers, dealers, advisers, and transfer agents) and employees of such entities (including employees of banks) who have been convicted of a felony or are subject to a civil injunction. However, the Investment Company Act does not contain a similar statutory disqualification that would apply to a bank (the entity itself, as opposed to its employees) that had engaged in wrongdoing. In order to ensure that the protections of the Investment Company Act extend to investors in bank-advised mutual funds, the statutory disqualification provisions of the Act should be amended to include banks.

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[14] *See* note 7 and accompanying text above.

*E. Broker-Dealer Holding Companies*

In order to expand overseas, U.S. broker-dealer firms generally must demonstrate to foreign regulators that they are subject to comprehensive supervision on a world-wide basis. Thus, the Commission strongly supports the ability of U.S. broker-dealers to voluntarily subject their activities to Commission supervision on a holding company basis. The Commission's "umbrella" oversight would be based on a risk-supervision model that more appropriately reflects the predominant risk-taking securities activities of the consolidated entity. Of course, any regulated subsidiaries of a broker-dealer holding company would continue to be regulated by the appropriate statutory regulator.

The Commission believes that a supervisory framework for holding companies substantially engaged in securities activities would permit securities firms the flexibility to innovate and keep pace with the rapid changes in today's capital markets. This structure would impose risk-based supervision, consistent with the firm's principal business, and would help protect market integrity by ensuring that there are no supervisory gaps. Notably, the Commerce Committee markup of H.R. 10 in October 1997 also contained a provision allowing for broker-dealer holding companies that include a wholesale financial institution ("WFI") but that are primarily engaged in the securities business. The Commission strongly supports these provisions, which also enjoy the backing of Chairman Greenspan.[15]

IV. CONCLUSIONS

The Commission has testified many times during the past decade in support of financial modernization.[16] However, H.R. 10 as currently drafted provides for a labyrinth of complicated, technical exemptions from federal securities law regulation—the loopholes in the regulatory scheme are now larger than the scheme itself; this could dramatically undermine market integrity. Furthermore, as a practical matter, H.R. 10's securities exemptions have become so complex that it would be a "compliance nightmare" for banks to implement and for the Commission to monitor.

In the debates surrounding this issue, the Commission's primary concerns have been the protection of the integrity of U.S. markets and those who invest in them. Unfortunately, H.R. 10 as reported by the Banking Committee would prevent the Commission from effectively carrying out its statutory mandates, and the Commission is therefore strongly opposed to this bill. However, the Commission supports

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[15] In response to a question posed to Alan Greenspan during the April 28, 1999 hearing of the House Commerce Subcommittee on Finance and Hazardous Materials on the subject of financial modernization, Chairman Greenspan indicated his support for Commission-supervised broker-dealer holding companies.

[16] *See, e.g.,* Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Committee, Concerning Financial Modernization Legislation Before the Senate Comm. on Banking, Housing, and Urban Affairs (Feb. 24, 1999); Testimony of Harvey J. Goldschmid, General Counsel, U.S. Securities and Exchange Commission, Concerning H.R. 10, The "Financial Services Act of 1999" Before the House Comm. on Banking and Financial Services (Feb. 12, 1999); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 10, The "Financial Services Act of 1998," Before the Senate Comm. on Banking, Housing, and Urban Affairs (June 25, 1998); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization and H.R. 10, the "Financial Services Competition Act of 1997," Before the Subcomm. on Finance and Hazardous Materials of the House Comm. on Commerce (July 17, 1997); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Modernization, Before House Comm. on Banking and Financial Services (May 22, 1997); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Regarding H.R. 1062, the "Financial Services Competitiveness Act of 1995," Before the Subcomm. on Telecommunications and Finance and the Subcomm. on Commerce, Trade and Hazardous Materials of the House Comm. on Commerce (June 6, 1995); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning the "Financial Services Competitiveness Act of 1995" and Related Issues, Before the House Comm. on Banking and Financial Services (Mar. 15, 1995); Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 3447 and Related Functional Regulation Issues, Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce (Apr. 14, 1994); Testimony of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, Concerning Financial Services Modernization, Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce (July 11, 1990); Memorandum of the Securities and Exchange Commission (under Chairman David Ruder) to the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, Concerning Financial Services Deregulation and Repeal of the Glass-Steagall Act (Apr. 11, 1988); Testimony of David S. Ruder, Chairman, U.S. Securities and Exchange Commission, Concerning the Structure and Regulation of the Financial Services Industry, Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce (Oct. 5, 1987).

the effort to advance this process and is eager to continue to work with the Commerce Committee and the Congress on these issues.

The Commission encourages all involved to step back and look at the securities issues arising out of financial modernization and the complexity of the current rigid structure. We must not lose sight of basic securities law protections and goals, which have served to ensure that the U.S. markets are the fairest, safest, most vibrant, most transparent, and most liquid markets in the world.

As it has stated in its principles, the Commission believes that it may be time to rethink the approach to the functional regulation provisions of financial modernization legislation. They have become too complicated and may not be flexible enough to deal with developments over time. Rather than an inflexible laundry list of complex exceptions and loopholes, the Commission suggests we consider deleting many, if not all, of the exceptions and instead adopt exemptive rules in areas of traditional bank securities activities, an approach that would pose fewer investor protection and market integrity concerns.

We thank you for offering the Commission the opportunity to appear here today. I would be happy to answer questions that you may have.

## APPENDIX

### COMMISSION CONCERNS WITH H.R. 10

This appendix discusses specific provisions in the version of H.R. 10 reported by the House Banking Committee that pose some of the most serious threats to the Commission's ability to protect investors and the integrity of our markets.

*A. Broker-Dealer Activities*

1. *New Products*—The new products provision was originally designed to provide a fair process for handling new products sold by banks that might have securities elements. Briefly, this process is as follows. With respect to a new product sold by a bank, the Commission would be required to conduct a rulemaking in consultation with the appropriate banking regulators. Before requiring a bank to move any new activities into a separate entity, the Commission would have to formally demonstrate that the new product is a security and that investor protection concerns warrant requiring activities with respect to such new product to be conducted through a registered broker-dealer. The rulemaking process is designed to give fair notice to the banking industry and opportunity for all interested persons to comment.

However, this process has now been expanded to include requirements that are unacceptable to the Commission. H.R. 10 now includes a provision that permits any bank to obtain an automatic stay of the Commission's action, if the bank challenges the Commission's determination. The Commission does not object to judicial review of its actions, and, in fact, any aggrieved party can currently go to court to seek a stay of Commission action if it feels one is warranted. However, the automatic stay in H.R. 10 would act to delay Commission enforcement or regulatory action against a bank, perhaps for years. This is an unreasonable burden to place on the Commission, particularly given the speed with which this industry innovates and the fact that the rulemaking process—in lieu of enforcement actions or use of the Commission's interpretive authority—would already delay significantly the Commission's actions. The Commission's hands should not be tied indefinitely while the judicial review process winds its way through the courts. Moreover, as the nation's securities regulator, the Commission is bewildered by a new provision that would appear to give *bank* regulators deference in determining which products are securities, and subject to securities regulation.

2. *Derivatives Activities*—The Commission's principal concern in this area involves derivatives activities where the derivatives are securities or involve delivery of securities. Earlier bills have allowed these products to be booked by banks, but required the transactions to be conducted only with qualified investors, and effected through a registered broker-dealer. This scheme carefully permitted banks to maintain most of their derivatives activities "as is"—securities law protections would only apply where the derivative product was a security or involved delivery of a security. Moreover, it recognized investor protection concerns by restricting such derivatives dealing activities to qualified investors.

However, the version of H.R. 10 reported by the Banking Committee wreaks havoc with this delicate balance. It would exempt "any swap agreement" from the broker-dealer registration requirements, even swaps that are securities or that involve delivery of securities. Swap agreement is defined broadly and, as markets develop, could include standardized products that are used for price discovery purposes in equity and debt markets, all outside the scope of federal securities law. This open-ended exemption is unacceptable to the Commission because all securities can be recast as derivatives—a callable bond could be viewed as a derivative.

Because those derivatives that are securities or that involve the delivery of securities no longer would need to be sold through a registered broker-dealer, many of the protections of federal securities laws would not apply. Thus, the sales practice, net capital and other investor and market protection requirements of the federal securities laws will not govern sales of securities derivatives. In addition, the current version of H.R. 10 would eliminate the statutory requirement that securities-based derivatives be sold only to qualified investors, thus permitting an expanded class of products to be sold to any type of investor, regardless of the level of sophistication.

Finally, the banking regulators, rather than the Commission, would control the scope of this exemption for securities-based derivatives. For example, bank regulators would decide whether investor protection concerns warranted limiting bank sales of credit and equity derivatives to sophisticated investors.

3. *Receipt of Brokerage Commissions for Trust and Transfer Agency Activities*—Banks have traditionally provided trust services. Previous versions of H.R. 10 contained an exemption tailored to cover traditional trust activities. Specifically, this provision covered instances where a bank executed securities transactions in a fiduciary or trustee capacity through its trust department, or in employee benefit plans, dividend reinvestment plans, and issuer plans, but was not compensated on an incentive basis for such activity. In order to protect trust customers from banks having a "salesman's stake" in their transactions, previous bills did permit banks to charge an annual fee, an assets-under-management fee, or an order processing fee, but expressly prohibited a bank trust department and transfer agent from charging brokerage commissions that exceeded execution costs.

H.R. 10 has since been rewritten to permit banks, provided they are "primarily" compensated by fees other than brokerage commissions, to accept commissions in excess of their execution costs. The vague term "primarily" makes this a potentially huge loophole. Even though the current version of H.R. 10 attempts to limit potential excess by further requiring that additional compensation be "consistent with fiduciary principles," this is shallow protection. Any protections afforded to investors under fiduciary law will vary by state. In addition, fiduciary law may permit investor protections to be lessened, if not eliminated entirely, by contractual provisions. Significantly, we understand that banks also have been effective recently in lobbying state legislatures to statutorily relax some state fiduciary law requirements.

It is not enough to say that banks are "fiduciaries." Broker-dealers are also "fiduciaries;" nonetheless, Congress has determined that the protections of federal securities laws are necessary and integral to provide customers with full investor protection. Under the current version of H.R. 10, a bank and its personnel could have economic incentives—a so-called "salesman's stake"—in a customer account, without being subject to the strict suitability, best execution, sales practices, supervision, and accountability requirements that are imposed by the federal securities laws. As the Commission has stated, consistent regulation of securities activities is imperative in order for the nation's investors to be fully protected.

Moreover, investor protections with respect to bank activities in certain stock purchase plans were even further eroded under the current version of H.R. 10. The bill would delete the prohibition on a bank accepting brokerage commissions that exceed its execution costs, without even a requirement that any brokerage commissions that the bank receives be "consistent with fiduciary principles." In fact, transfer agents involved in sales of issuer stock purchase plans owe a fiduciary duty to issuers, not to investors, and the investor protections of the federal securities laws would not apply to bank customers.

4. *Private Placement Activities*—Small banks have traditionally conducted private placements in order to assist local business clients in capital formation. Accordingly, previous versions of this bill have permitted a bank that was not affiliated with a registered broker-dealer to engage in private placement activities with qualified investors.

The version of H.R. 10 reported by the Banking Committee would abandon this focus on small banks. H.R. 10 has been rewritten to allow all but the very largest banks to conduct private placement activities. The only restriction is that a bank that wishes to engage in private placements directly cannot be affiliated with a broker-dealer that underwrites corporate debt and equity securities. This would permit a large universe of banks (regardless of their size and history of private placement activities) to conduct private placement activities directly, outside of the reach of many of the investor protections provided under federal securities law. As it is, private placements are subject to fewer disclosure requirements under federal securities laws because they qualify for an exemption from the Securities Act of 1933.

Although banks have been permitted to engage in private placement activities for about 25 years, most big banks have moved such activities to their registered broker-dealer section 20 affiliates (where private placement activities count toward the 75 percent of "permissible" revenue). Once Glass-Steagall barriers (and the 75 percent revenue test) are eliminated, this significant market will be moved back into banks, outside of the protections of federal securities regulation.

5. *Definition of "Qualified Investor"*—Many of the exceptions provided for bank securities activities in previous bills have relied on the fact that less sophisticated investors would continue to have the protections of the federal securities laws governing their transactions. Thus, earlier versions of this legislation generally defined "qualified investor" narrowly with respect to complex instruments, like derivatives (essentially institutional investors), and more broadly with respect to private placements, asset-backed securities and loan participations.

Unfortunately, the current version of H.R. 10 defines "qualified investor" broadly with respect to all products, including derivatives, to include corporations, natural persons with more than $10 million and governments with more than $50 million. By significantly expanding the definition of "qualified investor," the current version of H.R. 10 would permit banks to offer derivative instruments to a broader class of investors, including individuals, fully outside the protections of federal securities law. This means a less sophisticated class of investors will not be protected by the additional supervisory, sales practices and suitability requirements imposed by federal securities laws, at the very time they would need them most. Moreover, certain municipalities and the Government Finance Officers Association ("GFOA") have stated that even sophisticated investors require the protections of federal securities laws, particularly suitability, with respect to derivatives trading activities.

*B. Mutual Fund Advisory Activities*

The Commission is pleased to see that the current version of H.R. 10 maintains important amendments to the federal securities laws to close the loopholes that banks enjoy with respect to their mutual fund advisory activities. These provisions were non-controversial and are necessary to evenly protect all mutual fund investors. In addition, these provisions are important because they would afford Commission examiners greater access to information regarding bank advisory activities that could affect bank-advised mutual funds. Such access is necessary to detect and prevent front-running, abusive trading by portfolio managers, and conflicts of interest. In addition, the Commission suggests one additional technical change discussed below.

Currently, the Investment Company Act statutorily disqualifies certain types of entities (such as brokers, dealers, advisers, transfer agents) and employees of such entities (including employees of banks) who have been convicted of a felony or have been subject to a civil injunction. However, the Act does not contain a similar statutory disqualification that would apply to a bank (as opposed to employees of the bank) that had engaged in wrongdoing. Commission staff have drafted a brief amendment that would accomplish this, and we encourage the Commerce Committee to adopt such an amendment, which is important to provide investors in bank-advised funds the same protections provided to investors in other funds.

*C. Broker-Dealer Holding Company*

In order to provide an effective two-way street between the banking and securities industries, securities firms must have the ability to affiliate with banking institutions without subjecting their entire holding company to top-down, bank safety and soundness supervision by the Federal Reserve. Accordingly, a broker-dealer holding company ("BDHC") must have the ability to affiliate with a wholesale financial institution ("WFI"), and BDHCs that engage primarily in securities activities (regardless of whether they are affiliated with a WFI) must be able to choose Commission supervision of the holding company. In addition, the Commission should retain backup examination authority over WFI holding companies to ensure compliance with securities laws. The Commission advocates the addition of broker-dealer holding company provisions to H.R. 10, and notes that an effective provision of this nature was included in the Commerce Committee's H.R. 10 report of October 1997.

Mr. OXLEY. Thank you, Chairman Levitt. Let me begin a round of questions for both of you gentlemen. Commissioner Nichols, the NAIC just for the record did not support last year's bill as it came out of the Commerce Committee; is that correct?

Mr. NICHOLS. That is correct, sir.

Mr. OXLEY. If you were to compare from your perspective the bill that we have before us now that we have from the Banking Committee this year as opposed to last year's bill, what are your general thoughts and what would we, this committee, essentially have to do to earn the support of the commissioners?

Mr. NICHOLS. First of all, I would like to say that we appreciate the bipartisan support that has occurred this year, and we do think that the bill has made improvements. However, the struggle that we have in terms of our role is, one, it does not adequately address our authority related to affiliations. There is broad language in there that preempts our authority as it relates to banks and bank affiliates.

We believe there is a need for you to address the issue of deference with our Federal regulators. Specifically, by putting in any laws that occur prior to September 1998 basically takes and calls into question everything that we do that is on the books today.

We also are concerned from our perspective that the whole tone of this actually, as Chairman Levitt has said, is more focused on the banks. If we are going to truly do financial services and you want functional regulation to work, we believe that it should be a level playing field. The same as you are addressing on the market side and the same on the regulatory side.

If there is the deference issue addressed, the language is cleaned up not to have sweeping preemption of our authority if you are a bank or affiliated with a bank, and then again address the issue of true financial service and functional regulation. I think that it is something that we could support.

Mr. OXLEY. Your testimony, as I recall, you also said that you would eliminate the—I forgot what term you used—eliminate the difficulty of out-of-state insurance sales.

Mr. NICHOLS. The issue of re-domestication you may be discussing. What it was is it was allowing companies to move to a State that would allow them to go into a different organizational structure.

We believe that it's important for individual States to maintain that level of control. If you have you a State that has investigated quite a bit, whether it be tax structures or other things, to organizationally make it appropriate for large insurance entities to function there, we would hate to see them to be able to move somewhere just because they don't like the rules.

We think that insurance rules based on a State basis are those unique to the people that live there. When you think of insurance and the uniqueness of it, we think that it is very, very critical that you focus on the individual needs of the States. My need for crop insurance and other things in Kentucky may be totally different than what you have in New York. Let us recognize the differences that our States offer and make sure that each State can protect its citizens in relation to the business of insurance.

Mr. OXLEY. Chairman Levitt, you indicated that there were too many products exempted under securities laws in the version that we have inherited from the Banking Committee. Do you believe that there are any exemptions that should be allowed for banks under securities laws?

Mr. LEVITT. Well, I think, if those exemptions were tailored very rigorously, that is possible. But the exemptions in this bill are so broad that the cleanest way to approach this, it seems to me, would be to look at them anew. These exemptions have come down the pike over the past 12 or 15 years, and it is very hard to be able to take them and streamline them and pick from column A and column B. I think we have to take a fresher approach to them.

Certainly we would be willing to sit down and work with you on the specific details. The ones that we have the greatest problems with, of course, are future products, private placements, trust activities, and the treatment of derivatives and swaps. Those are the ones that really open up the banks to dealing with securities issues directly and freezing out securities regulators. They could use these exemptions to, in effect, open the door for securities activities to go unregulated by securities regulators and to be under the jurisdiction of the banks.

Mr. OXLEY. How would you argue with those folks who say, for example, that within the trust department that there ought to be some exemptions from the securities laws based on the fact that you are dealing with generally sophisticated investors; you are dealing with trust departments and banks that have been there for a number of years; that the protections are adequate currently to deal with that without having another layer of regulation by the Securities and Exchange Commission?

Mr. LEVITT. The trust activities of banks have been part of banking as long as we have had a banking system. I think they operate reasonably and fairly, and we certainly would not propose sweeping away trust departments from banks.

But, the way this bill is written today, a full service broker could be run out of the trust department of a bank, which could charge commissions for securities activities. We would have to carefully address that provision in a way that would not broaden and extend the trust activities that are presently under the jurisdiction of banks to include consumer securities activities.

Mr. OXLEY. Thank you. My time has expired. Let me now recognize the gentleman from Michigan, the ranking member of the full committee, Mr. Dingell.

Mr. DINGELL. Mr. Chairman, thank you. Welcome to our panel, Mr. Chairman and Mr. Nichols. Thank you both for being here. I would like to focus with you, if you would, please, Mr. Nichols, on some very important questions since you have the expertise that has been denied this committee through a series of circumstances for a considerable while.

First of all, insurance is now regulated by the States, is it not?

Mr. NICHOLS. Yes, that is correct.

Mr. DINGELL. To the best of my knowledge, there is only Federal statute that relates to insurance regulation, and that is one which confers the basic authority over insurance regulation on the States; is that correct?

Mr. NICHOLS. Yes, sir, that is correct.

Mr. DINGELL. So if States are not permitted to regulate bank insurance sales, then who would regulate bank insurance sales?

Mr. NICHOLS. No one, from our perspective, sir.

Mr. DINGELL. So if we were to move to deny State insurance commissions the authority to regulate bank sales of insurance, we could guarantee that there would be no regulation of insurance sales at any level; is that correct?

Mr. NICHOLS. That is correct.

Mr. DINGELL. Sales made by the banks?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. That would completely strip the consumers of insurance services of any place to complain, would it not?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. The Federal Reserve, the Treasury, the Comptroller of the Currency have no statutory authority whatsoever to regulate sales of insurance; is that right?

Mr. NICHOLS. That is correct. And they also informed us they would not——

Mr. DINGELL. They would have no authority to deal with the questions of actuarial soundness of the insurance plans; is that correct?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. Now, having said that, how many of Michigan's insurance laws would be preempted by the bill that has been sent to us by the Banking Committee?

Mr. NICHOLS. Thirty-three.

Mr. DINGELL. Thirty-three. Would you submit the list of those, please, for the committee.

Mr. NICHOLS. Yes, sir. I think they have been handed out, sir.

Mr. DINGELL. If you would hand them out, Mr. Chairman, I would ask that they be inserted into the record.

Mr. OXLEY. Without objection.

Mr. Dingell, Michigan

## PROTECTING INSURANCE CONSUMERS

## IN THE UNITED STATES

- An average family can easily spend $3,000 each year on insurance products. Insurance comes in many varieties, including life, health, auto, home, mortgage, credit, corporate casualty, and crop insurance.

- All insurance policies have two things in common –
  - Consumers pay money to insurers for insurance policy coverage.
  - Insurers pay money to consumers when claims are made under a policy.

- State insurance regulators supervise this process in order to –
  - Protect the money consumers pay to insurers.
  - Assure that policyholders and claimants receive the insurance payments they are due.

- HR 10, as passed by the House Banking Committee, preempts essential State laws and guts the ability of insurance regulators to protect insurance consumers.

## WHEN MICHIGAN CONSUMERS PAY MONEY TO INSURANCE COMPANIES

➢ **State insurance regulation –**

- **Safeguards consumer premiums**
- **Monitors the financial stability of insurers**
- **Assures fair sales practices & consumer treatment**

| MICHIGAN LAWS AND REGULATIONS | Safeguard consumer premiums | Monitor the financial stability of insurers | Assure fair sales practices and consumer treatment | Does the House Banking Committee version of HR 10 preempt some or all of this law / regulation? |
|---|---|---|---|---|
| 1. **Third Party Administrator Statute** MICH. COMP. LAWS §§ 550.901 TO 550.962 (1985/1998). | X | X | X | YES |
| 2. **Rule (Regulation) Requiring Annual Audited Financial Reports** MICH. COMP. LAWS §§ 500.1001 TO 500.1025 (1992). | | X | | YES |
| 3. **Agents and Brokers Licensing Law** MICH. COMP. LAWS §§ 500.1200 TO 500.1244 (1972/1989). | | | X | YES |
| 4. **Agents Continuing Education Regulation** MICH. COMP. LAWS § 1204c (1992/1997). | | | X | YES |
| 5. **Managing General Agents Law** MICH. COMP. LAWS §§ 500.1401. TO 500.1419 (1990/1991). | | X | | YES |
| 6. **Investments of Insurers Law** MICH. COMP. LAWS §§ 500.901 TO 500.947 (1956/1994). | | X | | YES |

| MICHIGAN LAWS AND REGULATIONS | Safeguard consumer premiums | Monitor the financial stability of insurers | Assure fair sales practices and consumer treatment | Does the House Banking Committee version of HR 10 preempt some or all of this law / regulation? |
|---|---|---|---|---|
| 7. Organization and Ownership of New Insurance Companies Law MICH. COMP. LAWS §§ 500.402 TO 500.410 (1956/1982). | X | X | | YES |
| 8. Business Transacted with Producer Controlled Property/Casualty Insurer Law MICH. COMP. LAWS §§ 500.1451 TO 500.1459 (1994). | | X | X | YES |
| 9. Consumer Credit Insurance Law and Regulation MICH. COMP. LAWS §§ 550.601 TO 550.624 (1958/1987). MICH. ADMIN. CODE R. 550.201 TO 550.221 (1987/1995); SEE ALSO MICH. INS. BULLETIN 82-7 (1982); BULLETIN 87-07 (1987). | | | X | YES |
| 10. Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition MICH. COMP. LAWS § 500.436 (a) (1992). | X | X | | YES |
| 11. Law on Examinations MICH. COMP. LAWS § 500.222 (1957/1994). | | X | | YES |
| 12. Insurance Holding Company System Regulatory Act and Regulation MICH. COMP. LAWS §§ 500.1301 TO 500.1379 (1970/1995). | X | X | | YES |
| 13. Life and Health Insurance Guaranty Association Law MICH. COMP. LAWS §§ 500.7701 TO 500.7780 (1982/1997). | | | X | YES |

| MICHIGAN LAWS AND REGULATIONS | Safeguard consumer premiums | Monitor the financial stability of insurers | Assure fair sales practices and consumer treatment | Does the House Banking Committee version of HR 10 preempt some or all of this law / regulation? |
|---|---|---|---|---|
| 14. **Post-Assessment Property and Liability Insurance Guaranty Association Law** MICH. COMP. LAWS §§ 500.7901 TO 500.7949 (1969/1982). | | | X | YES |
| 15. **Insurers Rehabilitation and Liquidation Law** MICH. COMP. LAWS §§ 500.8101 TO 500.8159 (1990/1996). | | X | | YES |
| 16. **Life Insurance Disclosure Regulation** MICH. COMP. LAWS §§ 500.2226, 500.4012, 500.4038; BULLETIN 95-04 (1995). | | | X | YES |
| 17. **Life Insurance Illustrations Regulation** BULLETIN 97-06 (1997). | | | X | YES |
| 18. **Replacement of Life Insurance and Annuities Regulation** MICH. ADMIN. CODE R. 500.601 TO 500.606 (1971/1984). | | | X | YES |
| 19. **Long-Term Care Insurance Law and Regulation** MICH. COMP. LAWS §§ 500.3901 TO 500.3955 (1992). | | | X | YES |
| 20. **Medicare Supplement Insurance Minimum Standards Law and Regulation** MICH.COMP. LAWS §§ 500.3801 TO 500.3861 (1992) (includes regulation). See also, MICH. COMP. LAWS §§ 500.3701 TO 500.3728 (1956/1964); §§ 333.21054c TO 333.21054t (1990). | | | X | YES |
| 21. **Insurance Fraud Prevention Law** MICH. COMP. LAWS §§ 500. 4501 TO 500.4511 (1996). | X | X | X | YES |

| MICHIGAN LAWS AND REGULATIONS | Safeguard consumer premiums | Monitor the financial stability of insurers | Assure fair sales practices and consumer treatment | Does the House Banking Committee version of HR 10 preempt some or all of this law / regulation? |
|---|---|---|---|---|
| 22. Viatical Settlements Law MICH. COMP. LAWS § 550.521 TO 550.528 (1997). | | | X | YES |
| 23. Property and Casualty Rating Law MICH. COMP. LAWS §§ 500. 2600 TO 500.2674 (1957) (fire); MICH. COMP. LAWS §§ 500.2101 TO 500.2114 (1979) (auto and homeowners); §§ 500.2408 TO 500.2484 (1956) (casualty). | | X | X | YES |
| 24. Credit for Reinsurance Law and Regulation MICH. COMP. LAWS §§ 500.1101 TO 500.1105 (1994); MICH. ADMIN. CODE R. 500.1121 TO 500.1129 (1996). | | X | | YES |
| 25. Reinsurance Intermediary Law MICH. COMP. LAWS §§ 500.1151 TO 500.1171 (1994). | | X | X | YES |
| 26. Life and Health Reinsurance Agreements Regulation MICH. COMP. LAWS §§ 500.1121 TO 500.1127 (1994). | | X | | YES |
| 27. Standard Valuation Law MICH. COMP. LAWS §§ 500.834 TO 500.837 (1982/1995). | X | X | | YES |
| 28. Actuarial Opinion and Memorandum Regulation MICH. ADMIN. CODE R. §§ 500.881 TO 500.889 (1995). | X | X | | YES |
| 29. Unfair Trade Practices Act MICH. COMP. LAWS §§ 500.2001 TO 500.2093 (1957/1998). | | | X | YES |
| 30. Regulation on Unfair Discrimination in Life and Health Insurance on Basis of Physical or Mental Impairment MICH. COMP. LAWS § 500. 2027 (1977). | | | X | YES |

| MICHIGAN LAWS AND REGULATIONS | Safeguard consumer premiums | Monitor the financial stability of insurers | Assure fair sales practices and consumer treatment | Does the House Banking Committee version of HR 10 preempt some or all of this law / regulation? |
|---|---|---|---|---|
| 31. Unfair Claims Settlement Practices Act<br>MICH. COMP. LAWS § 500.2026 (1951/1977). | | | X | YES |
| 32. Rules Governing Advertisements of Accidental Sickness Insurance<br>MICH. ADMIN. CODE R. 500.651 TO 500.669 (1975/1991). | | | X | YES |
| 33. Rules Governing the Advertising of Life Insurance<br>MICH. ADMIN. CODE R. 500.1371 TO 500.1387 (1984). | | | X | YES |

# WHEN INSURERS PAY MONEY TO MICHIGAN CONSUMERS

- State insurance regulation –
  - Assures that companies have ability to pay claims
  - Assures that companies pay legitimate claims
  - Safeguards consumer rights to payment / coverage

| MICHIGAN LAWS AND REGULATIONS | Assure that companies have the ability to pay claims | Assure that companies pay legitimate claims | Safeguard consumers' rights to payment / coverage | Does the House Banking Committee version of HR 10 preempt some or all of this law / regulation? |
|---|---|---|---|---|
| 1. Third Party Administrator Statute MICH. COMP. LAWS §§ 550.901 TO 550.962 (1985/1998). | X | | X | YES |
| 2. Rule (Regulation) Requiring Annual Audited Financial Reports MICH. COMP. LAWS §§ 500.1001 TO 500.1025 (1992). | X | | | YES |
| 3. Managing General Agents Law MICH. COMP. LAWS §§ 500.1401. TO 500.1419 (1990/1991). | X | | X | YES |
| 4. Investments of Insurers Law MICH. COMP. LAWS §§ 500.901 TO 500.947 (1956/1994). | X | | | YES |
| 5. Organization and Ownership of New Insurance Companies Law MICH. COMP. LAWS §§ 500.402 TO 500.410 (1956/1982). | X | | | YES |
| 6. Business Transacted with Producer Controlled Property/Casualty Insurer Law MICH. COMP. LAWS §§ 500.1451 TO 500.1459 (1994). | X | | | YES |

| MICHIGAN LAWS AND REGULATIONS | Assure that companies have the ability to pay claims | Assure that companies pay legitimate claims | Safeguard consumers' rights to payment / coverage | Does the House Banking Committee version of HR 10 preempt some or all of this law / regulation? |
|---|---|---|---|---|
| 7. **Law on Examinations** MICH. COMP. LAWS § 500.222 (1957/1994). | X | | | YES |
| 8. **Insurance Holding Company System Regulatory Act and Regulation** MICH. COMP. LAWS §§ 500.1301 TO 500.1379 (1970/1995). | X | | | YES |
| 9. **Life and Health Insurance Guaranty Association Law** MICH. COMP. LAWS §§ 500.7701 TO 500.7780 (1982/1997). | X | | | YES |
| 10. **Post-Assessment Property and Liability Insurance Guaranty Association Law** MICH. COMP. LAWS §§ 500.7901 TO 500.7949 (1969/1982). | X | | | YES |
| 11. **Insurers Rehabilitation and Liquidation Law** MICH. COMP. LAWS §§ 500.8101 TO 500.8159 (1990/1996). | X | X | X | YES |
| 12. **Long-Term Care Insurance Law and Regulation** MICH. COMP. LAWS §§ 500.3901 TO 500.3955 (1992). | | | X | YES |
| 13. **Medicare Supplement Insurance Minimum Standards Law and Regulation** MICH. COMP. LAWS § 500.3801 TO 500.3861 (1992) (includes regulation). See also, MICH. COMP. LAWS §§ 500.3701 TO 500.3728 (1956/1964); §§ 333.21054c TO 333.21054t (1990). | | | X | YES |
| 14. **Insurance Fraud Prevention Law** MICH. COMP. LAWS §§ 500.4501 TO 500.4511 (1996). | X | | | YES |

| MICHIGAN LAWS AND REGULATIONS | Assure that companies have the ability to pay claims | Assure that companies pay legitimate claims | Safeguard consumers' rights to payment / coverage | Does the House Banking Committee version of HR 10 preempt some or all of this law / regulation? |
|---|---|---|---|---|
| 15. **Property and Casualty Rating Law** MICH. COMP. LAWS §§ 500.2600 TO 500.2674 (1957) (fire); MICH. COMP. LAWS §§ 500.2101 TO 500.2114 (1979) (auto and homeowners); §§ 500.2408 TO 500.2484 (1956) (casualty). | X | | | YES |
| 16. **Credit for Reinsurance Law and Regulation** MICH. COMP. LAWS §§ 500.1101 TO 500.1105 (1994); MICH. ADMIN. CODE R. 500.1121 TO 500.1129 (1996). | X | | | YES |
| 17. **Reinsurance Intermediary Law** MICH. COMP. LAWS §§ 500.1151 TO 500.1171 (1994). | X | | | YES |
| 18. **Life and Health Reinsurance Agreements Regulation** MICH. COMP. LAWS §§ 500.1121 TO 500.1127 (1994). | X | | | YES |
| 19. **Standard Nonforfeiture Law for Individual Deferred Annuities** MICH. COMP. LAWS § 500.4072 (1980/1987). | | X | X | YES |
| 20. **Standard Nonforfeiture Law for Life Insurance** MICH. COMP. LAWS §§ 500.4060 TO 500.4061 (1943/1994). | | X | X | YES |
| 21. **Standard Valuation Law** MICH. COMP. LAWS §§ 500.834 TO 500.837 (1982/1995). | X | | | YES |
| 22. **Actuarial Opinion and Memorandum Regulation** MICH. ADMIN. CODE R. §§ 500.881 TO 500.889 (1995). | X | | | YES |

| MICHIGAN LAWS AND REGULATIONS | Assure that companies have the ability to pay claims | Assure that companies pay legitimate claims | Safeguard consumers' rights to payment / coverage | Does the House Banking Committee version of HR 10 preempt some or all of this law / regulation? |
|---|---|---|---|---|
| **23. Unfair Trade Practices Law** MICH. COMP. LAWS §§ 500.2001 TO 500.2093 (1957/1998). | | X | | YES |
| **24. Unfair Claims Settlement Practices Law** MICH. COMP. LAWS § 500.2026 (1951/1977). | | X | | YES |
| **25. Viatical Settlements Law** MICH. COMP. LAWS § 550.521 TO 550.528 (1997). | | | X | YES |
| **26. Regulation to Define Standards and Commissioner's Authority for Companies Deemed to be in Hazardous Financial Condition** MICH. COMP. LAWS § 500.436 (a) (1992). | X | X | | YES |

Source: National Association of Insurance Commissioners

Mr. DINGELL. Now, Commissioner Nichols, please tell us what is the Unfair Claim Settlement Practices Act?

Mr. NICHOLS. That is an act that establishes the minimum standards for how insurance companies are required to handle the claim, paying it promptly, making sure they are communicating with you, making sure that you get what you deserve.

Mr. DINGELL. A version of that is in each State enforced by the State insurance commissioner; is that not so?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. If the State insurance commissioners were to be denied the authority to sell or, rather, to regulate insurance sales and insurance sales practices and practices of insurance companies with regard to consumers, there would be no one then to regulate that particular aspect of insurance company activities; is that right?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. Is there any other regulatory authority that can give Michigan consumers the same protections that this law provides?

Mr. NICHOLS. No, sir.

Mr. DINGELL. Now, let us look at another one. The Life and Health Insurance Guarantee Association Law and the Postassessment Property and Liability Insurance Guarantee Association Law, how do those benefit consumers?

Mr. NICHOLS. Those benefit consumers by if there is an insolvent insurer, those funds are made available to ensure that any policies that they have are fully enforced up to a financial limit. It is for their protection.

Mr. DINGELL. If these laws were to be preempted, what protection would be substituted, and what authority would either the Federal Reserve or the Comptroller of the Currency have to require protection of consumers with regard to these matters?

Mr. NICHOLS. There would be none, sir.

Mr. DINGELL. There would be none. So the consumers would be stripped naked of two very important protections, would they not?

Mr. NICHOLS. That is correct.

Mr. DINGELL. What is the Third Party Administrator's Law, and why should consumers be troubled if it were to be preempted by this legislation?

Mr. NICHOLS. The Third Party Administrative Law allows an insurance company to farm out or source out to another company the processing of claims and collection of premium. This makes sure that once that is done we are still allowed to hold full authority over the insurance company and they must assume responsibility for their claimants.

Mr. DINGELL. That is also administered by the State insurance commissioners, is it not?

Mr. NICHOLS. Yes, it is.

Mr. DINGELL. And State insurance commissioners, in most instances, administer similar, if not identical, statutes in each and every one of the States; is that not so?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. Now, if that were to be repealed by the action in this Congress in passing the legislation before us, there would be no one to provide that protection for American insurance consumers; is that correct?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. Now, Commissioner Nichols, some of these laws have been on the books for more than 40 years; is that correct?

Mr. NICHOLS. That is correct.

Mr. DINGELL. Is there any authority or expertise at the Federal level—now, I said authority and expertise at the Federal level which is comparable to the body of insurance law and regulations that now exists at the State level?

Mr. NICHOLS. There is none.

Mr. DINGELL. Is there any expertise in the Fed to do this?

Mr. NICHOLS. No, sir.

Mr. DINGELL. Is there any expertise in the Office of the Comptroller of the Currency or elsewhere in the Treasury Department?

Mr. NICHOLS. No, sir.

Mr. DINGELL. In a word, are you aware of any actions that have ever been taken by the Department of the Treasury or the Fed to regulate insurance matters?

Mr. NICHOLS. No, sir. But they have attempted to expand the ability of banks to do certain things in insurance.

Mr. DINGELL. In ways which would ofttimes deny you and the other State insurance commissioners the authority to regulate for the protection of consumers in your several States; is that right?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. Now it would seem that the Banking Committee's bill, therefore, lets the banks engage in insurance activities without regulations; is that correct?

Mr. NICHOLS. That is the way that we see it, sir.

Mr. DINGELL. And I would go on to note that while insurance companies are not bank related insurance agents would continue to be subject to Michigan's 33 insurance laws; is that right?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. And to regulation by the insurance commissioner; is that right?

Mr. NICHOLS. That is correct.

Mr. DINGELL. That would leave the insurance consumer in the State of Michigan afflicted with something of a Hobson's choice between banks totally exempt from regulation and an insurance salesman who would be subject to State regulations; is that right?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. So the banks could promise any damn thing they liked and deliver as little as possible; is that right?

Mr. NICHOLS. That is right.

Mr. DINGELL. There would be no place that the insurance consumer could go for redress; is that correct?

Mr. NICHOLS. That is correct, sir.

Mr. DINGELL. Now, is there any reason in your mind why we ought to abate the historic protection afforded to consumers by State insurance laws when they buy insurance at their bank?

Mr. NICHOLS. There is no reason, sir.

Mr. DINGELL. Banks are now subject to at least some of these insurance laws even while under the administration of the Comptroller of the Currency and the Federal Reserve Board; is that right?

Mr. NICHOLS. That is correct.

Mr. DINGELL. Is there any reason in your mind that would justify us coming to the conclusion that banks should be subject to less regulation than insurance companies and insurance agents?

Mr. NICHOLS. Not if you want to protect your consumers.

Mr. DINGELL. But if you want to scare them, letting the banks out from under regulation would be a fine way to begin, would it not?

Mr. NICHOLS. It would be an excellent way to do it, sir.

Mr. DINGELL. Thank you.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Iowa, Dr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman. I must commend Mr. Dingell for his thoroughness. If there were more members of the committee here, they each would have obtained their own personal handout on their own State insurance laws.

I appreciate Commissioner Nichols being here and Chairman Levitt. I want to follow up on a question that I asked Secretary of the Treasury Rubin; and that has to do with the NationsBank case.

And so, Chairman Levitt, I wonder—I understand that the NationsBank settled claims of $50 million for defrauding investors with securities sold by an op-sub. When I asked the Secretary Treasurer about this, he referred us to his assistant who then said rather blithely, said, Well, that was handled by the SEC, which actually I thought made my point in terms of functional regulation.

But I wonder if you could share with us the facts of that case; and specifically I would like to know, in your opinion, were investors confused by the sales of securities by a bank operating subsidy?

Mr. LEVITT. Yes. They clearly were. I think that, as Mr. Dingell pointed out, time and time again some years ago when banks began the sale of mutual funds to customers——

Mr. GANSKE. Mr. Chairman, can you pull the mike just a little closer.

Mr. LEVITT. That when banks began to sell mutual funds to individual customers, it became very easy to blur the lines between the banks, the insured deposits, the guarantees that went with so many banking activities, but clearly did not extend to money market funds or other funds that were being marketed to customers of banks.

And NationsBank was a clear case of blurring the lines, where investors were led to make purchases that they believed were totally secure. They thought that it was like a deposit; therefore, they couldn't lose any money. They were not told that the fund involved the purchase of very risky derivatives instruments. Furthermore, the sales of that fund—and I think this was the most repugnant part of all of it—were targeted toward elderly people, people who could ill afford to lose their funds, people who were really victimized by bank personnel using the prestige and power of the institution to imply a level of security that simply did not exist. It was fraud. It was misleading. It was a very bad performance.

Mr. GANSKE. Chairman Levitt, at the hearing before this committee on the last Congress, you stated, "It would be bad public policy to have the safety net extended over securities activities," that you thought the use of an affiliate was far preferable to having a subsidiary's structure. You were referring to bank securities underwriting in an op-sub. Do you still maintain that view in light of this case that you just told me about?

Mr. LEVITT. You know, I have learned—maybe I learn slowly, but I have learned after many years of dealing with complicated issues before the Congress that focus is all important. Any participant in any piece of legislation tends to have different interests. But here my interest is almost obsessional in terms of protecting investors.

This bill, as I see it, leaves investors naked, dangerously naked. If choosing an op-sub or choosing an affiliate were the central decision to be made, I don't think that bears as significantly on the well being of investors as other parts of the bill.

Yes, I believe that the affiliate structure certainly has administrative advantages. I am concerned about the fact that the op-subs are considered part of the bank for capital purposes and that the bank parent can suck out capital from the brokerage subs to help a weak bank. I think that, as I see it, is a shortcoming of the subsidiary structure. But overall, that is not our key issue.

Mr. GANSKE. Let me just follow up with one final question then because I want to get you on the record, the same as I did Secretary Rubin, on this issue of op-subs. And That is that you indicated that last year's committee print had your support to some degree.

The last—the Commerce Committee print from the last Congress provided for limited operating op-subs and these op-subs were limited to agency activities, as I said, to address Chairman Greenspan's concern about government coverage of taxpayer money. Can you give us your opinion? Would you be willing to support agency-only op-subs as a compromise?

Mr. LEVITT. I would have to think about that. My feeling is this: if this Congress is mindful of the importance to our markets of giving investors the basic protections that they have had for 65 years and extends to investors those same protections that they have had before and doesn't sweep them up in terms of calling something functional regulation which is not functional regulation, frankly, I would support any kind of structure that did that. I'm not going to get bogged down on one over the other.

We are most concerned with securities activities that remain in the bank. That is where our problem lies and our inability to get at that. That was one of the problems in NationsBank. It was one of the problems that we faced in terms of bank-marketed mutual funds. Clearly, I'm not going to be dogmatic about affiliates versus subsidiaries. I do feel that there are some administrative advantages to the affiliates, and it is for that reason that I gave support to that in the past.

Mr. GANSKE. Commissioner Nichols, would you concur with that?

Mr. NICHOLS. I think for the most part. That is clearly where our concern is; we cannot get to the situation occurring within the bank.

Mr. GANSKE. I thank you.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Wisconsin, Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman. Welcome, gentlemen. Prior to being on this committee I spent 6 years on the Banking Committee. One of the major reasons I left that committee was this legislation. So it is nice to see it again. I often described it as the legislative equivalent of the movie Groundhog Day. I don't know if you have seen that, a Bill Murray movie where every day was the same and the same thing would happen.

So now this is my fourth term in Congress and the fourth time I have seen this legislation, and I think your people have seen it for decades. Certainly careers are built around this legislation. But each time I go through it, I have to go back through a little primer and remind myself as to what we are doing.

I look at the various industries and those industries that may have the greatest incentives for this legislation and the ones that have the least incentive. In fact, I think of the securities and your office in particular as having one of the least incentives for this legislation. Maybe I'm wrong, but that is just my perception.

As I look through your testimony today, it is unclear to me as to whether your opposition is primarily that you don't think that the banks should be performing some of these functions or the fact, at least under your scenario, that they would be performing them without appropriate regulation. Can you help me with that?

Mr. LEVITT. Yes. I think the banking regulators of the United States do a superb job of protecting the safety and soundness of banks. I have sat on the boards of several banks. I have worked with banking regulators. I have listened to them make presentations to the boards. And the focus of their interests and their activity and their commitment has been the safety and the soundness of the bank.

Having been in the securities business for much of my life and now being a securities regulator, I understand what I have described as a cultural difference, where the interests of investment banks ad brokerage firms are entrepreneurial interests. The number of jobs that have been created in this economy and the strength of our economy are a function of a combination of risk-taking on the part of brokerage firms and capital extended by banks.

But they are two very different cultures. Now, the banking regulators—for instance, just to give you an example of some of the differences—don't impose enforceable sales practice rules. They don't have a duty to supervise. They don't have a system of arbitration enabling individual investors to bring their cases to arbitrators to decide them. They don't subject their supervisory and their sales personnel to testing and mandatory continuing education, and they don't require the disclosure to investors of a disciplinary history of those people selling products. They don't insure securities as SIPC insures the securities of investors at brokerage firms.

So my reason for so passionately opposing this bill is this: if you have the growing securities activities of banks involving individual investors subject to the oversight of examiners who are concerned primarily for the banks' interests and for the safety and soundness of the banks rather than for the investors' interests, that is just wrong. It represents a threat not just to investors, but I believe a threat to our markets.

Mr. BARRETT. So it is not, per se, an opposition to banks performing these functions?

Mr. LEVITT. Absolutely not. I think banks should perform this and other functions. I have no problem with that any more than I have a problem with allowing brokerage firms to perform banking functions. But I think it would be as wrong to ask the SEC to supervise banking activities of brokerage firms, because of the cultural difference, as it would be to ask banks to supervise the securities activities within the banks.

Mr. BARRETT. One of the other concerns that we often hear, of course, is then it becomes a fight among the regulators. We have heard from Mr. Greenspan; we have heard from yourself, all people of good will, obviously people who are committed to this. And it concerns me that there doesn't seem to be an acknowledgement or a belief that another regulatory agency can perform some of the same regulatory functions, for example, that your commission does.

Mr. LEVITT. Absolutely. And no doubt in time we could train the National Endowment of the Arts to supervise some of these activities. But why? To what end? We have contradictory objectives in some instances here. That is good; That is desirable to have that.

But to suggest that you take a 65-year history that is committed to investor protection—no such agency any place in the world can replicate the protection to investors extended by the SEC—and in one fell swoop, for whatever reason, you want to wipe that out in favor of having banking regulators do this? To what end? What reason do you have not to ask that securities activities be supervised by those who have been trained for 65 years to do them and not change cultures in midstream?

Mr. BARRETT. You make a passionate case for your agency.

Mr. LEVITT. I make a passionate case for investors, not for our agency.

Mr. BARRETT. Let me continue because I think if you look at it, if one looks at it from a perspective of a regulator from the government, you make all the sense in the world. But if one were to look at it from the standpoint of the business to say, well, this week we have got SEC in here and this week we have got the comptroller, this week this agency in here.

I'm not one who is considered a big lover of business, but I am sensitive to their concern that they are just going to be regulated to death. I just want you to respond to that.

Mr. LEVITT. Yes. If you look at the system of regulation involving financial services in the country today and you examine, for instance, a large multifaceted brokerage firm, a firm that is subjected to the inspection of State regulators, the SEC, Federal regulators, and self-regulatory organizations such as the New York Stock Exchange, that system works pretty darn well.

If you took away any element of it, if you remove the States, if you remove the self-regulatory organization, or if you remove the SEC, you would severely cripple the ability to police those markets; and the safety of those markets and the efficiency and the trust in those markets would evaporate virtually overnight. The same holds true here.

If banks are going to get into brokerage services, there is no reason to suddenly substitute a bank regulatory culture which is so different on those services. The bank regulatory culture is intended to protect the banks. The culture of securities regulation is intended to protect investors. Those two can work in a complimentary fashion, and there is no reason to substitute one for the other.

If we look at this 5 years from now and Merrill Lynch owns a large bank, I see no reason to suggest at that point in time that the SEC supervise Merrill's banking activities. That is not our experience; that is not our culture. That would not be in the best interests of banks or their customers.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Staten Island.

Mr. FOSSELLA. Thank you, Mr. Chairman. Chairman Levitt, let me concentrate briefly on securities regulation. I gather from your words you support SEC regulation of credit derivatives or swaps. Correct?

Mr. LEVITT. Yes, I do.

Mr. FOSSELLA. You state one of the principles at least for SEC support is that of sales practice regulation. Explain to me what the sales practice regulation is, please.

Mr. LEVITT. Well, the current provision allows banks to sell all derivatives to all investors without sales practice requirements. I think, to the extent that derivatives may be sold to nonsophisticated investors, to noninstitutional investors, there would clearly be the need to have certain disclosures.

Mr. FOSSELLA. With respect to the investor, I guess in some people's mind that would depend on the investor. I appreciate your advocacy clearly, in private and public, your support of protecting investors. But if you have a bank like a Citibank selling a derivative instrument to a sophisticated investor like a hedge fund, how does SEC sales practice regulation enter into that equation?

Mr. LEVITT. I think what the SEC has done with respect to the marketing of derivatives has been a very reasoned approach. We convened the largest derivatives dealers in the country, securities dealers representing nearly 90 percent of the securities activity in the derivatives market, and asked them to come up with a voluntary program of disclosure, of risk disclosure. That was called the Derivatives Policy Group. That has worked effectively without the need for regulatory oversight. I have said on a number of occasions that I'm not looking to develop a new series of regulations in the derivatives markets.

Mr. FOSSELLA. So where in there lies the sophisticated investor? They should self-regulate it?

Mr. LEVITT. I wouldn't use the word self-regulate. I think there is a need for greater disclosure, and we are getting that now with the Derivatives Policy Group, which up to now has worked reasonable effectively. The President's Working Group has made some suggestions, which Chairman Greenspan, Secretary Rubin, and I all support, for more disclosure. We simply cannot have enough disclosure in this regard, and I think I would use that expression rather than——

Mr. FOSSELLA. In an unrelated topic while I have you, however, I would like to get your opinion on what is commonly referred to as section 31 fees which support the SEC.

Mr. LEVITT. That is an easy one.

Mr. FOSSELLA. I beg your pardon?

Mr. LEVITT. That is an easy one.

Mr. FOSSELLA. That is what I am here to do, throw some softballs your way. It has been, I guess, demonstrated that section 31 fees generated are now in the area of $1.7 billion. There is different approaches as to what to do with the fees, I guess, on capital investment or tax on capital investment, depending on how you look at it.

Do you have a belief as to what should happen with the section 31 fees? There are different approaches that are being discussed, the rate cap, cap on fees. I would be interested to hear your opinion.

Mr. LEVITT. The section 31 fees changed their complexion when we extended those fees to include over-the-counter transactions. That happened as part of a funding mechanism for the SEC that Chairman Bliley devised. I guess it was 3 or 4 years ago.

There were a half dozen committees involved in this in both the House and the Senate, and I understand the desirability of reducing those fees. Indeed, by eliminating the double-counting that took place in the over-the-counter market, we have been able to constructively reduce those fees, I guess, by $10 or $15 million a year.

I think to further address that issue, the proposal to place a cap on the fees appears to be the most reasonable of the various proposals that I have seen. And the trick is to get the various committees that have an interest in these fees to come to the table and agree. But I think, of the various proposals that I have seen, that appears to be the one most likely to produce a consensus.

Mr. FOSSELLA. Thank you very much for your time, Mr. Chairman. I yield back.

Mr. OXLEY. The gentleman yields back time. The gentleman from New York, Mr. Engel.

Mr. ENGEL. Thank you, Mr. Chairman. Good afternoon, gentlemen. Chairman Levitt, this morning Secretary Rubin both in his written statement and his oral response to a question from Congresswoman DeGette indicated that the Banking Committee's security provisions in the bill provided inadequate consumer protections. I believe that he said that the exceptions swallowed the rules. And he indicated his willingness to work with you and with us to provide stronger investor protections.

I am wondering if you could help us understand what the sticking points are. I guess that is my question. He said there had been ongoing discussions with you and the bankers, but he felt there was still no solution.

Mr. LEVITT. That is true. We have had extensive discussions with Secretary Rubin and with Chairman Greenspan. And we have told them that we feel this bill does great, great harm to investor interest. With respect to the exemptions that have been created through the years, various changes that were made in the Senate version of this bill last year would, in effect, just substitute banking regulation for securities regulation over securities activities conducted within the walls of the banks.

Now, I don't have to tell you that any piece of complex legislation is a function of various interest groups that have an axe to grind. The insurance companies have an interest. You have heard about them. The banks have an overwhelming interest, and heaven knows we have heard about that. We have an interest. But the most powerful interest of all, in terms of the implications for the economy, is investor interest.

It is a question of who is willing to stand up, who is willing to say to the banks, look, I know you are not going to give in, but if you are not, you are not going to get a bill if you are going to hurt investors.

I have outlined before the loopholes created with respect to future products, trust activities, the way that derivatives and swaps are handled and private placements—private placements alone could be a proxy for investment banking activity. It's just there. It is there to happen. I understand Secretary Rubin is sympathetic and Chairman Greenspan is sympathetic. But will they say this issue is as important to them as the various issues that concern them? Time will tell.

Mr. ENGEL. One of the things that he also mentioned is that it would be cheaper for a small minority-owned bank to get into insurance and securities through an operating subsidiary versus a separate affiliate. I was wondering if that was your view as well.

Mr. LEVITT. I don't believe that. I think there are ways that an affiliate could be comparable. And certainly the Commission would be responsive to encouraging that in any way that we could.

Mr. ENGEL. What are the costs associated with setting up a broker-dealer as a separate affiliate?

Mr. LEVITT. I don't know precisely. I would have to do some work on that and get back to you, if I might.

Mr. ENGEL. The Secretary also said in his opinion the problem that our financial services face abroad is lack of access and not lack of competitiveness. I know it is a trade issue obviously in large part, but several large broker-dealers have told us that their access in some countries is hindered because they don't have a consolidated regulator or an umbrella supervisor.

Is there anything in H.R. 10 that would address this concern, and if not, should this concern be addressed? Do you have any suggestions for us on that?

Mr. LEVITT. I think to some extent the WFI might be one way to do this, and I think the problem that the Secretary mentions is a legitimate problem and something that I think we have to be mindful of.

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

Mr. LEVITT. By that I meant the broker-dealer holding company containing a WFI, which I think this committee considered seriously the last time out.

Mr. ENGEL. Thank you.

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

The gentleman from Florida, Mr. Deutsch.

Mr. DEUTSCH. Thank you, Mr. Chairman.

I thank the Commissioner as well.

Mr. Levitt, if you could, I have read through your testimony and I have heard some of the responses to questions in the last couple minutes as well, but just for a couple seconds, you have discussed the current bill's possible adverse effect on the economy. In layman's terms, could you maybe get into some analysis of the difference between the effect of the House banking bill versus the effect of the bill that this committee passed last year in terms of the market and in terms of the average consumer in America?

Mr. LEVITT. Last year's bill, which we supported as a better alternative than something which we felt was pretty bad, was by no means perfect. The reason that we favor the Commerce Committee's approach to this bill is that it respects the primacy of consistent regulation. I no longer use functional regulation because that word has been so misused by people who have other reasons for using it. This committee, in terms of its approach has respected consistent regulation, and its proposal last time was intended to see to it that all securities activities that take place within the banks are supervised and regulated by securities regulators. That is the fundamental difference between the bill that came out of the House which creates a situation where banking regulators supervise virtually everything that goes on within the walls of the banks.

I have mentioned specific areas which we find the most dangerous from that point of view. If anything, this year's bill is more troublesome, but the bill that is winding its way around the Senate is probably the worst of all.

Mr. DEUTSCH. My understanding, and you have testified to this effect of negotiations that you are in the process of having with Secretary Rubin as well as Mr. Greenspan regarding the—and I will use the term, because I guess that is a term that we are still using, the "functional regulation" issue, can you give us any report on the progress of those negotiations?

Mr. LEVITT. I think I said before that intellectually I am sure that I know that both of them share the concerns for investors that we have expressed, but their interests in and their versions of the bill have other aspects, with other constituencies.

As far as I am concerned, our only constituent is the investing public, and whether their interest is in coming to some sort of a consensus arrangement which has the chance of legislative reality and executive passage, signature, I simply don't know. I think that they have expressed support for our position, but how far that support will go in terms of its tradeoff for other interests, only time will well.

Mr. DEUTSCH. Is it fair to say that you are continuing in this process?

Mr. LEVITT. Is it fair to say what?

Mr. DEUTSCH. That you are continuing in these discussions, these negotiations?

Mr. LEVITT. Yes.

Mr. DEUTSCH. So these discussions are ongoing?

Mr. LEVITT. Absolutely.

Mr. DEUTSCH. Is there anything we can do to be helpful?

Mr. LEVITT. I will think about that.

Mr. DEUTSCH. Let me ask you—and again you talked a little bit about it in your testimony, and this is just, you know, as I try to understand what is actually going on in the world today, my understanding is that, in fact, banks are using swaps, using derivatives in equities, which have the equivalent of basically sales of securities. That is going on today. Would you say that is accurate, and if it is accurate, how does the SEC view that activity? My understanding is that it is going on without SEC interaction at all.

Mr. LEVITT. If there are derivative activities going on with securities involving fraud, the SEC would obviously have jurisdiction. I believe that the derivatives activities of banks are by and large being done with institutional investors. We have a much greater understanding of the nature and extent of those activities as a result of the establishment of the DPG which I mentioned before.

Mr. DEUTSCH. But again, if I can just follow up with just one final question, your answer seems to infer that only in cases of fraud would you be involved.

Mr. LEVITT. No, no, fraud in the swaps market is a rare occurrence.

Mr. DEUTSCH. Right. So again, if in fact they are trading securities, equities, through swaps, in effect you have no jurisdiction today; or are you not using what you might infer as jurisdiction? In other words, I guess my point is, isn't this already occurring and it is occurring within the banking laws without the SEC really being involved in this today?

Mr. LEVITT. Most swaps, I would point out, don't represent securities, and those that do should follow the same rules as securities that are sold by brokers.

Mr. DEUTSCH. I don't—I am still not hearing the answer. My understanding is that is going on today, but you are not regulating it, you are not involved.

Mr. LEVITT. You are correct, there is a blanket exemption now.

Mr. DEUTSCH. And if that is the case and we don't really see issues of fraud, then I mean why do we think there would be problems? I mean, in other words, it is already going on. Shouldn't all these parades of horribles that you described, shouldn't they be taking place already?

Mr. LEVITT. Because I think in the world as I see it developing, with more and more securities activities going into banks and the increasing likelihood of acquisitions of brokerage firms by banks, this will become far more important in terms of securities activities than it is today.

Mr. DEUTSCH. Okay. Thank you, Mr. Chairman.

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

The gentleman from Illinois, Mr. Shimkus.

Mr. SHIMKUS. Real quickly. Thank you, Mr. Chairman, and I welcome to the committee Chairman Levitt who graced us with his hospitality maybe 6 weeks ago at the SEC and I enjoyed that visit. I learned a lot too, and I think that is important.

I have been focusing on this issue, on safety and soundness, and now consistent regulation. Politicians—you have to be careful about changing words for us, because I am very comfortable with "functional," but I will use "consistent." And my focus has been on the operating sub and really the FDIC insurance and how that might impact safety and soundness.

Your predecessor, Richard Breeden, when asked about the operating subsidiary before the Commerce Committee made the following statement: "If government subsidies such as the operating subsidiary are introduced into the securities market, then the dulling narcotic effect of these subsidies and the related bureaucratic nannyisms will work a prompt and significant alteration on the culture of Wall Street." Do you agree with that?

Mr. LEVITT. My predecessor, whom I respect and admire a great deal, was much more confrontational than I am. Again, it is not my primary issue. My issue is again consistent regulation, and I have expressed, for administrative purposes, some preference for the affiliate structure. Will western civilization rise or fall on that decision? I don't know. Again, I don't want to divert from something that I consider to be of much greater importance.

Mr. SHIMKUS. I think why members of the committee may be focusing on this is because there seems to be an impression that last year it was an issue which you were concerned about, and if the answer is no to this question, or to the view that they may be different than the position taken last year——

Mr. LEVITT. I think the difference is simply that the threat that I see to our markets and to investors in a bill which so blurs the line between banking and securities regulation is of such compelling and immediate importance that it overrides my concern for the structural issue. Again, I have some preference for the affiliate structure, but that is of a much lower level of concern than the other, and I am going to stick with that.

Mr. SHIMKUS. That answers my question. Or it doesn't—it addresses my question, so I will yield back my time, Mr. Chairman.

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

The gentleman from Michigan wishes to be recognized.

Mr. DINGELL. I thank you for that courtesy and I thank you for your patience.

Under the exemptions, Mr. Chairman, I note that private placements would be one of the exemptions. The Fed would be required to come up with certain rules, and the Fed, the OCC and the Treasury would be required to come up with certain rules with regard to these matters. Now, private placements are kind of peculiar. First of all, the number of people who can participate in them are very small, they have to be highly sophisticated, they have to have a lot of money, which makes them presume to be very sophisticated and smart. But there is much less in the way of protection for the rights of the investor in that situation.

In instances where there are private placements, the rules that are now in place under the SEC would not necessarily be in place under the new regime under the legislation. The practical result of that would be that every one of the placements could essentially become private placements playing under the rules which afford vastly less protection for the investor. Indeed, zero protection for the investor on the assumption that anybody who is silly enough to go into one of these private placements would be smart enough to protect himself and have enough money even if he missed it, isn't that right?

Mr. LEVITT. Absolutely.

Mr. DINGELL. Now, just one other thing. Your current authority over private placements regarding suitability, disclosure, failure to supervise, and the requirements with regard to keeping books and records would be significantly modified as to activities within the banks and also as to activities within the wholly owned op-subs, isn't that so?

Mr. LEVITT. That is correct, and I might say that a majority of the corporate debt you spoke of before is placed privately. A majority of corporate debt is privately placed.

Mr. DINGELL. Not subject to disclosure and not subject to other rules to protect the investor; isn't that right?

Mr. LEVITT. Not under this configuration.

Mr. DINGELL. Thank you.

Thank you, Mr. Chairman.

Mr. OXLEY. The committee wishes to thank both of you for, once again, excellent testimony. As I indicated when you first arrived, we hope this is the last time that you will be here testifying on this particular issue, although we welcome you on many issues in the future other than financial services modernization. Thank you very much.

Mr. NICHOLS. Can I make a comment, sir, before we go?

Mr. OXLEY. Please.

Mr. NICHOLS. I hope that as you all move forward on this, that you recognize that as we have addressed the issue of banking, we have talked about the business of banking, but on this panel you have heard from Arthur Levitt whose focus has been on the end result, the investor, and my focus has been on the insurance consumer. As we go through financial modernization, we should allow them to commingle, but let us keep that in perspective: that two of the pieces of the three-legged stool are very, very critical to the ones that are actually investing the money.

Mr. OXLEY. And two of those legs are under the jurisdiction of this committee, so I appreciate your remarks. Again, I thank you so much for your testimony.

The subcommittee will stand in recess for 5 minutes so that we can have the other panel come up to the witness table.

[Brief recess.]

Mr. OXLEY. The subcommittee will reconvene. I know that we have our final panel here, because they have been waiting patiently all day, since 10 o'clock this morning. So we are pleased to have you here. Let me introduce the panel. Mr. Arnold Schultz, Board Chairman for the Grundy National Bank from Grundy Center, Iowa; Mr. Mark Sutton, President of the Private Client Group from PaineWebber, from Weehawkin, New Jersey; and formerly mentioned and introduced by my colleague, Paul Gillmor, Mr. Craig Zimpher, Vice President of Government Regulations, Nationwide Insurance Corporation. I agree with most of the things that Congressman Gillmor said about you. Mr. Scott A. Sinder, partner of Baker and Hostetler, a good Cleveland-based firm located here in Washington, on behalf of the Independent Insurance Agents, the National Association of Life Underwriters, and the National Association of Professional Insurance Agents of America.

So gentlemen, thank you all for your patience. It is always difficult to be on the last panel, but we thank you for your patience and your understanding.

Mr. Sutton, I am going to begin with you, as I understand you might have a plane to catch. So let me begin with your testimony. After your testimony, again, feel free to stay as long as you can, but I understand your commitment as well.

**STATEMENTS OF MARK B. SUTTON, PRESIDENT, PRIVATE CLIENT GROUP, PAINEWEBBER INC.; ARNOLD SCHULTZ, BOARD CHAIRMAN, THE GRUNDY NATIONAL BANK; W. CRAIG ZIMPHER, VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONWIDE INSURANCE CORPORATION; AND SCOTT A. SINDER, PARTNER, BAKER AND HOSTETLER, LLP, ON BEHALF OF INDEPENDENT INSURANCE AGENTS OF AMERICA, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, AND NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS OF AMERICA**

Mr. SUTTON. Thank you very much. I appreciate it.

Chairman Oxley and members of the subcommittee, I am Mark Sutton, Executive Vice President of PaineWebber Group and President of PaineWebber's Private Client Group. I am also a member of the Board of Directors of the Securities Industry Association.

First of all, let me say I appreciate the opportunity to present PaineWebber's views on H.R. 10 and the Financial Services Act of 1999. PaineWebber commends you for your efforts and those of this subcommittee to enact desperately needed legislation to modernize the regulation of the United States financial services industry.

I manage PaineWebber's retail brokerage business. We have over 18,000 employees in 300 offices around the United States. Passage of H.R. 10 is essential to providing PaineWebber and the entire securities industry fair access to compete globally and nationally. This is a dynamic time in the financial services industry with the demographic shifts in the aging baby boomers and the increasing numbers of companies changing their pension plans from defined benefit to defined contribution. Each of these actions contribute to the creation of 50 million individual pension plan managers. These significant domestic shifts, along with global competitive challenges, present the platform for my appearance today, urging you to pass H.R. 10 this year.

Mr. Chairman, my message is simple. The securities industry strongly supports financial services modernization and urges this subcommittee, the Commerce Committee, the House, and the Senate to pass it promptly.

Last year, the House capitalized on a unique opportunity for the passage of financial services modernization legislation when large segments of the banking, securities and insurance industries were able to reach a series of compromise positions on issues that had previously divided them and that had previously prevented legislation from being enacted. We believe the opportunity created last year for passage of financial services legislation still exists, and we urge the House to act swiftly to pass this legislation.

PaineWebber believes that there is more than one approach to modernize the regulatory framework for the financial services industry. For the securities industry to support the legislation, it should satisfy three fundamental principles: first, maintaining functional regulation; second, providing a two-way street; and finally, fostering competition without Federal subsidies. For the legislation to be successful, it should incorporate the compromise provisions agreed to by industry and also by Members of Congress.

These provisions, particularly the functional regulation of bank securities activities are not only good public policy, but they also remove the disagreements that have derailed this legislation many times in the past. Today, financial institutions are affiliating with one another at an accelerating speed under a regulatory system that was intended to ban such affiliations. In the last 2 years, banks have acquired more than 50 securities firms. Mergers and acquisitions are occurring in spite of significant and anticompetitive regulatory obstacles.

For example, currently, banks can acquire securities firms while securities firms generally cannot acquire commercial banks. The financial services industry will continue to evolve in response to customers' demands, but it is simply not desirable, nor possible, to maintain the status quo. The fundamental policy question for Congress is not whether these affiliations should occur, but what regulatory systems should govern the combined entities. Surely it should not be the current patchwork regulatory structure that gives some financial institutions unfair and irrational competitive advantage over others.

PaineWebber supports key provisions of H.R. 10 because they go a long way toward meeting the three principles upon which any new financial legislation should be built. The first principle, functional regulation, would require one regulatory agency to apply the same set of rules to the same activity engaged in by any financial institution regardless of the type of financial institution it may be. Under H.R. 10, most securities activities would be performed outside of a bank, except for a small number of carefully defined securities activities that traditionally have been conducted in banks with the benefit of SEC, SRO, and State securities regulation.

After years of negotiation, the securities and banking industries developed a set of functional regulation provisions that permitted banks to continue to engage in certain securities activities that banks had traditionally provided to their customers as an adjunct to their banking services, but that required full-scale brokerage operations be conducted outside of the bank in an SEC- and NASD-regulated brokerage affiliate. Notably, PaineWebber is not aware of any significant opposition in either the banking or the securities industries to these functional regulation provisions. PaineWebber supports the strong regulation provisions in H.R. 10.

Second, the legislation generally provides for a two-way street by permitting securities firms, insurance firms and banks to freely affiliate with one another on the same terms and conditions and to engage in any activity that is financial in nature.

Third, PaineWebber supports the holding company affiliate structure. But importantly, H.R. 10 allows for the SEC to regulate securities activities whether they are conducted in an affiliate under a holding company structure or in an operating subsidiary of a bank. PaineWebber believes that this would, at a minimum, ensure that securities activities are regulated by the appropriate experienced authority.

Mr. Chairman, in the last session, PaineWebber supported H.R. 10 and worked actively to pass it. The bill presented a series of compromises by every sector of the financial services industry. We supported the bill because we were, and we are, committed to maintaining the delicate consensus compromise that emerged among all of the participants. PaineWebber has worked with you, Chairman Oxley, members of this subcommittee, others in Congress and many in the financial services community to reach a number of the compromise positions that are reflected in H.R. 10. The progress we have made cannot be overstated. Passage of the financial services modernization legislation is vital to maintaining the global competitiveness as well as the financial products and services for our individual customers.

Mr. Chairman, we look forward to working with you, members of your subcommittee, as well as the House, Senate and administration to enact financial services legislation reform this year. Thank you.

[The prepared statement of Mark B. Sutton follows:]

PREPARED STATEMENT OF MARK B. SUTTON, PRESIDENT, PRIVATE CLIENT GROUP, PAINEWEBBER GROUP, INC.

Chairman Oxley and members of the Subcommittee, I am Mark B. Sutton, President Private Client Group, PaineWebber Group, Inc. I am also a member of the Board of Directors of the Securities Industry Association. I appreciate the opportunity to present the views of PaineWebber on H.R. 10, the *Financial Services Act of 1999*. PaineWebber commends you for your efforts Mr. Chairman, and those of this Subcommittee, to enact desperately needed legislation to modernize the regulation of the United States financial services industry. PaineWebber is optimistic that this year Congress will pass, and the President will sign into law, widely supported financial services modernization legislation. We look forward to working with you and members of this Subcommittee to achieve this result.

I manage PaineWebber's entire retail brokerage business. We have over 7000 financial advisors and over 300 offices around the United States. Passage of H.R. 10 is essential to providing PaineWebber and the entire securities industry fair access to compete globally and nationally. This is a dynamic time in the financial services industry with the demographic shifts in the aging baby boomers and the increasing shifts in companies' pension plans from defined benefit to defined contribution in effect, contributing to the creation of 50 million individual pension planners. These significant domestic shifts, along with global competitive challenges, present the platform for my appearance today in urging you to pass H.R. 10 this year.

My message today is simple. The securities industry strongly supports financial services modernization legislation and urges this Subcommittee, the Commerce Committee, the House, and the Senate to pass it promptly. Last year, the House capitalized on a unique opportunity for the passage of financial services modernization legislation when large segments of the banking, securities and insurance industries were able to reach a series of compromise positions on issues that previously had divided them. We believe the opportunity created last year for passage of financial services modernization legislation still exists, and we urge the House to act swiftly to pass legislation this session.

PaineWebber shares the concerns of certain members of this Subcommittee that H.R. 10 has flaws. But reform of existing financial services regulations must be viewed in a realistic context. After more than 60 years of operating under the current regulatory structure, banks, thrifts, insurance companies and agents, securities firms, consumer groups, financial services regulators, executive agencies and others have legitimate, competing and often conflicting views of how the financial services industry should be regulated. Due in part to the large number of competing interests, financial services modernization legislation has stalled in every congressional session in recent memory. In this environment, no bill can be "perfect," because each bill will represent a compromise in which each industry may get some, but not all, of its favored solutions. It, therefore, is left to Congress to resolve these competing interests and develop legislation that is in the national interest.

Under the current regulatory system, banks are rapidly acquiring securities firms and banking regulators are being forced to devise new ways to regulate and supervise their bank securities affiliates—a role previously the exclusive domain of the Securities and Exchange Commission (SEC). Neither securities customers nor the financial services industry benefits from the ad hoc and duplicative regulatory scheme that has developed. And the longer regulators debate ever finer points of jurisdiction and competing regulatory schemes, the more deeply and permanently entrenched the banking industry and regulators become in the securities industry.

The regulatory system under H.R. 10, warts and all, is significantly superior to the current system for financial services consumers and firms alike.

Congress has the opportunity to build upon the momentum generated last year and act swiftly to pass legislation. To lose this opportunity would be highly unfortunate for the financial services industry, which is laboring under an antiquated and often counterproductive regulatory system. Moreover, it would be a loss for the American public, who, as consumers of financial products and services, are not receiving the benefits of competition and innovation that would result from financial services modernization legislation.

The need for prompt financial services modernization legislation is compelling. As I mentioned earlier, today financial institutions are affiliating with one another at a dizzying speed. What's more, these affiliations are occurring under a statutory system that originally was intended to ban such affiliations. These affiliations are the result of ad hoc decisions by banking regulators that have permitted banking organizations to acquire securities firms, while securities firms generally remain prohibited from acquiring commercial banks. This is the case, because, under current law, if a securities firm were to acquire a bank, the combined entity would become subject to the Bank Holding Company Act and the Glass Steagall Act, even though these laws were not designed to accommodate many of the ordinary and customary activities of securities firms (such as securities underwriting and dealing, the distribution of mutual funds, merchant banking, venture capital, commodities and various other activities). Also, many of the current restrictions on bank affiliates were imposed prior to the invention of computers, fax machines, ATMs, the Internet, and various other technological innovations that have transformed the financial services industry. Statutory impediments more than 60 years old make little sense in today's technologically sophisticated highly competitive and global financial world.

Still, financial services providers continue to affiliate under the current regulatory framework, despite outdated restrictions that unfortunately increase the cost of affiliations and limit the competitiveness of the combined firms. In the last two years, banks have acquired more than 50 securities firms. Financial services firms affiliate in response to their customers' and clients' demands and to remain competitive in the financial marketplace. The financial services industry will continue to evolve regardless of whether financial services modernization legislation is enacted. It is simply not desirable or possible to maintain the *status quo.* The fundamental policy question for Congress is not *whether* these affiliations should occur, but what regulatory system should govern the combined entities. Surely, it should not be the current patchwork regulatory scheme that gives some financial institutions unfair and irrational competitive advantages over other financial institutions. PaineWebber believes these combined entities should be regulated under a system similar to that contemplated under H.R. 10. Providing financial services in functionally regulated entities that may affiliate with one another in a holding company structure will enhance the competitiveness of all financial services firms, ensure investor protection, and assure the appropriate level of protection for depositors and the deposit insurance fund.

The U.S. securities industry is perhaps as competitive as any industry in the world. It is in part a result of that competition—including the ability to affiliate with entities other than banks—that the U.S. capital markets are the world's largest and most liquid. In the securities markets, one need only look at the vast choices in products, services, providers, and methods of compensation to see how competition has greatly benefited investors. Consumers can invest in stocks, bonds, and thousands of mutual funds. They can choose a full-service provider or a financial planner to receive advice on managing their assets. More independent and knowledgeable investors can use a discount firm to execute their transactions. Alternatively, consumers can make their trades electronically over the Internet for a fraction of the cost of just a few years ago. Investors can choose to compensate their broker in a traditional commission arrangement, a flat-fee basis, or as a percentage of assets under management. These changes greatly benefit investors and are the direct result of a highly diverse, competitive industry that is willing and able to invest the capital needed to meet the demands of its customers. Passage of financial services modernization legislation would bring the benefits of competition, including cost savings estimated at $15 billion over three years, to the entire financial services marketplace.

Mr. Chairman, PaineWebber generally supports H.R. 10 for several reasons.

First, H.R. 10 has an appropriate definition of "financial in nature," which governs the types of activities in which financial holding companies may engage. Permissible activities also would include activities that are incidental or complementary to activities that are financial in nature, in order to permit securities, insurance and other types of financial services firms to continue providing long-standing and important services to their customers.

Second, H.R. 10 would create a new regulatory structure that would enhance the competitiveness of financial services firms by permitting securities firms, insurance companies, and banks to freely affiliate in a holding company structure. This would increase competition between financial services firms, thus reducing costs and giving consumers more choices. It also would help the U.S. financial services industry maintain its preeminent status in the global economy. Under H.R. 10, the holding company would be regulated by the Federal Reserve Board. Each of the subsidiary financial institutions engaging in a securities business would be registered as a broker-dealer and would be functionally regulated by the SEC, thereby bolstering investor protection and fair competition.

Third, H.R. 10 would give customers more choices. Many individuals and corporate customers worldwide are demanding to have all their financial needs met by a single firm. The ability of securities firms, insurance companies, and banks to affiliate would allow a single financial services firm to meet those needs. Individuals could choose a full-service provider because they value something as simple as a single monthly statement showing their checking account balances, securities holdings, retirement account investments and insurance policy values.

Fourth, the legislation generally provides for a two-way street, by permitting securities firms, insurance companies, and banks to freely affiliate with one another, on the same terms and conditions, and to engage in any activity that is financial in nature.

Fifth, H.R. 10 would create wholesale financial institutions ("WFIs"), which are banks that do not accept deposits that are insured by the federal government—that is, they generally do not accept deposits under $100,000. WFIs would provide commercial banking services to institutional customers without imposing any risk to the bank insurance fund or U.S. taxpayers.

Significantly, the legislation would require each financial institution to be functionally regulated. One regulatory agency should apply the same set of rules to the same activity engaged in by any financial institution, regardless of the type of institution it may be. PaineWebber strongly believes that the SEC, the securities self-regulatory organizations ("SROs"), and the state securities regulators should oversee securities activities regardless of what entity performs those activities. Similarly, the appropriate federal or state-banking regulator should regulate banking activities, and the appropriate state insurance regulator should regulate insurance activities.

Functional regulation assures that the most knowledgeable regulator is supervising a financial services institution's diverse activities. In the securities markets, all participants would be equally subject to the principle of complete and full disclosure and regulation by the SEC and SROs. The guiding principle of disclosure protects investors, encourages innovation, and promotes fair markets. Indeed, under this regulatory structure, the U.S. capital markets have set the global standard for integrity, liquidity, and fairness. Investors understand the protections they are afforded and market participants understand their obligations.

Moreover, functional regulation eliminates regulatory discrepancies and the resulting competitive advantages between financial services firms engaging in the same activities. Under H.R. 10, all securities activities would be performed outside of a bank, with the benefit of SEC, SRO and state securities administration regulation, except for a small number of carefully defined securities activities that traditionally have been conducted in banks.

After years of negotiation, the securities and banking industries developed a set of functional regulation provisions (1) that permit banks to continue to engage in certain limited securities activities that banks traditionally have provided to their customers as an adjunct to their banking services, but (2) require all other securities activities be conducted outside of the bank in an SEC- and SRO-regulated brokerage affiliate. Notably, PaineWebber is not aware of any significant opposition—in either the banking or securities industries—to these functional regulation provisions. PaineWebber supports H.R. 10 in part because it incorporates the functional regulation provisions.

I would note that PaineWebber supports the holding company/affiliate structure. Importantly, however, although H.R. 10 allows for securities activities to be conducted in an operating subsidiary of the bank, the SEC is expressly authorized to regulate the securities activities of the operating subsidiary, as well as to regulate such activities if conducted elsewhere in the holding company. PaineWebber believes that this ensures that securities activities are regulated by the appropriate, experienced authority-the SEC, the National Association of Securities Dealers, Inc., New York Stock Exchange, and other securities regulators.

Mr. Chairman, last session PaineWebber and many other securities firms supported H.R. 10 and worked actively to pass it. That bill, while not perfect, represented a series of compromises by every sector of the financial services industry. Although there were a number of provisions that PaineWebber believed could be improved, we supported the bill because we were committed to maintaining the delicate compromise that had achieved consensus among all the participants. H.R. 10 represented a fair and thoughtful approach to balancing the competing interests of a wide range of financial services providers and regulators, and it is a vast improvement over our current regulatory system.

PaineWebber remains committed to working with the Commerce Committee to pass a consensus version of H.R. 10. However, if changes are to be made to the bill, we recommend the following:

- Increasing securities firms' ability to affiliate. Securities firms, insurance companies, and other diversified financial firms currently may affiliate with non-financial firms. PaineWebber believes that financial services modernization legislation should reflect current market practices and permit commercial affiliations to continue. Existing commercial affiliations have not weakened securities, insurance, and other financial services firms, and there is no reason to believe that permitting banks to similarly affiliate with commercial companies will endanger banks. Indeed, the experience under the unitary thrift charter, which currently permits commercial firms to own or affiliate with a thrift, is powerful empirical support for this view.
- Broadening the description of permissible merchant banking activities to assure that current market practices are not inadvertently restricted. For example, because of the restrictions in H.R. 10 against a securities firm becoming involved in a company's day-to-day management operations, the securities firm might be unduly limited in its ability to interact with the management of a company it acquired in a merchant banking transaction. Similarly, the securities firm might be required to divest that company in a "fire sale" because of the bill's restrictions on the length of time the company could be owned.

PaineWebber has worked with you, Mr. Chairman, members of this Subcommittee, others in Congress, and many in the financial services community to reach a number of the compromise positions that were reflected in H.R. 10. The progress we made cannot be overstated. Passage of financial services modernization legislation is vital to the financial services industry in general and to the securities community in particular.

Mr. Chairman, we look forward to working with you, members of your Subcommittee, as well as the House, Senate, and Administration to enact financial services reform legislation this year.

Mr. OXLEY. Thank you, Mr. Sutton.

Let's go now to Iowa and hear from Mr. Arnold Schultz.

## STATEMENT OF ARNOLD SCHULTZ

Mr. SCHULTZ. Thank you, Mr. Chairman, members of the committee. I am Arnie Schultz, Chairman of the Grundy National Bank, a $106 million community bank in Grundy Center, Iowa. We have been in business since 1934, serving the consumer, business and agriculture needs of our community. Thank you for giving me the opportunity to share my views on the financial reform legislation currently before your committee.

You asked that I testify on the operating sub issue. Let me say I support the position of Fed Chairman Alan Greenspan that risky, new activities that are authorized under this bill should be pushed out into separate capitalized affiliates of the holding company. Chairman Greenspan argues that the holding company structure is superior for two reasons. One of those reasons is to minimize the Federal subsidy arising from the Federal safety net that would flow to operating subs. The second is to protect the safety and soundness of our banking and financial system. I will limit my comments today to the safety and soundness issue.

One of the consequences of this bill will be for the emergence of large financial conglomerates. For example, a large commercial bank could merge with a securities firm that deals in derivatives which, in my judgment, is a risky line of business. If an op-sub incurred a rapid loss of capital from its derivative activities, it would immediately put pressure on the commercial bank to come to its rescue. The same reasoning applies to risky merchant banking activities. If trouble arises, and if the bank was also too big to fail, the Federal Reserve discount window would likely feel the pressure first, followed by the FDIC and ultimately, depending upon the size of the institution, the taxpayer.

Protection of the Federal safety net is crucial and is best served by the holding company structure. Shielding risky activities from the bank will provide maximum protection for the deposit insurance fund.

I would hate to see the failure of a large multinational bank jeopardize the solvency of the FDIC Fund because of its involvement in risky, nontraditional bank activities. As a community banker who is not protected by the "Too Big To Fail" doctrine, deposit insurance is the lifeblood of my operation. The bill that was reported out of the House Banking Committee would give the Fed some oversight over op-sub activities, but it doesn't provide maximum insulation of risky activities from the core bank and from the Federal safety net, as would the holding company structure.

Mr. Chairman, I would like to also briefly comment on the unitary thrift issue, which is a major significant public policy issue that risks getting lost in the shuffle as the most powerful men in the world fight over CRA and op-sub. How this issue is resolved will have a profound impact on our future economic and financial structure and on our diversified financial system.

Under current law, there are no restrictions on what a unitary thrift company can own or who can own a unitary thrift, including commercial firms. The case against mixing banking and commerce is well established.

Taking this issue to the community banking level, if a bank such as mine owned a grocery store, why would I want to lend money to someone else who wanted to open a competing grocery store in our community? While the bill before you partially closes the unitary thrift holding company loophole by prohibiting the chartering of new unitaries owned by commercial firms, it fails to close the loophole completely and allows each of the 600 or so grandfathered unitary thrifts, most of which are not currently owned by commercial companies, it allows them to be acquired by commercial firms.

Chairman Greenspan has warned that these kinds of affiliations pose serious safety and soundness hazards. We believe it, and I think I heard Secretary Rubin state this morning that he would also concur. I believe strongly that the unitary thrift holding company loophole should be closed, and that grandfathered unitaries should not be allowed to be acquired by commercial firms.

Finally, Mr. Chairman, my written testimony spells out my concerns with the insurance language in the House Banking Committee version of H.R. 10. Community banks like mine will be facing cross-marketing competition from financial conglomerates like

Citigroup and it is important that our ability to retail insurance products not be undermined.

Mr. Chairman, that concludes my testimony. Thank you for the opportunity to present my views. I would be pleased to respond to questions at a later time.

[The prepared statement of Arnold Schultz follows:]

PREPARED STATEMENT OF ARNOLD SCHULTZ, BOARD CHAIRMAN, GRUNDY NATIONAL BANK

Mr. Chairman, Members of the Committee, my name is Arnold Schultz, and I am Board Chairman of The Grundy National Bank in Grundy Center, Iowa. I am also president and CEO of GNB Bancorporation, a two-bank holding company that owns 100 percent of Grundy National Bank and Ackley State Bank, a state-chartered bank in Ackley, Iowa. Both banks have multiple-line insurance agencies. In addition, Ackley State Bank recently formed an operating subsidiary that purchased Kastendick and Associates, which holds a general agents contract for the sale of Blue Cross and Blue Shield health insurance products directly and through 20 subagents in Iowa.

My bank, which is located in a farming community of 2,500 people in central Iowa, has approximately $106 million in assets and $85 million in deposits. We have two branches and 37 full time employees. We have been in business, serving the consumer, business and agricultural needs of our community, since 1934.

Thank you for giving me this opportunity to share my views on the financial reform legislation currently before this Committee. By way of background, I have just completed my second 3-year term as a member of the Board of the Federal Reserve Bank of Chicago—an elected position. I am also the first community banker to serve on FASAC, the advisory council to FASB, and I am the present chairman of the Bank Operations Committee of the Independent Community Bankers of America (ICBA).

You asked that I testify on the operating subsidiary issue, that is, what activities are appropriate to be conducted in an operating subsidiary of a national bank, versus what activities should be pushed out into an affiliate of the bank's holding company. I would be pleased to respond to this issue, and share with you my views on several other aspects of the legislation that is before you, H.R. 10, the Financial Services Act of 1999.

*Op-Sub Issue*

Mr. Chairman, I support the position of Federal Reserve Board Chairman Alan Greenspan that new, risky activities—those other than agency activities that are not now permissible for national banks but would be authorized under this bill—should be shielded as much as possible from the national bank itself and conducted in a separately capitalized affiliate of the holding company.

The formation of a holding company is not that difficult and, in my case—like many other community banks—it was done originally for the purpose of maintaining a market for company stock which enables us to continue to operate as a locally owned community bank.

Chairman Greenspan argues that the holding company structure is superior for two reasons—to minimize the federal subsidy arising from the Federal safety net that would flow to operating subsidiaries, thereby creating a competitive advantage over non-bank entities; and to protect the safety and soundness of our banking and financial system.

Mr. Chairman, I do not feel qualified to comment on whether or not the sovereign credit of the United States produces a subsidy that would accrue to an operating subsidiary to the competitive detriment of other corporate structures. There appears to be some disagreement on this subject.

As a national banker, I am more qualified to make observations on whether or not these risky new activities would pose a safety and soundness problem to the bank.

One of the consequences of this bill will undoubtedly be the emergence of more very large financial conglomerates combining various elements of the financial services industry and more cross-financial services industry mergers generally. For example, a large commercial bank could merge with an insurance company underwriting property and casualty insurance and a securities firm that deals in derivatives. Insurance underwriting and derivatives are very risky activities. If either the insurance component or the securities component got into financial trouble, it would immediately impact the commercial bank component that is in the universal bank structure, and put pressure on the commercial bank to directly fund the insurance and securities departments out of their difficulties. In the event of failure or too-big-to-fail rescue, this would put immediate pressure on the federal safety net. The Federal Reserve discount window would likely feel the pressure first. Then, the FDIC would feel the pressure, and ultimately—depending on the size of the too-big-to-fail institution—the taxpayer.

In these situations, we believe it is imperative to build in maximum insulation of the risky activities from the bank component of the financial conglomerate. The holding company structure does this.

If the risky activities were conducted in an operating subsidiary of a universal bank structure, the threat to the bank is even greater. Any losses experienced in the subs would impact the bank's capital. By contrast, losses incurred by a holding company affiliate would not impact the bank's capital. Thus, the holding company structure better insulates the bank.

*Deposit Insurance Protection*

Protection of the deposit insurance fund is and will remain the top priority of all community bankers. As a community banker who is not protected by the too-big-to-fail doctrine, deposit insurance is the lifeblood of my operation.

Community banking is not what it was 30 years ago, when in many communities the only place to invest your money was in the local bank. Today, we compete with tax-free credit unions and farm credit associations, with mutual funds you can buy over the Internet, with Edward Jones offices in virtually every small community that soon may be offering a full array of banking services under its unitary thrift charter, and with a public equities market that has not faced a real down market in more than a decade.

We pay an insurance premium for deposit insurance and we would differ with Chairman Greenspan that there is a subsidy. It would damage the FDIC and be a misuse of banker premiums to stretch the deposit insurance safety net to cover losses of merchant banking or securities underwriting subsidiaries that threaten to bring down a universal bank.

The bill that was reported out of the House Banking Committee and is before you now would permit an operating subsidiary of a national bank to engage in any banking activity, and in any activity that is financial in nature or incidental to financial in nature, except insurance underwriting and real estate development. Requiring, as the bill does, that a bank over $10 billion in assets must have a holding company if it wants to engage in financial activities through an op sub, does give the Federal Reserve some oversight over the entire entity. But this doesn't provide maximum insulation of merchant banking and securities underwriting activities, and losses from the core bank, as the holding company structure would.

The House bill also provides the Federal Reserve sole authority to prescribe regulations and issue interpretations regarding merchant banking activities. The bank I am associated with does not engage in merchant banking activities, but my gut instinct tells me that these are risky indeed. And one must look with great concern at the Senate Banking Committee bill which permits commercial banks to hold indefinitely the securities of a commercial firm underwritten by a different component of a financial conglomerate while operating the commercial firm on a daily basis.

Again, allowing such activities through a universal bank structure brings them that much closer to the federal safety net. I would much prefer to see the bill amended to push all risky new activities, including merchant banking and non-government securities underwriting, into a separately capitalized affiliate of the holding company, thus providing maximum insulation of the safety net, including the deposit insurance fund. This is Chairman Greenspan's position and we support this position.

Down the road, small national banks like mine could become interested in underwriting local government issues directly from the bank—but I don't believe this detracts from my strong support of Chairman Greenspan's position. I also applaud the initiatives of the OCC in bringing about a heightened awareness of the opportunities afforded banks by forming operating subsidiaries for activities that do not pose safety and soundness problems.

*Mixing Banking and Commerce*

Mr. Chairman, with your indulgence I would like to briefly comment on two other provisions in the bill that trouble community banks greatly. The first is the mixing of banking and commerce. This is an enormously significant public policy issue that risks getting lost in the shuffle as the most powerful men in the world fight over CRA and the operating subsidiary. How this issue is resolved will have a profound impact on our economic and financial structure, which is the envy of the world, and on our diversified financial system which has created the remarkable small business infrastructure of our Nation.

The case against mixing banking and commerce is well established, with both Chairman Greenspan and Secretary Rubin, in congressional testimony earlier this year, raising serious concerns about eroding the walls separating banking and commerce. Allowing the common ownership of banks and commercial firms could lead to "crony capitalism," and undermine the impartial allocation of credit, which is the foundation upon which our financial system is based. Taking this issue to the community banking level, why would a bank that owned a grocery store want to lend money to someone who wanted to open a competing grocery story in the community? Credit must be allocated impartially and on merit—not on the basis of ownership considerations.

There are two ways in which banking and commerce can be mixed. The first is through a "commercial basket," which would allow banks to acquire a "basket" of commercial holdings with certain restrictions based on asset size or earnings. Wisely, this concept was rejected by the full House and the Senate Banking Committee last year and has not been reincarnated in this legislation. It was, unfortunately, kept very much alive in the merchant banking language in this year's Senate Banking Committee bill.

*Unitary Thrift Holding Company Loophole*

The second way in which banking and commerce can be, and is, mixed, is through the unitary thrift holding company loophole. Under current law, there are no restrictions on what a unitary thrift holding company can own, or who can own a unitary thrift, including commercial firms. This, of course, runs counter to the prohibition against bank and commercial affiliations, despite the fact that there is very little difference between a bank and a thrift.

While the bill before you partially closes this loophole by prohibiting the chartering of new unitaries owned by commercial firms, it fails to close the loophole completely and allows each of the 600-or so grandfathered unitary thrifts (most of which are not currently owned by commercial companies) to be acquired by commercial firms. Equally troubling is the fact that under the bill, there are no restrictions on who could buy what unitary, leaving open the possibility, for example, for a large commercial firm to buy Washington Mutual, the largest unitary thrift in the world.

Chairman Greenspan has warned that these kinds of affiliations pose serious safety and soundness hazards. We believe Secretary Rubin concurs. In the current strong economic climate, commercial firms have shown considerable interest in getting into the banking business. But we all know that this boom period will not last forever. Commercial firm ownership of banking could have negative consequences in the future because of their lack of experience in assessing credit and other bank-related risk. Again, let's not follow the failed paths of Japan and other Pacific Rim nations.

I believe strongly that the unitary thrift holding company loophole should be closed completely and for good. Grandfathered unitaries should not be allowed to be acquired by commercial firms.

*Discriminatory Insurance Provisions*

I also would like to comment briefly on the insurance sales provisions in this legislation. A fair reading of the insurance sales language in this bill has to conclude that banks seeking to retail insurance products are disadvantaged. For example, the bill spells out in thirteen separate paragraphs thirteen specific ways in which states can pass laws that discriminate against insurance sales by national banks. These so-called "safe harbors" range from permitting discriminatory restrictions in advertising, to rules governing the payment of commissions, to where a customer's files may be kept in a bank. In addition, the bill provides that a state may impose any other restrictions on insurance sales in banks that are no more burdensome than these 13 "safe harbors."

These "safe harbors" will have the effect of making it very difficult for a national bank to get into, or remain in, the insurance business. It seems to me that in today's financial world, where regulators have authorized the common ownership of Citicorp and Travelers, such restrictions are not only anti-competitive, but also absurd.

We also note that without judicial deference being accorded to the OCC (just as it is any other federal agency), any challenges relating to interpretations of how future state laws impact national banks could end up in the courts for years.

What banks get in return is a shell of the *Barnett* standard. We get a "non-discrimination" standard that applies only if state laws expressly distinguish and discriminate against depository institutions, have a "substantially more adverse" impact on banks, or if the state law "effectively prevents" the bank from selling insurance.

This is what Comptroller of the Currency John Hawke had to say about these provisions at a recent banking convention:

> "One of the most controversial issues in the financial modernization legislation has arisen from the efforts of the independent insurance agents to burden banks with restrictions that would encumber their ability to sell insurance as agents in a free and competitive marketplace. And the most recent formulations of those efforts have been embodied in H.R. 10 and they include a list of so-called sale harbors—13 paragraphs describing areas in which states will be free to discriminate against banks with impunity. We think that banks should be treated on a completely non-discriminatory basis with respect to the sale of insurance—they shouldn't be treated differently from any other individual or entity licensed to sell insurance in the state. And we certainly should not tolerate laws that prohibit bank-related entities from selling insurance and as I'm sure you know that Comptroller of the Currency's office has taken a vigorous position on that issue in litigation. But this legislation would essentially empower the states—state legislatures—to adopt with impunity legislation that discriminates against banks . . ."

Most banking lawyers agree with Comptroller Hawke's interpretation.

Mr. Chairman, selling insurance as an agent is not a risky activity. We are not talking about underwriting insurance and assuming the actuarial risks. We are talking about selling a policy across a counter for a fee. Many community banks, like mine, already struggling to maintain their core deposits and compete with tax-free credit unions and farm credit associations, will want to get into this activity to diversify their earnings if they are not already there. And our getting into the business is very pro-competitive and pro-consumer in the emerging world where any large insurance company will be able to own a bank and cross market all its products. But if the language in this legislation remains intact, insurance sales in banks will be in real jeopardy in many states.

*Closing*

Mr. Chairman, that concludes my testimony. Thank you, again, for the opportunity to present my views. I would be pleased to respond to any questions.

Mr. OXLEY. Thank you, Mr. Schultz. Thank you for coming all the way from Iowa for this.

Mr. Zimpher.

**STATEMENT OF CRAIG W. ZIMPHER**

Mr. ZIMPHER. Mr. Chairman, members of the subcommittee, thank you very much for the opportunity to be here today. This is the second opportunity and privilege I have had to appear before your committee on this important issue. So on my behalf and Nationwide's behalf, we appreciate the opportunity for input today. I just trust that today's experience and prior experiences will not prove to be the victory of hope over experience, however, on final enactment and passage and enactment of H.R. 10, which we certainly are pleased to endorse today and endorse and support your efforts.

Mr. Chairman, my testimony has been submitted and I am going to try to just very briefly summarize a couple of key points in that testimony that we are interested in.

First, as we testified last year and we want to do again today, is our strong support and belief in the issue of functional regulation which you have heard a great deal about already by preceding witnesses and testimony. My predecessor on the prior panel, Mr. Nichols and his organization, the NAIC, outlined what could be serious consequences if functional regulation were eroded, or if it were eroded by this bill.

We would certainly agree with their testimony and support any effort to prevent that. As a matter of fact, on page 10 of our testimony, we make the statement that to exempt, either advertently or inadvertently, insurance offered by banks from State regulation would be unsound and counterproductive to protecting consumers of insurance products.

Just as important as we believe functional regulation is for leveling the playing field through which and on which various financial products will ultimately be offered by different industries, we believe there are very strong and compelling consumer protection interests to continue the regime of State-based insurance regulation.

Several instances come to mind, Mr. Chairman. Those safeguards include market-conduct examinations conducted by every State insurance department; triennial financial and solvency examinations conducted of all companies by departments; the applications of fair claims practice laws; guarantee funds in place in every State for both property casualty and life insurance policies for payments in cases of insolvencies; licensing and continuing education requirements for agents; consumer complaint and inquiry resolution procedures in place in all 50 States; and policyholder surplus investment regulations and supervision in place in all 50 States. So we strongly encourage the continuation of functional regulation by State insurance departments as it relates to the delivery—to the manufacturing and delivery of insurance products.

Second, Mr. Chairman, we would encourage the subcommittee to maintain the holding company structure that is contained in H.R. 10 for mutual companies such as Nationwide. As it is currently structured and governed, this is the only practical governance structure for them to participate under the bill's affiliation opportunities if it were to become law and avoid the dilemma of dual regulation, both at the State and the Federal level.

Mr. Chairman, I will just conclude my comments there, and again I appreciate the opportunity to be here.

[The prepared statement of W. Craig Zimpher follows:]

PREPARED STATEMENT OF W. CRAIG ZIMPHER, VICE PRESIDENT OF GOVERNMENT RELATIONS, NATIONWIDE INSURANCE ENTERPRISE

Mr. Chairman and members of the subcommittee, my name is Craig Zimpher. I am Vice President of Government Relations for Nationwide Insurance, headquartered in Columbus, Ohio. Nationwide Insurance is a group of core insurance companies, including Nationwide Mutual Insurance Company, Nationwide Life Insurance Company, Nationwide Financial Services. Our products range from personal auto, homeowners, commercial/workers' compensation to life insurance, annuities, financial services, and health insurance. Our companies are licensed to engage in the business of insurance in all 50 states. In addition, Nationwide operates several affiliated insurance operations in Europe and has entered into partnerships with other companies to market our products in Asia and Latin America.

I am honored to be with you today and intend to discuss Nationwide Insurance's perspective on financial services modernization. These issues are significant and have vast public policy ramifications for they affect the financial security of millions of Americans. Overall, we are encouraged by the direction that Congress is taking on financial services reform. But, there are three major areas where we believe that problems could arise. I would like to discuss these areas today, specifically:

1. The need to retain the mutual holding company structure for mutual insurers;
2. The risk the use of operating subsidiaries pose to the solvency of financial service entities; and,
3. The need for continued consumer protection at the state level.

Nationwide continues to support H.R. 10. We believe that the bill represents a good compromise and an excellent place to begin the process of modernizing the nation's financial services laws. However, absent the mutual holding company structure, mutual insurers that retain their unique corporate characteristics cannot participate fully in a post-financial services reform world.

Under current law, utilization of the unitary savings and loan holding company is currently the only structural model available for an insurance company to affiliate with a depository institution. Some state laws may prohibit or impede the ability of a mutual insurance company to affiliate with a unitary savings and loan holding company.

Mutual insurance companies are incorporated under state law for the benefit of their policyholders. Because mutuals do not have stockholders, they utilize a holding company structure, unless domiciled in a state that has adopted a mutual holding company act. Such statutes provide for the conversion of the mutual insurer into a stock company controlled by its mutual holding company parent. In addition, mutual insurers are subject to a variety of state laws that prohibit or limit the size of an investment the insurer can make in a bank subsidiary.

While the language contained in H.R. 10 would allow any financial services company to become a bank financial services holding company, for regulatory reasons there are only two practical ways a mutual insurer could affiliate with a depository institution:

- Demutualize and create an upstream holding company; or,
- Create a mutual insurance holding company.

A mutual insurer could demutualize and create an upstream stock holding company, which could form or acquire a bank as an affiliate of the insurance company. However, demutualization is not a solution many mutual insurers would be eager to adopt, as they are either committed to the mutual concept or do not want to undergo the disruption and significant costs posed by demutualization. The second option is to permit a bank and an insurance company to become affiliates of one another and subsidiaries of a parent holding company.

As you know, while the Bank Holding Company Act currently prohibits such affiliations, federal financial services reform proposals would amend that Act to allow affiliations and, therefore, preempt state laws. This means that the state insurance laws would not apply to stock companies; however, mutual insurance companies, like Nationwide, still could not avail themselves of the holding company affiliation model unless they are domiciled in one of the 21 states that have laws permitting mutual insurance companies to convert to a mutual holding company structure. These include Iowa, Minnesota, Ohio, Pennsylvania, Rhode Island, Vermont, Missouri and California.

As we understand it, some would like to prohibit the use of mutual holding companies. We would strongly oppose such a move and urge Congress not to prohibit mutual life and mutual property/casualty insurance companies from creating mutual holding companies under state law, in order to affiliate with depository institutions. Otherwise, you would condemn an entire sector of the financial services sector to a slow death, because mutual insurers would not be able to fully participate in the new financial services arena.

Nationwide believes that all insurance activities should occur within an affiliate of a bank or financial services holding company, because this is the only way to guarantee functional regulation. Allowing these operations to occur in an operating subsidiary would defeat the concept of functional regulation and would lead to a dual regulatory system.

Appealing features of the affiliate model include the following:

1. It is consistent with functional regulation and so entails minimum federal intrusion into the affairs of insurance company affiliates of the depository institution.
2. There is no restriction on the types of activities that can be conducted in the holding company; i.e. affiliations with non-financial commercial companies are permitted.
3. It provides sufficient supervisory mechanisms and authority for appropriate oversight for financial system stability.

Nationwide believes that expansion of banking powers into the insurance business, absent continued state regulation of such business, would be misguided. We believe that state insurance regulation has worked effectively and efficiently for both those regulated and those protected, the consumers. To exempt the bank-owned insurance operations from such regulation would disrupt and distort the insurance marketplace across the country.

Nationwide strongly endorses appropriate safeguards and provisions for state regulation of insurance products, regardless of risk bearer or distributor of such products. Our concern about bank exemption from insurance regulation has been heightened by a series of rules and opinions issued by the Comptroller of the Currency over the past several years, that have unilaterally expanded insurance authority of national banks. These rulings have allowed banks to extend their reach into the insurance area without proper regulatory oversight.

One of the worst decisions by the OCC was the rule that would allow banks to engage in non-banking activities, including insurance underwriting, through downstream operating subsidiaries.

This last development, known as the final Operating Subsidiary Rule, is the most serious expansion of regulatory power yet undertaken by the OCC. The purpose of these regulations is to provide banks with the opportunity to engage in non-banking activities though downstream operating subsidiaries, without oversight by state insurance regulators.

The Op-Sub rules, as they have become known, are purposely vague when it comes to who would regulate a bank's insurance subsidiary. The OCC contends that certain safeguards would be imposed on an operating subsidiary engaging in activities not permissible for the bank, including requiring the operating subsidiary to be adequately capitalized under "relevant industry measures". However, it is unclear *what* industry measures are intended to apply and *which* regulatory entity would be applying them. Moreover, certain prohibitions on affiliated transactions would apply, but the rules do not go so far as to prohibit tie-in sales.

The Op-Sub rule makes it very clear that the OCC will consider any application from banks to engage in any "non-bank" activities, including insurance underwriting. Furthermore, taking a cue from its past actions, the OCC could very well use these rules to establish itself as the regulator of all bank-operating subsidiaries, including insurance subsidiaries. I believe that the OCC overstepped its authority when it issued its Op-Sub rule and that their rule, unless curtailed by Congress, might very well serve as the foundation for future and drastically expanded erosion of state insurance regulation and consumer protection.

It should be abundantly clear to all that the OCC is engaged in a policy of incremental preemption of state insurance regulation, while expanding its own regulatory power. This policy benefits national banks at the expense of consumers, agents and insurers, creating anything but a level playing field.

We strongly believe that if banks engage in any phase of the insurance business, it should be conducted on a level playing field. To pre-empt 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 . . . which would not provide consumers with adequate protections. Regulation of financial services must be focused on the specific function being performed and not on the corporate form.

True functional regulation focuses on the activity rather than the entity engaged in that activity. Under functional regulation, bank regulators regulate banking and the states regulate insurance activities, regardless of whether the activity is being conducted in a bank or an insurance company. Bank regulators lack the specialized experience and expertise needed for effective regulation of insurance activities of banks, just as insurance regulators are not competent to regulate banking activities of insurance companies or their affiliates.

Consumer protection is an important aspect of insurance regulation. This is due in part to the long-term relationship between a consumer and his or her insurance company in which the benefits of an insurance policy are not enjoyed until the risk the policy protects against has been realized. This period can be as long as one's lifetime, in the case of a life insurance policy. Generally, insurance claims can be made only under a policy that was in place at the time the loss or damage occurred. An insurance customer unhappy with the performance of a company cannot take his or her claim to another company.

Most consumers have a much different relationship with depository institutions. Checking and savings accounts can easily be moved from one institution to another. Once a loan has been made, the borrower's relationship with the lender ends except for payment and recordkeeping. In neither case does the bank customer pay today for a promise of long-term future performance, as is the case with insurance customers.

Consequently, state insurance laws and departments emphasize consumer protections in substance and procedure. Consumer protections imposed by bank regulators regarding bank customers purchasing insurance pale in comparison to those mandated by state insurance laws. Examples of state rules include the following:

1. *Licensing.* Insurance agents must be licensed by each state in which they sell insurance and are subject to the rules and regulations of that state. Agent applicants are subject to a back-ground investigation and must pass a licensing examination. Most states require agents to take pre-licensing educational courses before taking the licensing exam. To maintain their licenses, agents must meet continuing education requirements designed to ensure that they are knowledge-

able about their product and professional in their conduct. State insurance regulators' enforcement authority includes the ability to deny, suspend and revoke a license as well as impose fines against wrongdoers. States share information about agents and applicants through the NAIC.

2. *Marketing.* Unfair Trade Practices and Competition Acts adopted by the states prohibit deceptive acts and practices by insurance agents and companies. Regulated practices include tying, rebating, advertising, manner of sale, privacy protection, and any other practice a state insurance regulator deems to be unfair or anticompetitive.
3. *Underwriting.* Insurers are required to file policy forms and rates either at the time of use or before, and in both cases, are subject to the state insurance regulator's review and approval. States also set minimum values on auto liability insurance policies sold within the state. States require insurers selling certain types of insurance, e.g. automobile liability, homeowners', and workers compensation, to participate in shared risk pools, thus promoting consumer access and affordability. Insurance companies are subject generally to stringent regulations relating to cancellation and nonrenewal of insurance policies.
4. *Guaranty Funds.* Most insurers are required to participate in guaranty funds so that claims against an insolvent company will be paid at least in part and the consumer so protected. Acts governing the rehabilitation or liquidation of insolvent insurers exist in all jurisdictions.
5. *Company Service.* Each state has a process to address complaints made against an insurer. Complaints received by the state regulator are automatically forwarded to the company and must be answered within time restrictions mandated by the state. A full explanation is required from the insurer regardless of the apparent merits of the complaint. The insurance regulator will continue to demand further explanations from the company and to encourage resolution between the complainant and the company.
6. *Claims.* Insurance companies also are subject to state fair claims practices acts. These acts require all claims to be handled fairly, timely and in compliance with the policy.
7. *Market Conduct.* The states examine for market conduct as part of the regularly scheduled financial examinations and at any other time determined by the state regulator. Companies that fail to comply with applicable statutes can be fined or have their certificates of authority suspended or revoked.

Federal banking rules do not include the type of insurance customer service and complaint resolution provisions found in state insurance laws. For example, the OCC guidelines provide that a bank should have an "orderly process for assessing and addressing customer complaints and resolving compliance issues." The guidelines suggest that banks use a complaint tracking process or complaint file and comply with state laws that require copies of customer complaints to be forwarded to the state insurance regulator, but do not impose the substantive and procedural provisions found in state insurance laws. The guidelines also state that the OCC expects bank insurance sales personnel to be licensed in accordance with state law. However, compliance with these guidelines is essentially voluntary for banks. Compliance with state laws is mandatory for insurance companies and agents

Federal rules prohibit a bank from tying, either by restricting the availability or varying the consideration, of a product or service on the condition that a customer purchase another product or service offered by the bank or by any of its affiliates. The Federal Reserve and the OCC have extended the tying prohibition to bank holding companies and their nonbank subsidiaries, and to operating subsidiaries of national banks, respectively. The anti-tying prohibition can be enforced by the bank regulators, the Justice Department or aggrieved private parties, although enforcement actions are rare.

This brief comparison between the insurance consumer provisions of federal banking rules and the consumer provisions of state insurance law illustrates the superiority of the states' consumer protections.

State regulation has a two-fold purpose. First, it is designed to assure that insurance providers treat customers fairly. Second, it is designed to protect consumers, and their long term financial needs, through solvency regulation and oversight of insurance companies.

During the last several years, significant strides and progress have been made in standardizing state financial reporting and monitoring requirements. Minimum standards of insurance company capitalization to assure individual company solvency are in place. These capitalization requirements differentiate among insurance product lines and their associated degrees of risks. Included in these standards are specific reserving requirements for various types of claims with which companies must comply. If banks were to be exempted 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, creating an extremely dangerous situation for the public.

All states have rate regulations laws that assure insurance rates are not unfair, excessive, or inadequate. Exemption from such rate regulation would, it is so obviously clear, create an unfair and unlevel competitive environment in a particular state.

Through various "market conduct" regulations the various insurance departments of this country have promulgated a series of requirements and regulations designed to ensure that agents and companies comply with state laws and regulations in the marketplace. Market conduct laws and regulations apply to insurance practices and operations including: insurance nonrenewals and cancellations; review of agent conduct and activities; claims handling and processing procedures; compliance with unfair claims practices provisions; individual company underwriting practices; and assurance that appropriate rates are being charged for various lines of insurance. Such state regulations ensures that insurance products are being offered in a way so as not to create discrimination, that fair and prompt claims handling practices are being adhered to, and that honest marketing and sales practices are conducted. The fact is that these regulations effectively serve to protect consumers and assure the long term financial viability of those offering customers insurance products.

One additional feature unique to the state regulatory scheme has been the development and successful operation of state guaranty funds. These funds are in place in the various states and are funded by assessments of existing insurance companies. They are designed to assure long term protection of policyholders whose insurance companies may become insolvent. Any company involved in the insurance business must participate in such guaranty funds.

The United States does not need a dual system of regulation for insurance. A steady and sound insurance regulatory system has been in place for decades. State regulation of insurance is getting the job done effectively and efficiently. To exempt insurance offered by banks from state regulation would be unsound and counter-productive to protecting consumers of insurance products.

In conclusion, Nationwide supports H.R. 10, as it is currently drafted. However, we believe that several key elements are necessary to the success of financial services reform efforts, including:

1. All insurance activities should be conducted by an entity or entities separate from any depository institution, preferably in an affiliate of a bank or financial services holding company.
2. All such insurance affiliates should be subject to all the requirements of the appropriate state insurance regulatory authority;
3. Any structure permitting such affiliations should permit both stock and mutual insurance companies to engage equally in the business of banking and other activities in which depository institutions are permitted to engage, including the option of allowing mutual insurers to use a mutual holding company structure.

Mr. Chairman and members of the Subcommittee, that concludes my testimony today and I wish to express, on Nationwide's and my own behalf, our deepest appreciation for the opportunity to appear before you today. We stand ready to assist you and other members in any way possible to affect positive and practical reform of the financial services industry. Thank you.

Mr. OXLEY. Thank you, Mr. Zimpher.

Our final witness, Mr. Scott Sinder, representing several insurance groups.

**STATEMENT OF SCOTT A. SINDER**

Mr. SINDER. Good afternoon, Mr. Chairman and members of the committee. My name is Scott Sinder. I am testifying today on behalf of the Independent Insurance Agents of America, the National Association of Life Underwriters, and the National Association of Professional Insurance Agents, which together represent virtually all of the insurance agents of America and their employees, nearly 1 million men and women who work in every part of the United States.

First, Mr. Chairman, let me thank you for holding this hearing today. Before proceeding with my comments, I must commend you for the role you played last term in brokering an historic agreement that resulted in a bill that was eventually passed by the House. Without your commitment and heavy involvement, no bill would have proceeded to the floor and, in all likelihood, we would be no closer to the enactment of a financial services reform bill today.

The insurance agents want you to know that they intend to do everything within their power to help you mold a bill that can take flight and become the law of the land. We want a bill to pass.

As you know, Mr. Chairman, the insurance agents strongly supported the H.R. 10 bill that you brokered and shepherded through the House. We recognize the need for eliminating the barriers that still exist between the banking and insurance and securities industries. We believe, however, that this concern also mandates insuring that consumer choices are well informed and freely made, and State regulators have been virtually the exclusive protectors of such interests since the creation of an insurance industry in this country. We, thus, have one basic concern: Ensure that every entity that is involved in the insurance business is subject to State regulation. Federal banking regulators are in no position to substitute for the comprehensive State insurance laws that have developed over the last 100 years.

The bill that you shaped last term included several provisions that the insurance agents believe to be essential to ensure adequate functional regulation of insurance sales activities. After that bill was passed by the House, however, the Senate Banking Committee drastically revised many of its most essential provisions, especially in the insurance sales context. For that reason, the insurance agents actively opposed the bill that was passed out of that committee.

After the Senate Banking Committee completed its work on the bill, Senator D'Amato mediated a negotiation among selected banking and insurance industry representatives. The insurance agents participated in those negotiations, but State insurance regulators were excluded. The exclusive focus of those negotiations in the insurance sales context was on the scope of the preemption safe harbors.

At the conclusion of the negotiations, the insurance agents made clear that they could not support the Senate proposal, but through the safe harbor improvements that had been agreed upon were sufficient to remove our outright opposition.

The Senate proposal was never considered on the Senate floor. When this Congress convened in January, however, the proposal was reintroduced as the 1999 version of H.R. 10. The Senate package was largely untouched by its consideration of the House Banking Committee. We therefore sit before you today in virtually the same position that we were in at the close of the Senate last year. The insurance agents do not support the current proposal, but we believe it can be improved in a manner sufficient to gain our support.

Banking industry representatives have been quite vocal in recent weeks regarding their belief that any changes that are made to the current proposal will eliminate any prospects for passage. At the same time, however, many of the same representatives have themselves been requesting that some changes be made in the insurance sales provisions.

Many things have changed since last October. First and foremost, State insurance regulators, through the NAIC, have taken a harder look at the compromised proposal and have concluded that it would dramatically undermine their ability to adequately regulate insurance activities. In addition, the issuance of two recent court decisions calls into question the ability of the Comptroller, an ability that many had begun to take for granted, to unilaterally authorize national banks to engage in expanded insurance sales and underwriting activities absent congressional action.

It should be clear that both the insurance industry and the banking industry believe that the current proposal can be improved, and the insurance agents want a bill to be enacted. The current H.R. 10 proposal, however, would jeopardize many of the consumer protections already in place in as many as 30 States. In addition to the noninsurance sales amendments that the NAIC has presented for your consideration, the agents believe that three sets of changes also championed by the NAIC would alleviate these shortcomings.

First, clarify that State insurance regulators are entitled to receive consideration of their views in court when disputes arise between regulators, regardless of when a State law that is challenged on preemptory grounds was enacted. The bill as currently drafted permits the views of State insurance regulators to be considered only in court challenges to laws enacted in the future. The inevitable deference to any OCC preemption opinions regarding current laws would place many longstanding State laws in jeopardy.

Second, the so-called nondiscrimination provision that blanketly prohibits the imposition of any rules that treat banks differently on their face, or that inadvertently treat banks differently, should be narrowed to delete the inadvertent treatment prohibitions set forth in section 104(c)2, and to clarify that the core nondiscrimination provision prohibits treating federally insured depository institutions differently based on their insured financial status. Contrary to the suggestions of some members of the banking industry, consumer protection provisions that specifically address bank insurance sales practices are not impermissibly discriminatory, as 30 States and even the OCC itself have explicitly recognized in their enactment and support of such provisions.

Third and finally, the safe harbor provisions should be clarified. In our written comments we have outlined four small changes that we believe should be made to improve the existing safe harbor provisions and we have suggested that two more be added. One, protecting State laws that require execution of acknowledgment form of requisite disclosures already protected by the existing safe harbors where provided, and a second, protecting State laws to require banking institutions to separate their banking activities from their insurance activities within the bank. Both new safe harbors, like many of the other existing safe harbors, encompass provisions already mandated under the section 176 Federal consumer protection provisions.

Without enactment of legislation that includes changes such as those that we have outlined, the emerging regulatory void in portions of this industry will continue to fester.

Mr. Chairman, we look forward to working with you to pass a financial services reform bill.

[The prepared statement of Scott A. Sinder follows:]

PREPARED STATEMENT OF SCOTT A. SINDER ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA, INC., THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS, AND THE NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS

Mr. Chairman, and members of the Committee, my name is Scott Sinder. I am a partner in the Washington, D.C. office of the Baker & Hostetler law firm. I appear today on behalf of the insurance agents of America, and their employees—nearly 1,000,000 men and women who work in every part of the United States. These people are represented by the Independent Insurance Agents of America, Inc. (IIAA), the National Association of Life Underwriters (NALU) and the National Association of Professional Insurance Agents (PIA), on whose behalf I testify today and for whom I serve as outside counsel. Their members sell and service all lines of insurance.

INTRODUCTION

First, Mr. Chairman, let me thank you for holding this hearing today. Throughout your career, you have been a friend to the insurance industry and you have been sensitive to the interests and concerns of insurance agents. It is those interests and concerns that I would like to focus your attention on today once again.

IIAA, NALU and PIA are appearing before you today to comment on the newest version of H.R. 10, the "Financial Services Act of 1999," that was reintroduced on the very first day of this new Congressional term. Before proceeding with my comments, I must commend you for the role you played last term in brokering an historic agreement that resulted in a bill that was eventually passed by the House of Representatives by a razor-thin one vote margin. Without your commitment and heavy involvement, no bill would have proceeded to the floor and, in all likelihood, we would be no closer to the enactment of a financial services reform bill today than we were during the many past legislative terms in which such a bill was discussed and debated but was repeatedly unable to take flight.

One message that I have been asked to deliver to you today, Mr. Chairman, is that the insurance agents want you to know that they intend to do everything within their power to help you mold a bill that can take flight and become the law of the land.

As you know, Mr. Chairman, the insurance agents strongly supported the H.R. 10 bill that you brokered and shepherded through the House of Representatives last term. That bill included several provisions that the insurance agents believed to be essential to ensure adequate functional regulation of insurance sales activities. The bill, for example, included a provision that would ensure that the opinions of state insurance regulators were given equal consideration with those of federal banking regulators in any preemption challenges asserted against state insurance consumer protection provisions; established preemption "safe harbors" that would shield any provision similar to provisions included in the Illinois bank sales of insurance consumer protection provisions from preemption challenge; and did not impose a blanket prohibition on insurance sales provisions that addressed many of the unique consumer protection concerns that arise when insured depository institutions engage in insurance sales activities.

After that bill was passed by the House, however, the Senate Banking Bill drastically re-wrote and revised many of its most essential provisions, especially in the insurance sales context. That bill, for example, drastically limited the application of the "no unequal deference" provision; drastically reduced the scope of the preemption "safe harbors"; and imposed a blanket "nondiscrimination" requirement on state laws or regulations enacted in the future that would prohibit those provisions from specifically addressing bank insurance sales activities and from having a greater regulatory impact on those activities than on the insurance sales activities of other agents. The insurance agents actively opposed the bill that was passed out of that Committee.

After the Senate Banking Committee completed its work on the bill, Senator D'amato mediated a negotiation among selected banking and insurance industry representatives. The insurance agents participated in those negotiations but state insurance regulators were excluded. The exclusive focus of those negotiations in the insurance sales context was on the scope of the preemption safe harbors. The banking industry representatives made clear that the deference and "nondiscrimination" sections of the bill were not open for debate during those negotiations. During those negotiations, the safe harbor provisions had been improved but they still did not provide the protection of the Illinois-based preemption safe harbor provisions that were included in the House bill.

At the conclusion of the negotiations, the insurance agents made clear that they still had serious concerns and problems with the Senate proposal, and they could not support the bill, although there would be no active opposition either.

As you know, the Senate proposal was never considered on the Senate floor. When this Congress convened in January, however, that proposal was re-introduced as the 1999 version of H.R. 10. The Senate package was largely untouched during its consideration by the House Banking Committee. We therefore sit before you today in virtually the same position we were in at the close of the Senate last year—the insurance agents do not support the current proposal and we urge this Committee to improve the proposal by adopting the amendments outlined below.

Banking industry representatives have been quite vocal in recent weeks regarding their belief that any changes that are made to the current proposal will eliminate any prospects for ultimate passage. They argue that agreements were reached in the fall and that those agreements should be maintained. At the same time, however, many of these same representatives have themselves been requesting that some changes be made in the insurance sales provisions.

Many things have changed since last October. First and foremost, state insurance regulators, through the National Association of Insurance Commissioners, have taken a harder look at the compromise proposal and have concluded that it would dramatically undermine their ability to adequately regulate insurance activities if it is enacted. In addition, the issuance of two recent court decisions calls into question the ability of the Comptroller —that many had begun to take for granted—to unilaterally authorize national banks to engage in expanded insurance sales and underwriting activities absent Congressional action.[1]

It is against the backdrop of the tortured history of Congress' consideration of financial services reform proposals and the ever-evolving world in which those proposals are generated that this Committee must consider the latest iteration of H.R. 10. In undertaking that consideration, it should be clear that both the insurance industry and the banking industry believe that the current proposal can be improved. The insurance agents want a bill to be enacted and we have been falsely accused of trying to block passage of a viable proposal.

The remaining portions of this testimony will focus on the improvements the insurance agents seek to ensure that state authority and expertise in the regulation of the business of insurance is not overturned or undermined in any way as other industries become more heavily involved in providing insurance services. This statement is divided into four parts. Part I summarizes the basis of the insurance agents' historical support for the continued separation of the banking, insurance and securities industries and the reasons that we are now prepared to embrace reform provided that it ensures adequate regulation of all who seek to engage in the business of insurance. Part II explains why the regulation of insurance activities of everyone should be left to the States. Part III what is at stake if the bill fails to leave that regulation to the States. And Part IV explains the changes that we believe must be made to ensure the requisite functional regulation.

*I. The Insurance Agents' Historical Support For Continued Separation*

As you know, Mr. Chairman, we have in the past advocated that the traditional separation between the banking and insurance industries should be maintained. During your consideration of H.R. 10 last term, however, we for the first time came to you prepared to support financial modernization in the form of affiliations between banking, securities, and insurance entities. The market is evolving even in the absence of new legislation and today more than ever before agents are entering into an increasing number of relationships with members of the banking and securities communities. We can accept formal affiliation relationships, however, only if there is clear functional regulation of the insurance activities of every entity, and only if insurance consumer protections are addressed.

The monumental shift in our position has not come easily. As small business people, we are painfully aware that, as a practical matter, such affiliations will be a

[1] *See Independent Insurance Agents of America, Inc., et al. v. Hawke,* Civil Action No. 98-cv-0562 (U.S.D.C. D.C.) (slip op issued March 29, 1999) (granting the Plaintiffs' Motion for Summary Judgment and concluding that the OCC's ruling that national banks located outside of small towns were authorized to sell crop insurance products was precluded by the applicable provisions of the National Bank Act); *Blackfeet Nat'l Bank v. Nelson,* No. 96-3021 (11th Cir. April 4, 1999) (concluding in its primary holding that the OCC's ruling that national banks are authorized to underwrite an annuity product was precluded by the applicable provisions of the National Bank Act).

one-way-street. That is, the average insurance agency is not going to be in the position to acquire a bank; the acquisition will run the other way. But we are convinced that we can not only survive, but thrive, in such a new world. True competition can work and consumers will benefit, however, only if the rules of the game establish a level playing field for all participants. It is only that which we seek.

The historic change in our position on affiliations has been prompted by marketplace and political reality. The Supreme Court's decision in *Barnett Bank of Marion County, N.A. v. Nelson*[2] holding that the Section 92 power[3] granted to town-of-5000 national banks to act as insurance agents preempts State laws that would otherwise prohibit such conduct, coupled with the Comptroller of the Currency's ever-broadening interpretations of Section 92, effectively vitiate the separation between the industries. And Congressional inaction to reign in the OCC's creation of new policy by administrative fiat has exacerbated the situation.

At the same time, the *Barnett* decision has created a great deal of uncertainty regarding who has regulatory authority over bank sales of insurance and what is the extent of any such authority. This uncertainty is undermining the efforts of all of the participants in the insurance sales arena—insurance companies, insurance agents, banks and State regulators—to move the insurance industry into the twenty-first century. The remaining portions of this statement will therefore focus not on whether financial institutions should be permitted to affiliate with insurance providers—we do not oppose such relationships—but on the need for the functional regulation of all members of the financial and insurance industries. Especially in the insurance context, we believe that it is essential that all insurance activities continue to be regulated at the State level—where they have been regulated for nearly two centuries. In championing this approach, we recognize the pressing need for eliminating the barriers that still exist between the banking, insurance and securities industries so that members with roots in all three sectors will better be able to serve the needs of their customers. We believe, however, that this concern also mandates ensuring that consumer choices are well-informed and freely made and, in the insurance context, state regulators have been the virtually exclusive protectors of such interests since the creation of an insurance industry in this country. This bill must ensure that their authority and expertise in the regulation of the business of insurance is not overturned or undermined in any way as other industries become more heavily involved in providing insurance services.

*II. Regulation of the Business of Insurance Should be Left to the States*

Because no insurance licensing and regulatory scheme exists at the federal level, the only available regulators of the participants in the insurance industry are the States themselves. Some national banks, however, appear to believe that they are exempt from at least some of the governing insurance regulations in States in which they are currently engaging in the business of insurance. Although the OCC has recognized that State laws generally apply to national bank sales of insurance, it also has emphasized that national banks need not comply with State laws that interfere with their activities. Without the creation of a federal regulatory authority or a reaffirmation of the absolute right of States to regulate such insurance activity, the scope of this "exemption" will remain unsettled and national banks may be free to engage in the business of insurance without significant oversight.

Given the sophisticated insurance licensing and regulatory structure developed exclusively at the State level over the past 200 years and given the current climate disfavoring the creation of more federal regulatory authority (especially when it is duplicative of current State efforts), reaffirmation of the right of States to regulate the insurance business appears to be the only viable solution. Such reaffirmation is required to ensure that all entities involved in the insurance industry are on a level playing field; to ensure that they are all subject to effective consumer protection requirements; and to ensure that the insurance-buying public has consistent assurances of quality.

Any such reaffirmation would not be new or radical. To the contrary, it merely would build upon and clarify a federal policy that has been in place for over 200 years that States have virtually exclusive regulatory control over the insurance industry. Indeed, up until 1944, it was universally understood by everyone (including Congress) that Congress has no constitutional authority to regulate the business of insurance. This changed with a single Supreme Court decision issued 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."[4]

[2] 116 S. Ct. 1103 (1996).
[3] 12 U.S.C. § 92.
[4] *United States Dep't of Treasury v. Fabe,* 113 S. Ct. 2202, 2207 (1993).

McCarran's statement of federal 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." [5] Given the States' historical expertise in the realm of insurance regulation and the absence of any such expertise at the federal level, there does not appear to be any compelling reason for abandoning this traditional policy approach.

At a time when Congress is seriously considering empowering States in a myriad of areas, Congress should not strip the States of their authority to regulate in a business arena that has been within their virtually exclusive domain throughout this country's fruitful history.

The States are the only logical choice for comprehensive regulation of insurance. Although there are uniform national concerns in this industry as in many others, in uncountable ways, insurance involves concerns of an intensely local nature. The concerns in Ohio, for example, with its multiple urban centers, lakefront communities and manufacturing concerns, are quite different than the insurance issues raised in Iowa with its thousands of farmers and few large urban areas.

The public has a substantial interest in the continued functional regulation of insurance by the States, regardless of who is conducting the activities. Because of the social need for insurance and its importance to the public, the underwriting and sale of insurance has become one of the most highly regulated professions today. By their regulation, the States ensure that those who engage in the business of insurance are qualified to do so, remain appropriately qualified, offer sound insurance products, and comply with reasonable safeguards for the protection of consumers. This entire body of State insurance statutes and regulations is frequently revised and updated to address evolving regulatory issues and to ensure comprehensive consumer protection. Preservation of the applicability of these State regulations is essential because, at least at the current time, no comparable regulations exist at the federal level and no federal regulator has expertise in this arena.

*III. What Is At Stake*

In March 1996, the Supreme Court issued its decision in Barnett. The Supreme Court's central holding was that Section 92 preempts State laws that prohibit national banks from selling insurance, pursuant to their Section 92 authority. In the course of rendering this decision, however, the Supreme Court also acknowledged that "[t]o say this"—to say that Section 92 preempts State laws that would otherwise prohibit small-town national banks from selling insurance—"is not to deprive States of their power to regulate national banks, where (unlike here) doing so does not prevent or significantly interfere with the national bank's exercise of its powers." [6] The OCC has ceased upon this standard as a potential mechanism for disrupting and potentially eliminating state efforts to regulate national bank sales of insurance products.

A request for comments issued by the OCC on January 14, 1997 dramatically illustrates this.[7] The question at the heart of the OCC's consideration is whether any provisions of the State of Rhode Island's "Financial Institution Insurance Sales Act" ("Rhode Island Act") [8] which governs the insurance activities of financial institutions should be deemed preempted by Section 92. An anonymous Requestor that asked the OCC to consider this issue contends that five of the provisions included in the Rhode Island Act "discriminate" against national banks and significantly interfere with the exercise of their Section 92 powers.[9]

The Rhode Island Act was supported by a bipartisan group of state legislators. Indeed, it was agreed to by a significant portion of the State's banking industry. As reflected in the Rhode Island Governor's statement upon signing, the Act is designed to level the playing field. None of the provisions at issue actually or constructively preclude national banks from engaging in the business of insurance in any way, and none of the challenged provisions impose different requirements on national banks than those imposed on any other financial institution engaging in the sale of, or in the solicitation for the purchase of, insurance products.[10]

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[5] 15 U.S.C. § 1012(a).

[6] *Barnett,* 116 S. Ct. at 1109.

[7] *See* 62 Fed. Reg. 1950 (Jan. 14, 1997).

[8] *See* R.I. Gen. Laws §§ 27-58-1 *et seq.*

[9] 62 Fed. Reg. at 1951.

[10] The challenged provisions generally prohibit the tying of banking and insurance; generally require that a financial institution's loan and insurance businesses be physically segregated; generally prohibit financial institution employees with loan or deposit-taking responsibilities from soliciting and selling insurance; require that loan and insurance transactions be completed independently and through separate documents; and prohibit usage of nonpublic customer information without the written consent of the customer. *See id.*

The OCC, however, apparently believes that these provisions may "significantly interfere" with a national bank's exercise of its Section 92 powers, although the agency has not articulated the standard by which any such significant interference will be measured.[11] Indeed, based on the OCC's supplemental request for comments on the issue, it appears that the OCC is prepared to impose its own views of how best to legislate on the States. Not only is the OCC inquiring whether the Rhode Island provisions prevent or significantly interfere with national banks' insurance sales activities, the OCC is asking whether there are "better" means that the State might have chosen to effectuate its policy goals. This is clearly beyond the OCC's legitimate role as banking regulator. It is the role of legislators—and in this context, State legislators—to determine how best to effectuate public policy, not the OCC.

During the first round of comments, numerous members of Congress expressed their belief that it was inappropriate for the OCC to attempt to preempt any State insurance laws. No member voiced the opposite view. Nevertheless, the OCC labors on, possibly prepared to opine that these state law provisions—enacted on a bipartisan basis by state legislators *with the agreement of significant representatives of the banking industry in the State*—should not be applied to national banks. Interestingly, the Rhode Island law has been in force now for over two and a half years and all players seem to be functioning remarkably well.

The question whether any of the provisions of the Rhode Island Act may be preempted is not an isolated one. Sixteen other States have enacted laws that seek to regulate bank involvement in insurance sales activities,[12] another seven have acted by regulation,[13] and at least six other States are now considering legislation to regulate bank sales of insurance. And, in the meantime, the OCC is meeting with State insurance regulators intimating that it is prepared to preempt any laws or regulations that it views as going too far. There is thus an intense need to clarify the States' regulatory supremacy in this area. The financial services proposal currently before you, however, fails to adequately ensure that state regulators will remain empowered to insurance activities in general and, more specifically, the unique consumer protection concerns that arise when federally insured depository institutions engage in insurance sales.

*IV. Ensuring That The Bill Does Not Undermine Functional Regulation*

Put simply, enactment of the current H.R. 10 draft would dramatically undermine the ability of state insurance regulators to regulate and it would jeopardize many of the consumer protections already in place in many states that are designed to ensure that consumers are well-informed and free to choose to purchase insurance products adequate to address their insurance needs. Although the bill pays lip service to functional regulation in certain respects, it ultimately fails to adequately protect it. It is for this reason that we support the amendments sought by the NAIC to improve the bill's preemption provisions. In the insurance sales context, we be-

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[11] Remarkably, the OCC first sought comments on the preemption of the Rhode Island Act before the State Insurance Department had finalized regulations that would implement the statute. We, among others, pointed out the prematurity of the OCC's request. Apparently recognizing its error, the OCC recently reopened the comment period to permit consideration of the finalized regulations. It is only in light of those regulations that the meaning of the statute can be ascertained.

[12] Arkansas (House Bill 2070 (1997)); Colorado (House Bill 97-1175 (Colorado Rev. Stat. §§ 10-2-601 et seq.)); Connecticut (Public Act No. 97-317 (Connecticut Gen. Stat. § 36a-775)); Illinois (House Bill 586 (1997) (The Illinois Insurance Code Article XLIV)); Indiana (House Enrolled Act No. 1241 (1997) (Indiana Code §§ 27-1-15.5-8 et seq.)); Kentucky (Kentucky Laws Ch. 312 (H.B. 429) (1998) (Ky. Rev. Stat. § 304)); Louisiana (House Bill No. 2509 (1997) (La. Rev. Stat. 22:3051-3065)); Maine (S.P. 439-L.D. 1385 ((9-A Maine Rev. Stat. Ann. §§ 4-401 et seq.)); Massachusetts (Senate 1948, Bill No. MA97RSB (May 15, 1998)); Michigan (House Bill No. 5281 (1993) (Mich. Compiled Laws § 500.1243)); New Hampshire (House Bill 799 (1997) (N.H. Rev. Stat. Ann. §§ 406-C et seq.)); New Mexico (House Bill 238 (43rd Legislature, 1st Sess.) (New Mexico Stat. Ann. §§ 59A-12-10 et seq.)); New York (Bill No. 5717-B (July 18, 1997) (New York Banking Law § 14-g; New York Insurance Law §§ 2123 and 2502) (sunsets July 18, 2000)); Pennsylvania (House Bill 1055 amending the Act of May 17, 1921 (P.L. 789, No. 285), Printer's No. 1985 (June 9, 1997), 40 Penn. Stat.); Texas (House Bill No. 3391 (1997) (Texas Insurance Code Article 21)); and West Virginia (H.B. 2198 (March 14, 1997) (W.V. Code Chapter 33)).

[13] Florida (Dept. of Insurance Rules 4-224.001-4-224.014); Georgia (Rules and Regulations of the Office of the Commissioner of Insurance Chapter 120-2-76 (adopted February 17, 1997)); Maryland (Advisory Letter Issued by the Insurance Commissioner and the Commissioner of Financial Regulation on October 31, 1996); Mississippi (Executive Memorandum issued by the Commissioner of Banking and Consumer Finance on May 13, 1997); Ohio (Department of Insurance Rule 3901-5-08); Vermont (Insurance Division Bulletin 117 (June 13, 1997)); and Wyoming (Chapter 16 of the Rules of the Division of Banking).

lieve three core sets of changes supported by the NAIC would improve the proposed legislation: (1) clarify that state insurance regulators are entitled to receive consideration of their views in court when disputes arise between regulators; (2) amend the so-called "non-discrimination" provision to appropriately clarify the scope of the standard; and (3) strengthen and clarify the safe harbor consumer protection provisions. It is worth noting that *all* of these "improvements" that we are now seeking were included in the bill that you shepherded through the House last term, Mr. Chairman.

*Clarify That The Opinions of State Insurance Regulators Are Entitled To Consideration In Court Reviews of State Insurance Laws.* The viability of regulatory provisions already in force in many States would be put into jeopardy because of the implication created in the bill that the OCC is entitled to exclusive consideration when a court confronts the question whether a challenged provision should be preempted because it "significantly interferes" with a national bank's exercise of its insurance sales powers. Although Section 306 creates a special procedure for the challenge of state insurance regulations and dictates that the state insurance regulator and the OCC are entitled to equal consideration during that review, Section 104(b)(2)(C) exempts laws in existence prior to September, 1998 from the "no unequal deference" standard. The OCC, however, simply has no expertise in the regulation of the business of insurance. Moreover, the OCC has repeatedly demonstrated that the expansion of national bank powers is at the forefront of its concerns. This preoccupation has led the OCC to interpret a small exception to the general prohibition on national bank sales of insurance that authorizes national banks located and doing business in places with populations not exceeding 5,000 inhabitants as allowing national bank agents to sell from anywhere so long as they are headquartered in a small-town bank office and to sell to customers located anywhere without any geographic restriction whatsoever. For these reasons, we believe that OCC interference with State regulation of the business of insurance—and exclusive consideration of OCC opinions regarding such regulation—is inappropriate. The Courts are well qualified to determine whether State regulations prevent or significantly interfere with a national bank's exercise of its insurance sales authority and requiring or implying that the OCC is entitled to special deference over and above that accorded state insurance regulators on such questions is therefore unacceptable.

*Amend the "Non-Discrimination" Provision.* Section 104(c) completely prohibits States from distinguishing in any way between financial institutions and other entities—and from enacting provisions that may have a greater effect on financial institutions than on other entities (even if inadvertent)—in regulating the sale of insurance products. As over 25 States and the OCC itself have previously recognized, however, the sale of insurance products by financial institutions creates unique problems that require consumer protections tailored for the financial institution context. These laws are not "anti-competitive." Indeed, they expressly recognize that banks are in the business to stay. But they attempt to create a level playing field between bank and non-bank insurance agents and brokers, and to protect consumers from potential abuse. Banks' access to cheap funds, FDIC-insured status, and control over credit, puts them in a position not held by others in the insurance industry. For this reason, many States believe provisions regulating bank sales of insurance are necessary to prevent coercion and confusion and to protect customer privacy.

Indeed, as the OCC itself recognized when it published an advisory letter to provide guidance to national banks on insurance and annuity sales activities,[14] there are many instances in which "discriminatory" regulation (in the sense of treating banks differently than non-banks) is appropriate and necessary. Consequently, there is no basis on which to argue that the type of "discrimination" present in consumer protection provisions such as those contained in the Rhode Island Act are *per se* illegitimate.[15]

In working on these laws at the state level, agents have negotiated with all interested parties—banks, insurance companies, securities firms. Michigan's law, enacted almost six full years ago, is the product of negotiations between the banks and the agents. West Virginia's law, enacted two years ago, is the product of negotiations that included not just the banks and the agents, but insurance companies as well. The process has been no different in the other twenty-two States.

Although the safe harbor provisions are an effort to capture many of the substantive regulatory controls that currently are imposed, they are both under inclusive of the current universe of regulatory requirements designed to address bank-

[14] *See* OCC Advisor Letter AL 96-8 (October 8, 1996).

[15] Absolutely nothing in the *Barnett* decision, or its precedents, supports the argument that a State cannot regulate national banks in a manner that distinguishes them from non-banks.

specific consumer protection issues and they cannot possibly take into consideration the wide array of issues that may in the future require bank-specific regulatory solutions.

We believe that, as long as the legislation makes clear that States may not prohibit the exercise of authorized insurance sales powers, there should be no need to bar state legislatures and governors from implementing bank-specific solutions designed to address consumer protection concerns that may arise when such powers are exercised. This would mandate the complete elimination of the "non-discrimination" provision. At a minimum, however, we believe that the standard must be clarified in two ways. First, the prohibition on the enactment of provisions that facially differentiate between insured depository institutions and other entities must be amended to clarify that such provisions are impermissible only if they treat insured depository institutions differently based on their federally-insured status because it is only regulation of that facet of their insurance-related activities that should be limited in any way to the regulatory requirements dictated by the legislation or protected by the safe harbor provisions. Second, the "indirect discrimination" provision—104(c)(2)—must be completely eliminated. It is unfair and unreasonable to prohibit the application of broad regulatory requirements simply because they may happen to have an indirect disparate impact on financial institutions.

*Strengthening The Safe Harbor Provisions.* Finally, we believe that the current list of safe harbors must be strengthened. Section 104(d)(2)(B) establishes 13 separate "safe harbor" provisions. These "safe harbors" essentially permit a State to promulgate consumer protection laws and regulations that are substantially the same as but no more burdensome or restrictive than the requirements included in each provision. Any state law that falls within a safe harbor cannot be preempted. The "safe harbors" apply to laws already in place as well as those that may be enacted in the future. The "safe harbor" provisions included in the bill, however, are inadequate.

Consumer protection provisions that are at the heart of the regulation of banks sales of insurance in many states—requiring separation of banking and insurance activities within the bank, for example—have been excluded from the list of consumer protections that are automatically deemed to be permissible. That exclusion jeopardizes the application of many such provisions and may undermine the regulatory scheme of as many as 30 States that have been designed to address many of the unique issues that arise when banks—in their unique position controlling federally insured credit capital—also engage in the business of insurance.

Specifically, we believe four of the current safe harbor provisions should be clarified and two provisions should be added:

**1. Discrimination Against Non-Affiliated Agents (Safe Harbor ii)**

- The current version of the safe harbor permits a state to prohibit an insured depository institution from imposing a fee related to insurance required in connection with a loan when the insurance is purchased from an agent not affiliated with the bank that is not imposed if the insurance is purchased from an affiliated agent.
- This provision must be amended to clarify that an insured depository institution cannot impose any other condition related to insurance required in connection with a loan that is purchased from an unaffiliated agent that is not imposed when the insurance is purchased from an affiliated agent.

**2. Referral Fees (Safe Harbor v)**

- The current version of this safe harbor permits a state to prohibit an insured depository institution from paying a referral fee to an unlicensed person if that fee is based on the subsequent purchase of insurance.
- The provision should be amended to also permit a state to require that any referral fee paid to an unlicensed person can be no more than a nominal fee as many states have implemented such a requirement.
- The nominal fee requirement also is imposed through the federal consumer protection requirements that would be promulgated by the federal banking agencies under Section 176 of the bill.

**3. Anti-Tying (Safe Harbor viii)**

- The current version of this safe harbor creates an exception to the general rule by allowing insured depository institutions to engage in any practice that the Fed has determined is permissible under the Bank Holding Company Act anit-tying rules.
- This may allow insured depository institutions to offer product packages that would violate state anti-rebating rules applicable to all other agents.
- The provision should be amended to delete that exception.

**4. Disclosures (Safe Harbor x)**

- The current version of this safe harbor permits states to require insured depository institutions to disclose that insurance products are not insured by the FDIC or guaranteed by the state or federal government.
- The wording of the safe harbor permits states to require such a "disclosure, in writing, where practicable".
- That language creates an ambiguity regarding whether the disclosure need be in writing only where practicable or whether the disclosure itself need be given only where practicable.
- The comma between the words writing and where should be deleted to clarify that the disclosure need be in writing only where practicable.

**5. Disclosure Acknowledgment**

- A new safe harbor should be included that would allow a state to require the collection of an acknowledgment whenever a required disclosure is given. Many states currently require the collection of such an acknowledgment.
- An acknowledgment requirement in connection with disclosures also is imposed through the federal consumer protection requirements that would be promulgated by the federal banking agencies under Section 176 of the bill.

*6. Activities Separation*

- A second new safe harbor should be included that would permit a state to require insured depository institutions to separate their insurance sales activities from their deposit-taking and lending activities within the bank. Many states currently maintain such separation requirements.
- A separation of insurance and deposit-taking activities also is imposed through the federal consumer protection requirements that would be promulgated by the federal banking agencies under Section 176 of the bill.

CONCLUSION

The financial services mechanism H.R. 10 seeks to establish must function in the real world. That can only be accomplished if there is true functional regulation. We believe that virtually everyone in Congress supports such functional regulation. The task is to implement it effectively. The affiliations contemplated by H.R. 10 are exciting and probably necessary. But there must be a level playing field for everyone in the industries involved. Small business concerns cannot be swept away by the resulting mergers of the bigger players. And, most importantly, the interests of consumers that state insurance regulators have been exclusively charged with protecting for decades must remain at the forefront.

It is clear that the absence of sufficient regulatory authority over national banks—or any other entity—that is active in the insurance arena is a problem. Neither the Comptroller nor any other federal regulator possesses the necessary expertise to regulate the vast intricacies of the insurance business or of financial institutions' participation in that business. For this reason, and for the reasons delineated at length above, IIAA, NALU and PIA urge this Committee to recommend enactment of legislation that clarifies that all entities that engage in the business of insurance—including national banks and any other entity in a new financial services holding company—are bound by state law regulating those activities and incorporating the suggestions we have offered in an effort to improve the ability of the states to satisfy this regulatory obligation. This would maintain the status quo by ensuring that the States remain the paramount regulatory authority for the insurance industry. Without enactment of such legislation, the emerging regulatory void in portions of this industry will continue to fester. The primary victims if such a bill is not enacted will inevitably be the consumers who are confronted by the unregulated participants in the essential but highly complicated business of insurance.

Mr. Chairman, we look forward to working with you to pass financial services reform.

Mr. OXLEY. Thank you.

Let me begin with some questions.

Mr. Sinder, you referred to the court decision not by name I don't think, but the Independent Insurance Agents versus Hawke?

Mr. SINDER. Yes, sir.

Mr. OXLEY. Would you give the committee a little bit of background on that case and how that should, if indeed it should, affect our consideration of H.R. 10?

Mr. SINDER. Sure. That case was filed by the Independent Insurance Agents of America, NALU and PIA, the three clients who I am testifying on behalf of.

Mr. OXLEY. Did you litigate that case?

Mr. SINDER. Yes, sir. It has made it through the District of Columbia District Court. The case involves the OCC's grant of authority for national banks to sell crop insurance. They granted this authority under section 247 of the National Banking Act, which is the general powers provision of the National Banking Act. There is a separate provision, as you know, called section 92 which authorizes small-town national banks to engage in insurance sales activities.

The Comptroller argued that it was permissible for all banks to engage in crop insurance sales because it was credit-related insurance. There is a decision that was issued by the D.C. circuit several years ago that said that credit-related insurance products that are limited to the amount of the loan and for the terms of the loan are permissible for bank sales.

We argued that that is a very specific exemption and that crop insurance is a general insurance product, like any other PNC product, and that if you allow banks to sell crop insurance as a credit-related activity, you completely eviscerate the very small exception that is left by the small-town sales provision. The court agreed with us. The court said that section 247 does not authorize general insurance sales like crop insurance because of the existence of section 92, which limits those activities to small towns.

Mr. OXLEY. Thank you. That appears to be, that one and a similar one appear to be a different outcome than had been the case over the last several years, was it not? In other words, there were a number of decisions based on OCC decisions that went pretty much with the OCC, and then these two appeared to be going in the opposite direction.

Mr. SINDER. We believe the tide is turning.

The other decision in some ways might be more important for this committee's deliberation. It is a case that was issued by the 11th circuit and it involves the ability of national banks to underwrite annuity-based products. The 11th circuit held that the Comptroller had authorized this activity of section 247 under the National Banking Act, again as a general banking power. It involves a unique product called a retirement CD that is an annuity with a deposit component. The 11th circuit said that there is no underwriting authority that exists under section 247. The Comptroller had issued various statements saying that he believed that there was such authority. This is the first time that a court has had the opportunity to review the underwriting issue and they went against the OCC.

Mr. OXLEY. Thank you. Mr. Zimpher, what effect on Nationwide, what would be the effect on Nationwide if you were unable to form a mutual holding company? How would it affect your ability to raise capital and indeed be competitive in the marketplace?

Mr. ZIMPHER. Well, fortunately, Mr. Chairman, fortunately right now I don't know that it is necessary for us to consider that for current purposes to capitalize ourselves. Our life company, Nationwide Financial Services, is a publicly traded company. Our mutual company owns 80 percent of that company.

If this bill were to be in effect, though, I think the net effect would be we would have to form a mutual holding company. I don't think we would have to demutualize necessarily, but we would have to form a mutual holding company in which to engage in other affiliated activities. Otherwise, simply to avoid dual regulation or double regulation of all of the various products.

Mr. OXLEY. Thank you.

Let me ask Mr. Schultz, why aren't the provisions that H.R. 10 has included to require for a deduction from regulatory capital of a bank's investment and its operating subsidiaries sufficient to address these concerns?

Mr. SCHULTZ. I think many reasonable people in the past have indicated that, and I think you are addressing firewalls, I assume.

Mr. OXLEY. Yes.

Mr. SCHULTZ. Firewalls can evaporate pretty quickly at times, and it appears to me that the op-sub is just closer to the core bank than if it were in a separate holding company structure.

Mr. OXLEY. Have you had discussions with other bankers from Iowa on this provision, and is there a consensus on this issue?

Mr. SCHULTZ. I haven't had that many discussions on this specific topic recently, but I think most community bankers would support the affiliate approach.

Mr. OXLEY. Thank you.

The Chair's time has expired.

The gentleman from New York, Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman. If we simply pass the House banking version of H.R. 10 without any changes whatsoever, would your industry have a level playing field—I will sort of go down the line with this question—competing against one another? The banking market, if we pass it as is, if the Commerce Committee says okay, we like it, we smile and we send it on its way without doing anything to it—let's start with you, Mr. Schultz and then go down.

Mr. SCHULTZ. Again, the question is, am I going to smile and like it?

Mr. TOWNS. No, no. I am saying if we smile and say we like the bill and we send it on, the question is if we do that, would your industries have a level playing field for competing against one another? That is the question.

Mr. SCHULTZ. Possibly leveler, but I am not so sure completely level.

Mr. TOWNS. What should we do then to make it level?

Mr. SCHULTZ. I would have to think about that for a moment.

Mr. TOWNS. All right. We will go to Mr. Sutton.

Mr. SUTTON. From the standpoint of the securities industry I think it would go a long way toward leveling the playing field, particularly toward the areas that I pointed out in my testimony, us competing against banks, and us being able to purchase banks, which today we can't purchase; on the other hand they can purchase us. So I think it would make substantial progress toward leveling the playing field for us.

Mr. ZIMPHER. Mr. Towns, that is a very good question. I would have to say from our perspective, it does level the playing field. You heard some earlier testimony from Mr. Nichols expressing some concern about a couple of provisions as they relate to functional regulation of products in the insurance industry issued by banks or securities firms. With the assurance that functional regulation is secured for all products, I think it would level the playing field.

As you well know, H.R. 10, as reported by the Banking Committee, while it provides for an affiliate structure or an operating subsidiary structure in underwriting securities, it does not provide for such an underwriting insurance, and we are satisfied with that and would strongly encourage the committee to certainly at least retain that feature of the Banking Committee report.

Mr. TOWNS. Thank you.

Mr. SINDER. In the insurance sales context, we would not believe it would create a level playing field, but an unlevel one. The primary reason is that State insurance regulators would be tremendously inhibited in their ability to regulate bank insurance sales activities where they have an unfettered right to regulate all insurance activities of other agents.

In our written testimony we have suggested three specific areas that we believe need to be addressed to help level this playing field. One is to treat the opinions of State insurance regulators equally with those of Federal banking regulators when an insurance sales requirement is challenged by a bank. The second is to alter, amend, the nondiscrimination provisions.

Right now, those provisions did not allow you to take into account in any way the special situation of a bank when it engages in sales activities, including inadvertent impact on a bank even when the legislation is not directed on a bank. We believe that the inadvertent impact section should be deleted and that the core nondiscrimination provisions should be modified to indicate that it is only when you treat a bank differently because of its insured financial status that the law is prohibited.

The last thing we have suggested is that six changes be made to improve the safe harbor provisions that protect State insurance laws that do specifically address bank sales of insurance activities, and those specific changes are outlined in our testimony.

Mr. TOWNS. Thank you.

Some of my colleagues are saying that we should expand the provisions of the CRA to cover industries other than the banking institutions. What do you say to that?

Mr. SCHULTZ. Sometimes as a community bank I wonder why we are subject to CRA, because if we don't invest——

Mr. TOWNS. I didn't hear you.

Mr. SCHULTZ. I said sometimes we wonder as a community bank whether we should be subject to CRA, why we should be when maybe our credit union friends are not, you see. I am not sure that extending regulatory burden wider is really the solution in many cases, even though from a competitive standpoint it certainly raises some question. I make loans to customers and so on, and we also sell insurance. And getting back to the question you raised a little while ago, in my State, banks have been allowed to sell insurance for a long time. Our people are licensed agents, are subject to State insurance regulations and have had no problems. So I think the concern in the banking industry in some areas might be in the

States where this hasn't been the practice as to whether it will be easy enough for banks to enter the insurance business because of the safe harbors that are in the proposed legislation.

Again, getting back to the question about CRA and other types of regulation, you know, we are regulated as a bank and so on. As it relates to how we invest in our community and other consumer regulations, I am not sure who regulates Bob Spear, my American Family agent friend, when he makes a car loan, or makes a house loan, or the State Farm agent who is a friend of mine also who does the same thing.

Mr. TOWNS. My time has expired, so please respond briefly.

Mr. SUTTON. CRA is really not something I can comment on because it is not something we have been involved in.

Mr. ZIMPHER. I think you raise an interesting question. I don't believe the insurance industry should be subject to the CRA. I think the nature of investments, the nature of the use of capital within my industry as opposed to the banking industry, insuring properties and lending mortgage capital and lending practices are two very distinct business functions, and I think that I would seriously question whether CRA should be applied to the insurance industry. We make investments now, obviously, through our investment subsidiaries and any other urban projects or redevelopment projects. So there is money being used in an investment capacity, in a capital flow capacity and in hundreds of cities around this country.

Mr. SINDER. This is an issue on which the insurance agents have not focused and have no direct interest. We are comfortable with the provisions as they are in the bill, but we have no official position at all.

Mr. TOWNS. Thank you very much.

Mr. GILLMOR [presiding]. The gentleman from Illinois, Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman. Two quick questions for you all. It is one that I asked Secretary Rubin and a lot of you were in the room.

The major players in the debate obviously is Chairman Greenspan and the administration, whether it be Levitt or Rubin or the chair of the FDIC. If safety, soundness and stability is a principle that our financial institutions need to be based on, which I believe, and the political winds blow in different directions at different times, for the sake of talking to the average investor, who do you feel best is the least political of the players? Let's just go from Mr. Schultz down.

Mr. SCHULTZ. Of those two players?

Mr. SHIMKUS. Of the two sides of this debate, Chairman Greenspan or really Secretary Rubin.

Mr. SCHULTZ. I think the public would probably feel that Chairman Greenspan would be the less political.

Mr. SHIMKUS. Who do you feel?

Mr. SCHULTZ. And I would too.

Mr. SHIMKUS. You would agree, okay. Mr. Sutton?

Mr. SUTTON. I am not so sure that I know all of the views that have been expressed by all of the parties that you just discussed.

I would say that I think from what I understand, the various issues surrounding regulatory——

Mr. SHIMKUS. Well, the question is, to the consumer, if they want to make sure we are not playing politics and we want safety and soundness and really a nonpartisan overview of financial services, who would they trust?

Mr. SUTTON. I think they would trust safety and soundness to the bank regulators and investor interest to the SEC, which I think is what you have been hearing about probably all day long.

Mr. SHIMKUS. Well, I want to know what you would feel, but that is fine.

Mr. Zimpher.

Mr. ZIMPHER. Mr. Chairman and Mr. Shimkus, I have no idea who the public might—how they may perceive it. I have the utmost respect for both of those gentlemen. I think this country has been well-served by two very public-spirited gentlemen. I have read both of their testimony, studied their positions. I tend to support Mr. Greenspan. Whether the public would support that predominantly, I have no idea.

Mr. SHIMKUS. Well, I think the public understands that one is a politically appointed position and one is not.

Mr. SINDER. The insurance agents have the utmost respect for both Federal regulators, but the most important concern for us between the debate for subs and affiliates is not where insurance activities are performed, but it is who gets to regulate them. For us, we don't believe any Federal regulators should regulate them, because no Federal regulator has ever regulated insurance activities or other activities. Those should be left to be functionally regulated by the States.

Mr. SHIMKUS. Okay. The last question is: Is there a larger risk to the FDIC and the taxpayer if the operating subsidiary version of H.R. 10 becomes law over if the holding company version of H.R. 10; and I will just go down the line again. Mr. Schultz.

Mr. SCHULTZ. I think consistent with my testimony, it would be that there is less risk that is pushed out into a separate affiliate of the holding company, and after hearing this debate and reading the testimony, I do not know which one you are going to hear last. Both of them present very sound arguments, but I think the less risk is the holding company.

Mr. SHIMKUS. Mr. Sutton.

Mr. SUTTON. We are not currently involved in any banking activities——

Mr. SHIMKUS. But you might be.

Mr. SUTTON. So if we were, I would assume that from the issue of risk, that the holding company would probably be less risk.

Mr. SHIMKUS. Thank you.

Mr. ZIMPHER. I would probably agree with that, Mr. Shimkus, but that is an unfounded opinion. That is an uninformed——

Mr. SHIMKUS. You could be a Member of Congress, then. I mean it would work out.

Mr. ZIMPHER. I have thought about it.

Mr. SINDER. I hate to sound like a broken record, but again, we believe the most important focus is on who regulates the activities, not where the activities take place, and as long as whatever bill is enacted——

Mr. SHIMKUS. Now, that is a cop-out, because the issue in this debate is the holding company versus the operating subsidiary, and if insurance sales goes under the operating subsidiary, people are going to make the claim that the insurance is subsidizing some of that risk.

Mr. SINDER. I don't think from a sales perspective you have the same subsidization concerns as you do from an underwriting perspective. If we had to choose, we would choose to put it in the affiliate, but like Chairman Levitt, we believe that the most important——

Mr. SHIMKUS. We are the politicians here. We are asking for gut responses based upon your industry.

Thank you, Mr. Chairman. I yield back.

Mr. SUTTON. Mr. Gillmor, could I excuse myself?

Mr. GILLMOR. Mr. Sutton, yes, go ahead. Thank you for being here with us.

The gentleman from Michigan, the ranking member of the committee, Mr. Dingell.

Mr. DINGELL. Mr. Zimpher, you expressed concern that the Comptroller's op-sub rulemakes it clear that he is willing to allow the banks to do any nonbank activity, including underwriting. I share that concern. The Comptroller also told me that today, there are 19 national banks or subsidiaries of national banks underwriting insurance in the United States, and that there are 22 subsidiaries of banks engaged in reinsurance activities. Is there a risk to depositors when banks that don't have experience in the insurance industry get involved in such activities as underwriting and reinsurance?

Mr. ZIMPHER. I believe there very well potentially could be, sir; yes, sir.

Mr. DINGELL. As I note, the Comptroller indicates that 12 of the 22 banks that are engaged in reinsurance use managing general agents or independent contractors to perform at least part of these insurance activities. Doesn't that tell you that the banks who do this really don't know very much about the business, and are simply relying on others to do the job for them?

Mr. ZIMPHER. One could reach that conclusion, Mr. Dingell. I am not familiar with the specific examples you cite, but from your presentation, one could reach that conclusion, yes.

Mr. DINGELL. Now, doesn't it also make it clear that banks and its depositors are especially vulnerable to fraud and mismanagement by these contractors?

Mr. ZIMPHER. That is also a distinct possibility and potential, yes.

Mr. DINGELL. And that would be particularly true in view of the facts that banks would not be subject to State regulation and that there would be no substitute Federal regulation which would be put in place; isn't that right?

Mr. ZIMPHER. That follows along the reasoning of your earlier questioning of the prior panel, Mr. Dingell. Absent State regulation that particularly would relate to fraud or sales practices, there would be a void, and policyholders, other investors could very seriously suffer.

Mr. DINGELL. Indeed, the insurance pools that protect people in the event of collapse of an insurance company would no longer be present; isn't that right?

Mr. ZIMPHER. That's right. If the banking laws don't apply, that's right. They are not going to be assessed; they will not participate in their guarantee funds, so the holders of those policies are again——

Mr. DINGELL. The insurance commissioners have suggested amendments to this. Do you support the amendments that the insurance commissioners have suggested to protect against the abuses that you and I have been discussing?

Mr. ZIMPHER. Mr. Chairman and Mr. Dingell, we support any effort to strengthen and assure functional regulation.

Mr. DINGELL. It is my understanding—this one to Mr. Sinder, please. It is my understanding that 18 different states have laws that require separation of banks' loan making and insurance sales activity. If H.R. 10 in its present form were to become law, would the physical separation laws of these 18 states be preempted?

Mr. SINDER. Possibly.

Mr. DINGELL. Can you say they would not?

Mr. SINDER. You could not say they would not.

Mr. DINGELL. As a matter of fact, it is almost certain they would, isn't it?

Mr. SINDER. I believe that they would.

Mr. DINGELL. Very well. The Michigan State house has passed a resolution calling on the Michigan State delegation, our two Senators, and the Congress at large to enact legislation that affirms, not preempts, State insurance laws including Michigan's physical separation law. This resolution was supported not only by the Michigan Association of Insurance Agents, but also by the Michigan Bankers' Association and the Michigan Credit Union League.

Is it your view that H.R. 10 as reported by the banking committee fails to protect Michigan State insurance laws as this resolution suggests?

Mr. SINDER. Yes.

Mr. DINGELL. Now, why is it possible for the Michigan Bankers' Association to support Michigan's physical separation law, but the National Bankers' Association opposes the same law at the Federal level?

Mr. SINDER. I wish I knew the answer to the question.

Mr. DINGELL. It is a good question, isn't it? Now, your written statement says as follows: "Although the bill pays lip service to functional regulation in certain respects, it ultimately fails to protect it." That is a strong statement. Must the functional regulation provisions of the bill be strengthened if the insurance agents are to support financial services legislation?

Mr. SINDER. Yes.

Mr. DINGELL. Now, if the functional regulation provisions of the bill are not improved, would it be fair to say that the agents are no better off with the banking committee's bill than with the current law?

Mr. SINDER. That's essentially correct in my view.

Mr. DINGELL. Now, there have been some recent court rulings that have called into question the decisions of the Comptroller to permit banks to engage in insurance activities.

Are these rulings evidence that the courts thinks that the Comptroller has gone too far in improving insurance powers for banks? Is it possible that with the tide turning against the Comptroller that the courts' agents might be better off with the current law and fighting it out in the courts, rather than with the enactment into law of the banking committee's bill?

Mr. SINDER. Possibly. We are very much in favor of the decisions. They do point to specific areas where the Comptroller has overstepped his bounds, but there are certain advantages to the current bill if it is enacted.

Mr. DINGELL. Thank you. Thank you, Mr. Chairman.

Mr. GILLMOR. Thank you, Mr. Dingell. A question for Mr. Sinder and also if the other members would like to jump in, on the issue of title insurance. The banking version generally permits national banks to sell insurance with the exception of title insurance.

From your experience, is there any justification for treating title insurance different, or do you think they should be all forms of insurance?

Mr. SINDER. There is some justification for treating title insurance differently. It is a product that is a one-time sale. It primarily protects the bank's interests and not the consumer's interests in the underlying loan and protecting the underlying loan. There is some conflict of interest in a bank that is seeking to get the loan and will too readily approve a title insurance sale in order to secure the loan.

Mr. GILLMOR. Why wouldn't the same arguments apply to any other type of insurance that the bank was selling to a borrower?

Mr. SINDER. We believe there are issues involved in other sales to borrowers. But those products do not protect the interests of the bank. They do protect the first beneficiary of such products.

Mr. GILLMOR. How about credit life?

Mr. SINDER. Credit life has a long and tortured history.

Mr. GILLMOR. The fact is it protects the bank.

Mr. SINDER. If we had our druthers, the banks would not be permitted to sell credit life directly, but we have lost that fight.

Mr. GILLMOR. Basically, you would prefer that the bank not sell insurance, credit life, title, whatever?

Mr. SINDER. Under the bill, the bank can sell title insurance through an affiliate, it just cannot do it through a subsidiary. The title insurance product is very complicated because the agent takes on some of the underwriting risk.

When you sell any other type of insurance product, the underwriting and the sale are completely separate. So if the bank acts as the agent, or if the bank subsidiary acts as the agent in the sale of the product, a different company, which under the bill would have to be an affiliate, assumes all of the underwriting risk.

When you sell a title product, the agent him or herself also assumes some of the underwriting risk. So in effect if you don't treat title differently, you are allowing the bank to engage in some underwriting activities, whereas it can't for any other insurance product.

Mr. GILLMOR. Any other comments on that issue, Mr. Schultz? Mr. Zimpher?

Mr. ZIMPHER. I would not, no.

Mr. GILLMOR. Mr. Zimpher, is the banking committee bill's provisions regarding the separation of financial and commercial activities creating problems for insurance companies since insurance companies take money from policyholders and invest for those policyholders?

Mr. ZIMPHER. Mr. Chairman, you are right that insurance companies must invest the funds that they receive from policyholders. Those investments are strictly limited and regulated by State investment statutes and laws across the country.

Section 6 of H.R. 10, as it is reported by the banking committee, would permit insurance companies to retain some shares of interest in investment operations on behalf of policyholders. We happen to believe that that perhaps should be expanded, particularly on behalf of our policyholders whose funds it is we are investing; that insurance companies should continue to have some management supervisory role and responsibility in those operations.

Mr. GILLMOR. If I may go back to you, Mr. Sinder, we were told earlier by the Treasury Secretary that financial activities and operating subs would be regulated in the same manner as affiliates.

My question is what has been the real-life experience of insurance agents in respect to insurance sales through banks and bank operating subsidiaries? Is there a feeling on the part of an agent that there has been any loss of consumer protection?

Mr. SINDER. This is an area that the Comptroller of the Currency has tread somewhat lightly because of the pendency of the H.R. 10 bills. The history of this is that there was a real question about whether section 92, the small town sales authorization, overrode State laws that prohibited bank sales of insurance. That issue was not resolved until 1996.

In March 1996, the Supreme Court issued a decision. They said section 92 preempts. In the wake of that, 25 States enacted bank sale of insurance consumer protection provisions to regulate the manner in which small town banks sell insurance.

The first State to do so after the Barnett decision was Rhode Island. Within 6 months before the Department of Insurance could even issue its implementing regulations, the Comptroller of the Currency issued a request for comments in the Federal register asking whether certain provisions included in the Rhode Island bill should be preempted. That was in February 1997. It has been over 2 years.

The Comptroller has not issued any opinion on this. We believe that it is because the office fears congressional response if it oversteps its bounds in doing so. As soon as this issue is resolved, we also fear that the Comptroller will then step up and give his view on whether these laws should be allowed to exist. In the past, the Comptroller has made statements that licensing provisions shouldn't apply to national banks, and anything else that interferes in a way that the Comptroller feels is bad with the banks' insurance sales function should not be allowed to exist.

So today, is the real practical experience that banks are complying with these provisions? Yes. Do they want to challenge them? Yes.

Mr. GILLMOR. Mr. Schultz, are you a national bank or a State-chartered?

Mr. SCHULTZ. National bank. We have a holding company that also owns a State-chartered bank.

Mr. GILLMOR. You have been selling insurance for how long?

Mr. SCHULTZ. Many, many years, 30 years.

Mr. GILLMOR. Including title insurance?

Mr. SCHULTZ. No. I don't pretend to know much about title insurance. Iowa was one of the few States that doesn't allow, maybe the only State that doesn't allow title insurance.

Mr. GILLMOR. Doesn't allow title insurance? I used to practice real estate law. I'm glad I was in Ohio.

In any event, Mr. Towns, do you have any further questions? If not, I want to thank the panelists for being here. We appreciate it very much. Stand adjourned.

[Whereupon, at 3:10 p.m., the subcommittee was adjourned.]

[Additional material submitted for the record follows:]

PREPARED STATEMENT OF HON. KENNETH E. BENTSEN, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, I appreciate the opportunity to provide my views on financial modernization legislation before the House Commerce Committee. I would like to focus on one aspect of this legislation that directly relates to the safety and soundness of our financial system and competitive equity between foreign and national banks. This issue is about the corporate structure that this legislation will provide for our nation's banks.

I am a strong proponent of providing more than one option of operational structure to our nation's banks. I believe that decisions about corporate governance should be made by the bank's officers, not the federal government. Later this month, your Committee will be voting on H.R. 10, financial modernization legislation. I would urge you to keep those provisions included in the House Banking Committee version of this bill that would preserve flexibility for our nation's banks and would permit them to create operating subsidiaries or bank holding company affiliates to offer new services to their customers.

I believe that there is no safety and soundness associated with the inclusion of the operating subsidiary structure in financial modernization legislation. During testimony presented to the House Banking Committee in May 1997, I asked Federal Reserve Chairman Alan Greenspan whether there was any safety and soundness concern or risk with an operating subsidiary structure. Let me quote his response:

> "My concerns are not safety and soundness. It is an issue of creating subsidies for individual institutions which their competitors do not have. It is a level playing field issue. Non-bank holding companies and other institutions do not have access to that subsidy, and it creates an unlevel playing field. It is not a safety and soundness issue."

His response clearly indicates that safety and soundness is not a concern, assuming appropriate firewalls are in place, just as they are with a holding company-affiliate model and as provided by the House Banking Committee's legislation. In fact, Chairman Greenspan argued that a bank receives a subsidy form its parent bank, not its operating subsidiary. Further, Chairman Greenspan acknowledged that banks can also receive a subsidy through its holding company affiliate as well.

I believe that our capital markets today are very efficient and transparent and would be able to discount such subsidies if they do exist. In recent hearings, I asked several federal bank regulators about this issue and they all agree that there is no difference in capital costs for banks who wish to set up either an operating subsidiary or bank holding company affiliate. In addition, the House Banking Committee approved bill imposes strict firewalls and a requirement for the bank to be well-capitalized before it can opt to set up an operating subsidiary. Banks will benefit from this added flexibility by choosing whichever structure is better for their individual company. Finally, I would argue that the operating subsidiary structure will ensure that all assets of banks, including its operating subsidiary, are subject to Community Reinvestment Act (CRA) regulations.

As you may know, the current and three previous Chairs of the Federal Deposit Insurance Corporation (FDIC) have emphatically stated that restricting the organizational flexibility of banking organization will have a negative impact on the safety and soundness of our financial system. If banks are required to provide new activities through holding company affiliates, but not in operating subsidiaries, the revenues earned by these new activities will flow directly to the holding company shareholders, and not to the bank. If the bank runs into trouble, the FDIC will not be able to reach these holding company assets, which rightly should be used to protect the bank and the FDIC funds.

Further, I do not believe that there is any compelling evidence that the federal government should be interfering with private business decisions regarding organizational structure. Each business in this country should be free to organize its activities in the most efficient manner for that organization. For some banks, an operating subsidiary may be more cost-effective, while other banks may choose to use holding company affiliates to offer new services to their customers. For instance, it might be cheaper to organize an operating subsidiary because they do not require a multiple set of books and board of directors or legal requirements. Other banks, however, may elect to create a holding company structure because of tax consequences, compensation schemes, multibranding, risk management, and geographic location. Banks should be free to make business decision for themselves without unnecessary government mandates.

I would also encourage you to consider how these options will affect our nation's smaller, community banks. Because smaller institutions have a smaller revenue base, they may not be able to afford to absorb increase organizational and regulatory costs of operating a holding company. For these smaller banks, the operating subsidiary option may be the best and most economically feasible option for these banks to offer their customers a full range of financial products in the most cost-efficient manner.

We need to enact legislation that provides for adequate supervision to ensure that expanded financial activities are conducted safely and soundly in a subsidiary or an affiliate. The solution is not to favor one structure over another but rather to pass legislation that provides that the regulators can adequately supervise the effect on the bank of the expanded activities and bank's relationship with its subsidiaries or affiliates. This supervision along with adequate internal controls by the banks is the critical element to conducting in activities in a safe and sound manner rather than a mandated corporate structure.

Another argument that has been made in opposition to operating subsidiaries is that the banks are more protected from corporate veil piercing under a holding company structure. This is wrong. Bank subsidiaries, in the same manner as bank affiliates, are legally separate from the insured bank. In those extremely rare instances when a court ignores this legal separation and permits the corporate veil to be pierced, an exhaustive empirical study conducted by Cornell Law Review shows that affiliates, not parent organizations, have been found financially liable in the greater number of instances. Piercing the corporate veil depends on how entities conduct their operations and not on how the operations are structured within an organizational chart.

Opponents to the subsidiary option also assert that banks have a subsidy from the Federal safety net through the deposit insurance program, the access to the discount window and the payments system. These opponents argue that banks funding operations through subsidiaries have an unfair competitive advantage over non-bank owned competitors. I would disagree with this argument, because I believe banks are among the most heavily regulated private institutions in American society. After factoring in the costs of regulations and what banks' pay for the services in the federal safety net, I believe it is difficult to argue that any net subsidy exists. Even assuming for argument's sake that a net subsidy exits, there is no evidence that a holding company affiliate structure would be more effective than the operating subsidiary in containing the net subsidy because equivalent safeguard may be put in place. The subsidy could be passed through in the form of dividends to the holding company. And, in repeated questioning neither Chairman Greenspan nor the Federal Reserve has provided any quantitative evidence of such a subsidy nor any quantitative analysis determining a differential in such subsidy between an operating subsidiary and a holding company affiliate.

I would also like to point out that the Federal Reserve has not expressed the same concerns about transfer of the subsidy in connection with foreign bank operations in the United States. In this decade alone, the Federal Reserve Board has issued approvals for almost 20 foreign banks to own directly so-called Section 20 subsidiaries that engage in securities underwriting activities in the United States. While foreign banks are not supported by the United States federal safety net, they do have full access similar safety net benefits in their home country. Yet, these foreign banks are permitted to conduct non-banking activities directly through a subsidiary structure in the United States. In its first order permitting foreign banks to conduct securities underwriting through a Section 20 subsidiary, the Board states that any potential advantages of allowing foreign banks to operate through the subsidiary structure rather than the bank holding company structure is not significant in light of the firewalls imposed. These firewalls are similar to those including in H.R. 10 as reported by the House Banking Committee.

It simply does not make sense to permit foreign banks to enjoy the benefits of organization freedoms when acting in the United States but to deny these same benefits to United States banks. I believe in the principle of national treatment, which means foreign banks are treated in the same way as national banks. However, I do not believe that we should be providing flexibility to foreign banks that are denied to domestic institutions.

Further, I would like to inform the Committee that I believe that these operating subsidiaries would ensure functional regulation for products sold from them. This would ensure that the Securities and Exchange Commission and states' securities regulators would have primary regulatory jurisdiction of operations. I believe that functional regulation is the most appropriate manner to ensure that consumers will understand what they are buying.

Therefore, I urge this Committee to follow the approach of the Banking Committee by giving our banks the organizational choice that will be available to foreign banks under this legislation.

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## PREPARED STATEMENT OF THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

The National Association of Independent Insurers ( NAII) is the nation's largest full service property-casualty trade association with 619 members in the United States. NAII members include insurance companies of every size and type—stock, mutual, reciprocal and Lloyds. NAII members write almost $81.3 billion in annual premiums representing every type of property-casualty coverage, including automobile, homeowners, business insurance, workers' compensation and surplus lines.

NAII and its members applaud the work of this committee and Congress in moving the Financial Services Act of 1999 toward finalization. The current version represents long hours of work at modernizing the financial services sector of the United States economy, while attempting to retain the best of existing regulatory structure in each of the respective areas of financial services. In addition to the public policy discussion at the congressional level, interested parties have worked behind the scenes to voice their concerns. A variety of regulators at the federal level—including the Chairman of the Federal Reserve, the Secretary of the Treasury, and the heads of the Office of Thrift Supervision and the Securities and Exchange Commission—have given their input. Likewise, state insurance regulators, through their organization, the National Association of Insurance Commissioners ("NAIC"), have commented on H.R. 10. In addition, trade associations comprised of insurers, insurance agents, thrifts, and banks, to name a few, have suggested language in an attempt to draft a bill which recognizes the needs of all the interested parties under such a unified financial services package.

The authors of H.R. 10 have made great strides toward this objective by seeking to establish clear delineation of regulatory authority based on functional regulation. NAII and others believe that with modification, H.R. 10 can set out a bright line of functional regulation which will minimize needless costs of regulatory overlap and regulatory challenges, not only between the regulator and the regulated, but between the different kinds of regulators. NAII supports H.R. 10 and the concepts behind it. However, NAII believes that in order to achieve true functional regulation and a smooth running financial services sector of the economy, H.R. 10 must be modified to clearly delineate functional regulation and thus ensure that no element of the financial services sector receives an unfair advantage.

### *Section 104(c)(2)*

Of paramount concern to NAII members is the language in Section 104(c)(2). Summarizing Section 104(c)(2), no state may pass a law or regulate insurance activities where such law or regulation, as interpreted or applied, will have an impact on a bank that is substantially more adverse than on non-bank entities. On its face, this sounds rather innocuous, indeed laudable, as no law or regulation should be permissible if that law or regulation is intended to be more adverse to a bank than other similarly situated entities. Unfortunately, this provision is not intent-based. It is based on the effect a law has on a particular party. Therein lies our concern. Section 104(c)(2), because it is effect based, provides a loophole which will permit banks to challenge state insurance laws even where there was no intention by the state of treating banks differently than insurance companies. We believe this is a path that will destroy the concept of functional regulation that the authors of H.R. 10 have tried hard to preserve.

Under H.R. 10 as currently drafted, the advantage is given to the banks. Banks gain because state laws are preempted simply because they are banks. Such preemption is not a two-way street, as insurers are not positioned to have banking laws preempted where a banking law would have an adverse impact on an insurer.

A concrete example of where a bank could have an unfair advantage in relation to the business of insurance involves accounting practices. Currently, under what are called Statutory Accounting Principles (SAP), insurers are required to report their financial results under what tend to be more conservative accounting rules than Generally Accepted Accounting Principles (GAAP). Banks follow GAAP accounting. Would an insurer affiliated with a bank not be held to SAP, and not be as strictly regulated as an insurer without bank affiliation, since the imposition of differing accounting principles is an additional cost to the bank?

The problem with Section104(c)(2) is that it is not directly tied to the intent of the state to adversely impact a bank. Section 104(c)(2) operates regardless of the state's intent. The only test of Section104(c)(2) is if the impact on a bank is different because it is a bank. If that impact exists, then any such state law or regulation is preempted. This is not preemption based on a state passing a law intentionally to affect a bank in the context of insurance business. It is preemption by hindsight, as the state's action will be viewed in relation to what happens, potentially years down the line, to a bank. It will not matter that the state had absolutely no intention of adversely impacting a bank. It will not matter that the state law was reasonably related to proper governmental objectives. What will matter is that a bank need not comply with such a law. That is an unfair advantage to the bank.

Nor is it true functional regulation to give a bank this advantage, for by granting the advantage, there is an area where the function of the business of insurance is not regulated by the states. It is likely, too, that under Section104(c)(2), costly litigation will arise, for the bright line of functional regulation will become blurred as banks attempt to show that the effect, not the intent, of a state law adversely impacts the bank. In the context of these likely squabbles between banks and their regulators, and insurers and their regulators, under current Section 104(c)(2), financial services modernization would not be controlled by functional regulation, but rather plagued by dysfunctional regulation.

*NAIC Amendments*

The National Association of Insurance Commissioners recently submitted to the Committee a package of amendments which include a call for deletion of 104(c)(2). NAII supports this and other NAIC amendments, and strongly encourages members of the House Commerce Committee to seriously consider their adoption. Please note that while stating NAII's support for removal of Section104(c)(2) from H.R. 10, the NAII strongly opposes any state law which is intended to have an adverse impact on a bank or which on its face singles out banks. Many NAII members have business relationships with banks, and would find affiliations with banks mutually advantageous.

In addition, NAII strongly supports the proposed NAIC clarification to Section 303 stating that all insurance activities, not just sales, are to be functionally regulated. This change is consistent with the deletion of Section 104(c)(2) in order to achieve with "bright line" functional regulation.

*Operating Subsidiaries*

NAII applauds the language in H.R. 10, Section 304, stating that a national bank and the subsidiaries of a national bank may not provide insurance as principal. To do otherwise would make functional regulation virtually impossible. However, there are activities which are permitted to national banks and bank subsidiaries. These include "authorized products" or other insurance related activities. Because these products or activities are insurance related, consistent with functional regulation, these should be regulated by the states.

At this point, it is appropriate to cite an example of an activity in which national banks or subsidiaries of national banks are permitted to engage but which should be functionally regulated as insurance. National banks are authorized to enter into debt cancellation agreements providing for the cancellation of the borrower's outstanding debt upon the death of the borrower. The Office of the Comptroller of the

Currency ("OCC") recently extended that authority to include debt cancellation agreements pursuant to which debt is cancelled as a result of the borrower's disability or loss of employment. These products resemble insurance and should be functionally regulated by the states. This is not to prohibit the banks from offering the products, only to regulate the product as insurance.

A similar product is Guaranteed Auto Protection Coverage ("GAP Coverage") whereby coverage is issued for the excess of the outstanding loan amount over any recovery from an insurer in the event of theft or total loss of a vehicle. For example, an individual may have a loan balance outstanding of $5000. The car is in an accident and totaled, but the appropriate payment by the insurance company is determined to be $4000. GAP coverage would pay $1000. National banks are permitted to offer this product. This product should be regulated by the state as insurance.

The effect of a failure to regulate the above products as insurance if offered by a bank results in an unfair advantage to the bank in the sale of the product. If offered by a bank, these products are not subject to state regulation as are the same products if offered by an insurer. All of the additional cost of state regulation, and all of the additional state consumer protections, do not exist in relation to the bank's issuance of these products. These costs do exist if an insurer offers the same products. Thus, it is the insurer which is disadvantaged.

*Affiliations*

Undoubtedly, mergers and acquisitions are a reality of the modern corporate world and are a proper subject for financial services modernization. It is wholly appropriate for banks and insurers to affiliate. Such affiliation, however, must be consistent with functional regulation. The current language of H.R. 10 in Section 104(a)(2) attempts to grant functional regulation of the transaction to the states as to the business of insurance, but in reality merely enumerates the information a state may require relating to the transaction. Indeed, under H.R. 10, a state may require that the insurer's capital be restored to a certain level, but that is the extent of state authority. There are factors other than capital that relate to insurer solvency. Thus, the state effectively does not have functional regulatory authority over the affiliation. The NAIC's proposed amendment goes far to restore functional regulation as applied to affiliations by permitting the states to collect, review, and take actions on such applications, provided that the state law does not discriminate against the bank. NAII supports this amendment as protective of the solvency of insurers in affiliations.

*Lee Amendment*

The NAII urges the Committee to delete the so-called Lee Amendment in Section 6(b). The Lee Amendment would apply Fair Housing Act standards to insurance affiliates of banks and represents a backdoor attempt to implement federal regulation of insurance. The Fair Housing Act, which was initially enacted in 1968 and amended in 1988, prohibits discrimination in housing on the basis of race, color, religion, sex, familial status, national origin or handicap. It expressly applies to home sales and rentals and the service of home sellers, landlords, mortgage lenders and real estate brokers. The Act does not make any reference to the separate service of providing property insurance for the simple reason that Congress, in enacting the law, recognized that insurance is a state regulated business. The Lee Amendment runs counter to the McCarran-Ferguson Act of 1945 which mandates the state regulation of the business of insurance. Every state and the District of Columbia have laws that prohibit insurance redlining. The addition of a federal application in this area will, at best, lead to a system of dual state and federal regulation of insurance.

*Conclusion*

NAII urges the Committee to adopt the NAIC amendments to H.R. 10 as consistent with and in furtherance of the concept of functional regulation. It is clear that the intent of the drafters of H.R. 10 is preserving state regulation of the business of insurance. No better tangible evidence of Congressional intent in this area exists than the wording of Section 301 of H.R. 10 which states that the intent of Congress with reference to the regulation of the business of insurance as embodied in the McCarran Ferguson Act remains the law of the United States. It is to the benefit of banks as well as insurers that H.R. 10 draw a "bright line" to define insurance and regulate the insurance function. With that "bright line," H.R. 10 will indeed be financial services modernization, streamlining the financial services sector.

PREPARED STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

*I. Introduction*

The Investment Company Institute is the national association of the American investment company industry. The Institute's membership includes 7,546 open-end investment companies ("mutual funds"), 457 closed-end investment companies and 8 sponsors of unit investment trusts. The Institute's mutual fund members have assets of about $5.730 trillion, accounting for approximately 95% percent of total industry assets, and have over 73 million individual shareholders. The Institute's members include mutual funds advised by investment counseling firms, broker-dealers, insurance companies, bank holding companies, banks, savings associations, and affiliates of commercial firms.

The Institute has been an active participant in the debate on financial services reform and has provided testimony to Congress on subjects directly related to such reform numerous times over the last twenty-three years. The Institute appreciates the opportunity to provide the Committee with its views on H.R. 10, the "Financial Services Act of 1999."

Initially, we would like to commend the continued leadership of the House Commerce Committee in its effort to reform our nation's financial services laws. To most observers, it is now abundantly clear that the laws that separate mutual funds, banks, broker-dealers, insurance companies, and other financial services firms are obsolete in the face of technological advances, fierce competition, and dynamic and evolving capital and financial markets.

By permitting affiliations among all types of financial companies, H.R. 10 represents a major step forward in the effort to modernize the nation's financial laws and to realign the financial services industry in a manner that should benefit the economy and the public. It also includes one of the most important principles that underlie successful financial services reform: the establishment of an oversight system based on functional regulation.

Thus, H.R. 10, like S. 900, the "Financial Services Modernization Act of 1999," reflects a sound framework for reform of the financial services industry, and we urge Congress to enact it. We are concerned, however, that attempts will be made to weaken its commitment to functional regulation, to apply the Community Reinvestment Act (CRA) to mutual funds, or to affect the ability of mutual fund organizations and other service providers to share certain information that is necessary to effectively operate a mutual fund. Any of these actions would pose serious concerns for mutual funds and their shareholders.

*II. Background*

*Regulation of the Mutual Fund Industry.* Since 1940, when Congress enacted the Investment Company Act, the mutual fund industry has grown steadily from 68 funds to over 7,000 funds today, and from assets of $448 million in 1940 to over $5 trillion today. In our view, the most important factor contributing to the mutual fund industry's growth and success is that mutual funds are subject to stringent regulation by the Securities and Exchange Commission (SEC) under the Investment Company Act. The core objectives of the Investment Company Act are to: (1) ensure that investors receive adequate, accurate information about mutual funds in which they invest; (2) protect the integrity of the fund's assets; (3) prohibit abusive forms of self-dealing; (4) restrict unfair and unsound capital structures; and (5) ensure the fair valuation of investor purchases and redemptions. These requirements—and the industry's commitment to complying with their letter and spirit—have produced widespread public confidence in mutual funds. In our judgment, this investor confidence has been, and continues to be, the foundation for the success that the industry enjoys.

Our opinion concerning the efficacy of the mutual fund regulatory system has been confirmed by the General Accounting Office. In its report on mutual fund regulation twenty-four months ago, the GAO found that "the SEC has responded to the challenges presented by growth in the mutual fund industry." It also noted that the "SEC's oversight focuses on protecting mutual fund investors by minimizing the risk to investors from fraud, mismanagement, conflicts of interest, and misleading or incomplete disclosure." To carry out its oversight goal, the SEC performs on-site inspections, reviews disclosure documents, engages in regulatory activities, and takes enforcement actions. The SEC is also buttressed by "industry support for strict compliance with securities laws." [1]

[1] *Mutual Funds: SEC Adjusted its Oversight in Response to Rapid Industry Growth* (GAO/GGD-97-67, May 28, 1997) at pages 28, 5 & 29, respectively.

The mutual fund industry has always spoken out against developments that would impair this effective and time-tested regulatory system which is what would occur if aspects of banking regulation were imposed on the mutual fund industry.

*Differences Between Bank Regulation and Mutual Fund Regulation.* H.R. 10 recognizes that if financial services reform is to succeed in producing more vibrant and competitive financial services companies, it must provide a regulatory structure that respects and is carefully tailored to the divergent requirements of each of the business sectors that comprise the financial services marketplace. The mutual fund industry has historically and continues to be subject to extensive SEC oversight. And for reasons that continue to make good sense even in this era of consolidation and conglomeration, the regulations governing the mutual fund business rest on different premises, have different public policy objectives, and respond to distinct governmental and societal concerns.

Our securities markets are based on transparency, strict market discipline, creativity, and risk-taking. The Investment Company Act and federal securities laws reflect the nature of this marketplace and, accordingly, do not seek to limit risk-taking nor do they extend any governmental guarantee. Rather, the securities laws require full and fair disclosure of all material information, focus on protecting investors and maintaining fair and orderly markets, and prohibit fraudulent and deceptive practices. Securities regulators strictly enforce the securities laws by bringing enforcement actions, and imposing substantial penalties in a process that by design is fully disclosed to the markets and the American public.

Banks, by contrast, are supported by federal deposit insurance, access to the discount window and the payments system, and the overall federal safety net. For these reasons, banking regulation imposes significant restraints and requirements on the operation of banks.

It may well be that this regulatory approach is prudent and appropriate when it comes to the government's interest in overseeing banks. But it would be fundamentally inconsistent with the very nature of the securities markets to impose bank-like regulation on mutual fund companies and other securities firms. To do so could profoundly impair the ability of mutual funds and securities firms to serve their customers and compete effectively. More worrisome, it could compromise the continued successful operation of the existing securities regulatory system.

Finally, and perhaps most importantly, imposing bank-like regulation on an industry for which it was not designed could even jeopardize the functioning of our broad capital markets. This would risk the loss of a priceless and valuable national asset. As SEC Chairman Arthur Levitt has stated, "[o]ur capital markets must remain among our nation's most spectacular achievements . . . Those markets, and investors' confidence in them, are rich legacies we have inherited, but do not own. They are a national asset we hold in trust for our children, and for generations of Americans to come."[2] Thus, this Committee is wise to ensure that otherwise well-intended efforts to modernize financial services law and regulation do not compromise our capital formation system.

### *III. Successful Financial Services Reform Should Not Be Undermined*

Both H.R. 10 and S. 900 establish a new structure for the affiliation of financial services companies in the United States. The bills do not merely alter the nature of the banking system through banking reform, but instead propose a regulatory structure that reflects the new economic relationships. But because each of the industries in the new holding company is subject to extensive oversight under distinct regulatory systems, both bills appropriately adopt the concept of functional regulation as the proper regulatory oversight system for an integrated financial services industry. This fosters regulatory reliance and respect for the jurisdiction of the regulatory agencies that supervise these industries. The Institute strongly supports this result.

Importantly, both bills protect the domestic banking and international financial system as well as insured depository institutions and the deposit insurance funds by providing the banking agencies with authority to take appropriate action when necessary. At the same time, they prevent the imposition of a banklike regulatory approach on the mutual fund industry by avoiding conflicting and duplicative regulation. This is accomplished without creating any regulatory gaps in the structure.[3]

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[2] "A Declaration of (Accounting) Independence," Remarks by Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before The Conference Board, New York, New York (Oct.—8, 1997).

[3] For these reasons, the Federal Reserve Board (FRB) has indicated that this functional regulation oversight system would maintain the safety and soundness of our financial system in general and the banking system in particular. *See generally Hearings before the Senate Committee on Banking, Housing and Urban Affairs on H.R. 10, the Financial Services Act of 1998,* Written Statement of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System on H.R. 10 at 5 & 13-15.

We would like to take this opportunity to urge the Committee to oppose amendments that would (1) change the provisions in the bill that carefully proscribe the authority of bank regulators with respect to mutual funds and securities firms; (2) seek to apply aspects of the Community Reinvestment Act to mutual funds; and (3) limit, by statute, the ability of mutual fund organizations and other service providers to share certain information regarding fund investors that is necessary to effectively operate a mutual fund.

In addition, we recommend three changes to H.R. 10: (1) clarification of the supervisory authority of the OTS and OCC over regulated nonbank entities to strengthen functional regulation; (2)—allowing companies to engage in limited commercial activities; and (3) extending the "grandfather date" for companies with commercial activities to control a thrift.

Each of these points is discussed below.

*IV. No Weakening of Functional Regulation Oversight* [4]

To implement this oversight system, the FRB would be assigned regulatory responsibility over all holding companies, including any financial services organization that owns a bank. Both bills also would refine the authority of the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) in this same manner to ensure that they could not assert broader authority than that of the FRB with respect to regulated nonbank entities.

In adopting this approach, both bills recognize that in the process of merging banks with various industries, it is necessary to adjust the present statutory authority of the banking agencies. This adjustment is needed because the statutory schemes applicable to these agencies did not envision that a bank might be affiliated with several, significant regulated nonbank entities like mutual fund companies and broker-dealers. These nonbank entities each have regulators with the expertise to supervise their operations and these regulators may be relied upon to coordinate their supervisory efforts with the banking agencies.

Thus, H.R. 10 strikes an appropriate balance between preserving the authority of the FRB, OCC, FDIC and OTS to protect the safety and soundness of the banking, financial, and payments systems, and avoiding the potential for supervisory intervention into a regulated nonbank entity's day-to-day affairs that are the responsibility of its primary supervisor like the SEC for mutual funds.

In this connection, the Institute suggests that Sections 115(a)(4)&(5) and 118(b)(2)&(3) of H.R. 10 be deleted as inconsistent with this functional regulation framework. These Sections grant the OCC and OTS authority beyond that which is granted the FRB. Eliminating these provisions would pose no safety and soundness concerns. Such action will also reinforce an oversight system that relies on and defers to the expertise and supervisory strengths of different functional regulators (in the investment company case, the SEC). It would also reduce the potential for inconsistent and contradictory actions concerning investor protection, for overlap of regulation and for conflict among regulators.

As indicated by the FRB, a proper oversight system for these new financial services organizations is enhanced by "relying on the expertise and supervisory strengths of different functional regulators, reducing the potential [for] burdensome overlap of regulation, and providing for increased coordination and reduced potential for conflict among regulators." [5]

Unless the bill is amended, OTS and OCC will be able to assert the power to take discretionary supervisory action based on their judgment about business risk. This would allow them to claim the authority to apply a bank-like regulatory approach and/or impose activity or operational restrictions on mutual fund complexes in particular or the securities markets generally. This could profoundly impair the continued successful operation of the existing securities regulatory system and damage our capital markets. This is why we suggest that certain changes be made to clarify the role of the OTS and OCC—and to grant these agencies no greater authority then

[4] This section addresses the socalled "Fed Lite" oversight provisions in Subtitle B of Title 1 of H.R. 10 that relate to the functional regulation of mutual funds, securities firms and insurance companies in a holding company system.

[5] *See Hearings before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce on H.R. 10 and Financial Modernization,* Testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System at 10.

that which is granted to the FRB. This action will strengthen the strong functional regulation oversight system embodied in H.R.10.

*V. CRA Should Not Apply to Mutual Funds*

The mutual fund industry is opposed to attempts to extend CRA to mutual funds. Such an action would act against the interest of the millions of middleincome Americans who invest in mutual funds, would be directly at odds with the obligations imposed on fund managers to place the interests of the fund shareholders first, and would fundamentally misconstrue the nature of CRA and represent a drastic change in its purpose.

First, the effects of imposing CRA-like requirements on mutual funds would be largely borne by middle-income Americans. Institutions and wealthier individuals are better able to obtain the benefits of diversification and professional management of their portfolios through direct investments.

Second, forcing mutual funds to make investments in order to serve some general social or political purpose—no matter how well-intended—would be directly at odds with the entire regulatory and fiduciary structure that governs the activities of mutual funds, the purpose of which is to place the interests of the funds' investors first. (Unlike bank depositors, who receive a rate of return guaranteed by the federal government, the return on every investment made by a mutual fund is directly passed on to the fund's shareholders.) As the former acting Chair of the SEC stated, "Imposing community reinvestment requirements on funds similar to those imposed under the CRA would require fund directors and managers to take into account factors other than the interests of their shareholders, which would be fundamentally incompatible with the requirements of the Investment Company Act." [6]

Third, CRA is premised, in large part, on the fact that depository institutions are publicly chartered entities that receive significant federal subsidies, including deposit insurance and access to the discount window and the payments system. These benefits are provided so that banks may service the convenience and needs of the communities in which they are chartered. CRA is intended to ensure that those services are provided. Mutual funds, in contrast, are not publicly chartered and do not receive the benefits of those federal subsidies. Also, the types of activities contemplated by CRA, such as making loans to small businesses and offering housing loans, as well as offering basic banking services, are not offered by mutual funds, which are pools of liquid securities. Thus, it is difficult to contemplate how mutual funds could comply with CRA-like requirements.

It should be noted that mutual funds play an important role in economic development throughout America. Mutual funds are major investors in municipal securities, which finance projects such as housing, hospitals, schools, and infrastructure. Mutual funds also are significant purchasers of mortgage-backed securities; the growth of this market has reduced housing costs for millions of Americans. Mutual funds also supply capital to new and growing companies, for instance by purchasing shares in initial public offerings. Mutual funds are helping millions of Americans save for their retirement, in IRAs and employer-sponsored plans, as well as housing, education and other needs.

For these reasons, the Institute respectfully urges the Committee to reject attempts to extend CRA to mutual funds.

*VI. Sharing of Customer Information*

Various proposals have been offered to restrict the ability of financial services firms to share customer information. The Institute does not favor a broad legislative prescription on the sharing of customer information because it will fail to take into account the unique structure of mutual funds.

The structure and operation of a fund is unique because the fund itself is essentially a pool of assets under the supervision of a board of directors. Typically, a fund has few or no employees of its own. Instead, as is shown by the diagram in Appendix A, the fund's operations are carried out by various entities, including the fund's investment adviser, principal underwriter, transfer agent, and custodian. In order to service an investor's account, it is necessary for these entities to share customer information with one another.

Because of the structure of the industry, fund shareholders view themselves as customers of a mutual fund organization (or perhaps of the broker-dealer or other intermediary through which they made their investments), rather than of a particular entity within that organization (for example, a transfer agent or custodian).

[6] Letter from Mary C. Schapiro, Acting Chairman, U.S. Securities and Exchange Commission, to Frank N. Newman, Undersecretary for Domestic Finance, Department of the Treasury, dated May 26, 1993.

From the point of view of the shareholder, the fund operation is seamless, as it should be. This is apparent from the popularity of such features as exchange privileges among affiliated funds and consolidated account statements.

Thus, the application of a generic rule on the sharing of customer information to mutual fund organizations is almost certain to be disruptive. If fact, it could potentially make impractical existing mutual fund operations. This is true even if the rule contemplates an "opt out" approach (i.e., one in which customers must affirmatively act to restrict information sharing); funds would be forced to attempt to build extensive systems to track those customers that request to block information sharing in this context.

The Institute is sensitive to the concerns of many regarding their financial privacy. In fact, the Institute has been working for several months with the National Association of Securities Dealers (NASD) on rules governing the sharing of confidential customer information. It is our belief that the NASD is best-suited to address the matter, as it can adopt rules that are tailored to the structure of the mutual fund industry and the securities industry in general.

*VII. Nonfinancial Activities*

An important objective of any financial services reform legislation is to create competitive equality among banks, mutual funds, broker-dealers, and insurance companies. Unfortunately, H.R. 10 retains a strict separation between "banking" and "commerce," although it attempts to bridge this gap to a limited degree by permitting financial services companies to engage in a small amount of activities deemed "complementary" to financial activities. In general, however, a diversified financial services company that becomes a financial holding company would be required to divest its nonfinancial activities within 10-15 years. This approach would introduce a fundamental competitive inequity: all bank holding companies could enter the securities and insurance businesses, but mutual fund companies, broker-dealers and insurance companies with limited nonfinancial activities would be forced to alter their operations and structure in order to enter commercial banking.

For long-standing public policy reasons, still valid today, mutual fund companies and other nonbanking financial services firms have never been subject to activities restrictions like those contained in H.R. 10. In recognition of this and in order to provide a fair and balanced competitive environment, the Institute recommends that H.R. 10 be amended to allow a financial holding company to engage to a limited degree in nonfinancial activities, for example, at a minimum, the amount specified in the version of H.R. 10 that was passed by this Committee last year. This would create a financial services holding company that reflects the realities of today's marketplace in which financial companies often engage in limited commercial activities.

*VIII. Grandfathered Unitary Savings and Loan Holding Companies*

Under the Home Owners' Loan Act, in general, any company may establish or acquire a single thrift and become a socalled unitary savings and loan holding company. Such a company can be engaged in any kind of commercial or financial activity if its thrift complies with the qualified thrift lender test. H.R. 10 would bar a company engaged in any commercial or nonfinancial activities from securing a thrift, subject to a grandfather provision. Under the grandfather provision, if a company already owned a thrift as of March 4, 1999, or had made an application for one, it can retain or secure the thrift.

As a general matter, the Institute has no view on this new prohibition. However, we believe that any company that owns a thrift or has made an application for one should be covered by a grandfather provision that is available until this activity is actually prohibited by law. This approach provides all entities with an equal opportunity to take advantage of an existing business opportunity. Moreover, we are unaware of any identifiable risk to the banking system from extending the date. Accordingly, we support changing the applicable date for the grandfather provision to the effective date of H.R. 10.

*IX. Conclusion*

The Institute continues to support efforts by Congress to modernize the nation's financial laws. H.R. 10 represents a significant contribution to that endeavor, in particular, by permitting affiliations among all types of financial companies, by establishing a system of functional regulation and by raising the issue of whether a holding company should be able to engage to a limited degree in nonfinancial activities. The Institute's recommendations to the Committee are embodied in this statement.

We thank you for the opportunity to present our views and look forward to working with the Committee as this legislation moves forward.