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UNDERSTANDING THE ISSUES RAISED BY
FINANCIAL MODERNIZATION

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I. INTRODUCTION

On January 7, 1997, Representative James Leach, Chairman of the Committee on Banking and Financial Services of the United States House of Representatives (Banking Committee), introduced H.R. 10, the Financial Services Competition Act of 1997. H.R. 10 represents only the latest effort by Congress to achieve an elusive but necessary goal—comprehensive modernization of the laws governing our nation's banks and other financial intermediaries. After numerous amendments, H.R. 10 passed the Banking Committee in June 19971 and was referred to the House Committee on Commerce (Commerce Committee) for consideration. On October 30, 1997, the Commerce Committee approved a revised version of H.R. 10 that differs from the bill passed by the Banking Committee on several important issues, including the contentious issues associated with bank insurance and securities activities.2 In light of the differences between the Banking Committee and Commerce Committee bills and the difficult policy issues underlying these differences, members of the House were unable to devise a compromise bill in sufficient time to bring H.R. 10 to the floor before the first session of the 105th Congress concluded on November 13, 1997.

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The Senate has not taken up the issue of financial modernization in the 105th Congress and probably will not begin hearings on the matter until the House completes action on H.R. 10. Senator Alfonse D’Amato, the Chairman of the Senate Committee on Banking, Housing and Urban Affairs, however, has introduced a financial modernization bill—S. 298—that differs significantly from the bills passed by the Banking Committee and the Commerce Committee during the last session.\(^3\)

In light of this state of affairs, the prospects for financial modernization legislation in the second session of the 105th Congress, which began on January 27, 1998, remain unclear. On the one hand, the numerous parties involved in the ongoing debate regarding financial modernization—including the banking, insurance, and securities industries, the Treasury Department, the Federal Reserve Board (Fed), the Office of the Comptroller of the Currency (Comptroller), the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC)—agree that something needs to be done to prepare the American financial system for the 21st century.

The current bank regulatory framework was enacted when bank products and services could practically and functionally be separated from those offered by securities and insurance firms. Rapid advances in computer and telecommunications technology, however, have led to the development of new financial products that blur the traditional line between banking, securities and insurance products and services. Moreover, because financial products are increasingly interchangeable, many consumers now seek the convenience and flexibility to obtain most of their financially related products and services from a single “supermarket” provider.

While these changes are transforming the financial services marketplace, existing laws increasingly impede the ability of banking organizations and other financial intermediaries to meet the demands of their customers for the full range of functionally similar financial products and services and to remain competitive with foreign firms in the expanding global marketplace. Many in the insurance and securities industries now view the banking laws as a significant

impediment to their own business plans and competitiveness. While banking organizations have found ways to enter the securities and insurance businesses through administrative rulings by the banking agencies, securities and insurance firms have found their efforts to enter the banking industry largely blocked by the Glass-Steagall Act and the 1982 insurance amendments to the Bank Holding Company Act of 1956 (BHC Act).

If a general consensus exists among the banking, insurance and securities industries that legislative reform is necessary, why then has financial modernization been so difficult to achieve? Financial modernization necessarily involves the consideration of a wide array of important policy issues, such as whether combinations of banking and commerce should be permitted; the proper role and regulation of banks in the sale of securities and insurance; the appropriate level of federal supervision of holding companies with broad financial powers; and the most efficacious manner of ensuring that any structural revision to our financial system occurs in a safe and sound manner without undue risk to the federal safety net. Although the various industries and supervisory agencies generally agree that these issues need to be addressed, they have differing views on precisely how they should be resolved.

Not surprisingly, many entities involved in the current debate have sought to preserve those aspects of the current regulatory structure that provide their own industry with some form of competitive benefit, while at the same time seeking to break down those barriers that restrict their ability to enter other fields. In addition, each industry has sought to assure that any future regulatory framework is as consistent as possible with the policies that have

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4. The Glass-Steagall Act is the common name given to sections 16, 20, 21 and 32 of the Banking Act of 1933. See Pub. L. No. 73-66, 48 Stat. 162 (1933). As discussed further below, the Glass-Steagall Act generally prohibits national and state member banks from underwriting or dealing in debt or equity securities other than specified types of debt instruments (bank-ineligible securities). See 12 U.S.C. § 24 (Seventh) (1994). The Act also prohibits a national or state member bank from being affiliated with an entity that is "engaged principally" in underwriting or dealing in bank-ineligible securities. See 12 U.S.C. § 377.

guided its particular industry in the past. The debate between banks and insurance agents is the most prominent example of these conflicts—while banks generally believe that financial modernization legislation should expand (or at least not restrict) the ability of banks to sell insurance or insurance-like financial products, insurance agents believe that any legislation should curtail the insurance activities of banks and subject any such activities to state regulation.

In addition to these inter-industry issues, there are also significant issues involving the regulation of the banking, securities and insurance industries. For example, the SEC seeks to expand its ability to regulate the securities activities of banks; the OCC seeks to broaden the powers of national banks; the Fed seeks to maintain its ability to supervise the financial system and major bank holding companies; the Treasury Department seeks to expand its role in the regulation of financial holding companies; and the Office of Thrift Supervision (OTS) seeks to preserve the existing powers of thrifts and thrift holding companies.

This complex matrix of policy, economic and supervisory interests has made it difficult for members of Congress to fashion a financial modernization proposal that enjoys sufficient support to assure passage. This tangle of issues and interests also has made it difficult for persons not intimately involved with the ongoing legislative process to gain a clear understanding of the issues involved and the progress that the Congress has made to date in addressing these issues.

This Article is intended to assist the reader to understand the significant policy issues involved with financial modernization proposals. It provides an overview of the major policy issues associated with financial modernization and discusses the positions of the relevant industries and supervisory agencies on these issues. In addition, the Article compares and contrasts how these issues are addressed by the two versions of H.R. 10 recently reported out by the Banking Committee and Commerce Committee.6

6. As noted above, the Senate has not yet scheduled hearings on financial modernization and it is unclear what bills will serve as the initial basis for debate in the chamber. Accordingly, this Article reserves for the footnotes a discussion of how Senator D'Amato's bill, S. 298, addresses the major issues associated with financial modernization.
II. CURRENT REGULATORY FRAMEWORK

To understand financial modernization proposals, it is first necessary to have a working knowledge of the existing bank regulatory structure. Under current law, the powers of national banks are generally limited to those authorized by the National Bank Act of 1864 (NBA),\(^7\) as amended. The NBA permits national banks to engage in the “business of banking” and to exercise those incidental powers necessary to carry on the business of banking.\(^8\) The Glass-Steagall Act of 1933, however, provides that such powers shall not include the power to purchase equity securities for the bank’s own account or the power to underwrite or deal in debt or equity securities, except for limited types of “bank-eligible” securities.\(^9\) The NBA separately authorizes national banks located in places with a population of 5,000 or less to act as agents in the sale of insurance policies underwritten by unaffiliated insurance companies.\(^10\) As traditionally interpreted, these provisions significantly limited the ability of national banks to engage in securities activities as principal or to engage in widespread insurance activities.

The BHC Act of 1956 limits the permissible activities and affiliations of companies that control banks.\(^11\) As a general matter, the BHC Act allows bank holding companies to engage in, or control a company engaged in, any activity that the Fed determines is “closely related to banking.”\(^12\) In response to several actions by the Fed in the 1970s and early 1980s permitting bank holding companies to sell certain types of insurance,\(^13\) the insurance industry persuaded

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9. See id.
10. See id. § 92.
11. See id. §§ 1841-1850.
12. See id. § 1843(c)(8).
Congress to pass the Garn-St. Germain Act of 1982, which specifically provides that the Fed cannot consider the sale of insurance, as principal or agent, to be an activity that is “closely related to banking.” As a result, the Fed may no longer authorize bank holding companies to engage in, or affiliate with companies engaged in, the underwriting or sale of insurance.

Section 20 of the Glass-Steagall Act also prohibits bank holding companies that control member banks from controlling any entity that is “engaged principally” in underwriting or dealing in bank-ineligible securities. The Fed has interpreted the “engaged principally” language to permit bank holding companies to acquire or establish subsidiaries that underwrite or deal in bank-ineligible securities, if such subsidiaries do not receive more than twenty-five percent of their revenue from underwriting or dealing in bank-ineligible securities. Nevertheless, section 20 continues to prevent many large securities firms which cannot meet the twenty-five percent revenue limitation from acquiring (or being acquired by) a banking organization.

The existing financial landscape also includes savings associations, commonly referred to as thrifts. Although initially restricted to mortgage-related lending, federally chartered thrifts today may make consumer and commercial loans (within certain limits) and may engage through subsidiary “service corporations” in a wide variety of commercial activities. Thrift holding companies that control more than one thrift generally are permitted to engage in only a limited set of financial activities. Current law, however, does not place any restrictions on the activities or affiliations of so-called “unitary thrift holding companies,” which are companies that control only one savings association, provided that

14. U.S.C. § 1843(c)(8). Certain limited exceptions to this general prohibition are provided. See id.
15. See id. § 377.
17. See infra note 20.
19. See id. § 1467a(c).
the company's thrift subsidiary engages primarily in housing-related activities. Under this provision, industrial entities, securities firms, and insurance companies may control a single savings association.

III. SIGNIFICANT ISSUES ASSOCIATED WITH FINANCIAL REFORM

A. Banking and Commerce

Just a few years ago, much of the debate regarding financial modernization focused on whether banks should be permitted to affiliate with securities firms, insurance companies and other entities engaged in financial activities. Now, it is generally accepted that banks should be permitted to affiliate with other financial service providers and the debate has shifted to the corporate and regulatory structure under which such affiliations should occur and whether banks should be permitted to affiliate with companies engaged in nonfinancial or commercial activities.

1. Should Banking and Commerce be Mixed?

The United States has a tradition of separating banking and commerce, i.e., not allowing the combination of banks and commercial or industrial firms within a single corporate structure. The NBA generally restricts national banks to the "business of banking" and incidental financial activities. Similarly, the BHC Act generally prohibits banks from affiliating through a holding company structure with firms engaged in activities that are not "closely related to banking." This separation of banking and commerce in the American economy has been maintained for a variety of reasons. Traditionally, concern has existed that allowing the combination of banking and business interests could lead to the concentration of economic power

20. See id. § 1467a(c)(3) & (m). In particular, the subsidiary thrift of a unitary thrift holding company must comply with the "qualified thrift lender" (QTL) test, which generally requires that the thrift be predominantly engaged in housing-related activities. See id. § 1467a(m)(ii).
21. See id. § 24 (Seventh).
22. See id. § 1843(c)(8).
in the hands of a small number of industrial-financial conglomerates. In addition, allowing banks to affiliate with commercial firms may produce conflicts of interest that interfere with the traditional role of banks as impartial financial intermediaries. For example, a bank affiliated with a commercial enterprise may face pressures to deny credit requests from a competitor of its commercial affiliate. Likewise, a bank affiliated with a commercial firm may face internal pressures to extend credit to the commercial affiliate on favorable terms or in situations when such credit would not normally be extended.

Allowing banks and commercial firms to affiliate also could lead to the expansion of the federal safety net. Supervisory and empirical evidence suggests that holding companies act as unified business entities, obtaining resources from healthy affiliates to aid other affiliates in financial distress.\(^2\) As Walter Wriston, the former Chairman of Citicorp once stated, "it is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind [the subsidiary] in the real world."\(^3\) Even if restrictions are placed on transfers between federally insured banks and their commercial affiliates, and such restrictions are effective,\(^4\) the financial difficulties of a commercial affiliate could lead to a loss of confidence in the bank affiliate because consumers and the marketplace view holding companies as a single, unified entity.

Proponents of allowing a combination of banking and commerce contend that such consolidations would allow banking organizations to diversify their risk portfolios through expansion into nonfinancial industries. Some proponents also contend that the combination of banking and commerce would allow the resulting organizations to achieve economies of scale and synergies that currently are not possible through, for example, the cross-marketing of products. Others claim that eliminating the barriers between

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24. Id. at 476.

25. See infra note 52 (discussing the effectiveness of firewalls).
banking and commerce would allow banking organizations to attract new capital from other industries. Finally, some proponents assert that no significant regulatory problems have surfaced with unitary thrift holding companies, which currently are permitted to own a single savings association and engage in commercial activities.

Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, has expressed concern with those proposals that would permit the unlimited mixing of banking and commerce, noting that such a change "would be a profound and surely irreversible structural change in the American economy." Because existing law generally prohibits banking organizations from being affiliated with commercial entities, little empirical evidence exists to support the claims made in favor of mixing banking and commerce to an unlimited extent. On the other hand, the recent difficulties of financial institutions in certain Asian nations that permit extensive ties between financial and commercial firms suggest that such combinations present tangible risks. In addition, the banking industry today is well capitalized by historical standards and, thus, does not as a general matter require large scale capital infusions from other sectors of the economy. In light of the irreversible nature of such a change, and the continuing debate as to whether such a change would result in net public benefits, Chairman Greenspan has suggested that Congress should move cautiously in considering whether to allow combinations of banking and commerce, a position supported by the OCC and FDIC.


27. See Financial Modernization: Hearings Before the House Committee on Banking and Fin. Servs., pt. 1, 105th Cong. 8 (1997) [hereinafter Financial Modernization] (statement of James L. Bothwell, Chief Economist, General Accounting Office). Although unitary thrift holding companies are permitted to engage in commercial activities, only a relatively small number of such holding companies currently exist and, as the OTS itself has recognized, supervisory experience with the combination of banking and commerce through these entities is limited. See Financial Modernization, supra, pt. 2 at 526 (statement of Nicholas Retsinas, Director, Office of Thrift Supervision).


29. See id. at 461 (statement of Eugene A. Ludwig, Comptroller of the Currency).

30. See id. at 503 (statement of Ricki Helfer, Chairman, FDIC).
Some argue that a limited mixing of banking and commerce, however, may be necessary to allow consolidations in the financial services industry itself. For example, some limited "basket" of nonfinancial activities may be needed to allow securities firms and insurance companies, which frequently have limited nonfinancial holdings, to acquire banks. Some have argued that, given this need, fairness would require that bank holding companies also receive the benefit of any limited nonfinancial "basket" granted securities and insurance firms.

2. Current Legislative Positions on Mixing Banking and Commerce

The bills passed by both the Banking Committee and the Commerce Committee would allow the mixing of banking and commerce subject to certain limits. The Banking Committee’s bill would allow "qualifying bank holding companies" to receive up to fifteen percent of their United States revenues from commercial activities. It is estimated that this revenue limit would allow the largest banking organization to affiliate with any single commercial firm in the United States other than one of the 200 largest.

The Commerce Committee took a much more cautious approach to the issue, allowing financial services holding companies to receive the lesser of 5 percent of their worldwide revenues or $500 million from commercial activities. The $500 million revenue limit

31. S. 298, on the other hand, would place no restrictions on the types of companies that may be affiliated with a bank through a holding company structure and would thereby allow the unlimited mixing of banking and commerce. See S. 298, 105th Cong. §§ 101(a) & 104 (1997). Under S. 298, bank holding companies could acquire commercial firms of any size and any commercial firm could acquire a bank of any size. See S. 298 § 104.

32. See Banking Report, supra note 1, § 103. Under the Banking Committee bill, a bank holding company would be a “qualifying bank holding company” if all of its subsidiary depository institutions are well capitalized and well managed, have a “satisfactory” or better rating under the Community Reinvestment Act, 12 U.S.C. §§ 2901-2906 (CRA), and have a demonstrable record of providing low-cost “lifeline” deposit accounts. See id. In addition, if the bank holding company (or an affiliate) underwrites or sells annuities or insurance, the bank holding company (or the affiliate) must not be in violation of the Fair Housing Act (FHA) or any consent decree or settlement agreement premised on a violation of the FHA. See id. The bank holding company also must limit its activities to those permissible for qualifying bank holding companies and file a declaration with the Fed. See id. As a practical matter, it is anticipated that most bank holding companies would meet the criteria to be qualifying bank holding companies.

33. See Commerce Report, supra note 2, § 133. The Commerce Committee’s version of
contained in the Commerce Committee bill is designed to prevent banks from affiliating with any of the approximately 1500 largest industrial firms. The revenue limits adopted by both the Banking and Commerce Committees are continuing limits and, thus, prohibit a nonfinancial affiliate of a financial services holding company from growing, either internally or through acquisitions, if such actions would cause the holding company’s nonfinancial revenues to exceed the relevant limits set forth in the bills.

Although the Commerce Committee bill provides for a lower revenue cap on nonfinancial activities, the Commerce Committee bill would also grandfather the nonfinancial activities of companies that become financial services holding companies, provided that the revenues derived by the holding company from such nonfinancial activities did not exceed fifteen percent of the company’s gross revenues on the day before the company became a qualified bank holding company. The bill would accord such grandfather rights only to nonfinancial investments and activities held as of September 30, 1997.

Both the Banking Committee and Commerce Committee bills also prohibit financial services holding companies from acquiring the shares of any commercial company that had total consolidated assets of more than $750 million at the time of acquisition. This asset limitation is designed to prevent the establishment of excessively large financial-industrial conglomerates by prohibiting the combination of banking organizations with any of the largest 1000 commercial companies in the United States.

H.R. 10 uses the term “financial holding company” in place of the term “qualifying bank holding company” in the Banking Committee bill. The criteria for a bank holding company to be a “financial holding company” under the Commerce Committee’s bill are substantially identical to those for “qualifying bank holding companies” under the Banking Committee’s bill, except that the Commerce Committee bill eliminates the FHA compliance and “lifeline” account requirements. See id. For ease of reference, this Article will refer to both “qualifying bank holding companies” (Banking Committee bill) and “financial holding companies” (Commerce Committee bill) as “financial services holding companies.”

34. To prevent the worldwide nonfinancial revenue limit from unduly restricting the overseas activities of foreign banks, the Commerce Committee bill would impose a separate limit on foreign banks that is based on the nonfinancial revenues such entities derive from their United States activities. See id.

35. See id. Existing bank holding companies and foreign banks would not be eligible for these grandfather rights. See id.

36. See id.

37. See Banking Report, supra note 1, § 103; Commerce Report, supra note 2, § 133.
Unlike the revenue limits discussed above, this asset limit would apply only at the time of acquisition of a nonfinancial company. Thus, if a financial services holding company acquired a nonfinancial company with $749 million in consolidated assets, the nonfinancial company could expand its assets through internal growth or other acquisitions that themselves fell within the asset limit, provided that the revenue derived by the financial services holding company from nonfinancial activities did not exceed the appropriate revenue limit imposed by the bills.

The Banking and Commerce Committee bills, however, also permit financial services holding companies to invest in commercial entities in a variety of indirect ways. For example, as discussed further below, both bills permit financial services holding companies to engage in merchant banking activities and would permit the insurance affiliates of a financial services holding company to make investments in the ordinary course of the affiliate’s insurance business as authorized under state law.\footnote{See Banking Report, supra note 1, § 103; Commerce Report, supra note 2, § 133.} Under these provisions, the merchant banking and insurance affiliates of a financial services holding company could make controlling, portfolio investments in nonfinancial companies and, thereby, increase the holding company’s overall exposure to commercial activities.\footnote{The companies that a merchant banking or insurance affiliate may invest in are frequently referred to as “portfolio companies.”} Both bills, however, would prohibit the insured subsidiary banks of a financial services holding company from making loans or other extensions of credit to a portfolio company that was engaged in commercial activities and controlled by an affiliate engaged in merchant banking or insurance-related investment activities. The Commerce Committee bill would also prohibit the holding company’s insured subsidiary banks from making a loan or other extension of credit to, or engaging in any cross-marketing activities with, an affiliate engaged in merchant banking or insurance-related investment activities.\footnote{See Commerce Report, supra note 2, § 103.}

The Banking Committee bill, unlike the Commerce Committee bill, also would allow commercial companies to have a limited basket of banking assets. Under this “reverse basket,” a
commercial company could acquire one existing bank with assets of
$500 million or less at the time of acquisition.\footnote{See Banking Report, supra note 1, § 106. The bank acquired must have been in existence for at least five years prior to its acquisition by the commercial firm. See id.} At no time could the bank’s revenue account for more than fifteen percent of the commercial company’s domestic gross revenues. In addition, the bill would prohibit the commercial company from directly or indirectly acquiring additional banks.

A commercial company that acquired a bank through this “reverse basket,” however, would not be treated as a bank holding company and, thus, would not be subject to supervision by the Fed or other federal banking agency.\footnote{The bill would require, however, that the commercial parent control its banking subsidiary through a subsidiary that itself was a qualifying bank holding company subject to Fed supervision. See id.} By exempting the ultimate commercial parent from supervision on a consolidated basis, the bill would make it difficult for the federal banking agencies to understand and monitor the special risks that may arise from the affiliation of banks with commercial firms and to ensure that such risks do not endanger the safety and soundness of any insured bank. These risks are discussed in more detail in section C of Part III.

\subsection*{B. Expanded Bank Holding Company Financial Affiliations and Powers}

Although there is great debate as to whether the mixing of banking and commerce should be permitted, there is, as noted, a general consensus that any legislation should authorize banking organizations to affiliate with a broad spectrum of entities engaged in financial activities, including securities brokers and dealers, investment advisers, and companies engaged in underwriting and selling insurance products. Due in large part to this general consensus of opinion, the bills passed by both the Banking and Commerce Committees would significantly expand the range of financial activities that may be conducted by bank holding companies and their nonbank affiliates.\footnote{As noted above, S. 298 would allow bank holding companies to affiliate with any company and, accordingly, would permit bank holding companies to affiliate with securities firms, insurance companies, or other companies engaged in financial or nonfinancial} In particular, both bills
would repeal section 20 of the Glass-Steagall Act, which currently restricts the ability of bank holding companies to affiliate with securities firms. In addition, both bills would repeal those provisions of the Garn-St. Germain Act that prohibit bank holding companies from engaging in, or being affiliated with a company engaged in, insurance underwriting or agency activities.

In place of these restrictions, both bills would specifically authorize any bank holding company that met the criteria to be a financial services holding company to engage in, or affiliate with companies engaged in: (1) securities underwriting and dealing activities; (2) merchant banking activities; and (3) insurance underwriting, brokerage and agency activities. In addition, both versions would specifically allow the insurance company affiliates of a financial services holding company to make portfolio investments in other companies in the ordinary course of the insurance affiliate’s business, provided that the bank holding company did not participate in the day-to-day management or operation of the portfolio company. The effect of these changes would be to permit the affiliation of banking, insurance and securities firms under the aegis of a qualified bank holding company.

Both the Banking and Commerce Committee bills also would permit financial services holding companies to engage in other financial activities that are specifically listed in the bills, including providing financial, investment or economic advisory services. In addition, both bills would allow financial services holding companies to engage in other activities that are not listed in the bills if the activities are determined to be financially related (or incidental to financially related activities) in the future. Although both bills

44. See Banking Report, supra note 1, § 101; Commerce Report, supra note 2, § 101.
Both bills would also repeal section 32 of the Glass-Steagall Act (12 U.S.C. § 78), which prohibits officer, director, and employee interlocks between a company “primarily engaged in the issue, flotation, underwriting, public sale, or distribution” of bank-ineligible securities and any member bank, except as authorized by the Fed. See id.

45. See Banking Report, supra note 1, § 103; Commerce Report, supra note 2, § 102.

46. Banking Report, supra note 1, § 103; Commerce Report, supra note 2, § 103.

47. Bank holding companies that failed to meet the criteria to be a financial services holding company under the Banking Committee and Commerce Committee bills would generally be limited to engaging in those activities that are permissible for bank holding companies under existing law, with certain exceptions. See Banking Report, supra note 1, § 103; Commerce Report, supra note 2, § 102.
contain very broad language concerning the types of factors that may
be considered in determining whether future activities are financial,
the bills assign responsibility for making such determinations to
different bodies. On the one hand, the Banking Committee bill
would vest responsibility for determining whether a new activity is
financial with a newly formed National Council on Financial
Services (National Council). 48 The Commerce Committee bill, on
the other hand, would continue the long-established role of the Fed in
determining the extent of permissible activities for bank holding
companies. 49

C. Consolidated Supervision of Financial Service Holding
Companies

Proposals to allow banks to affiliate with securities firms and
insurance companies within the structure of a financial services
holding company necessarily raise the issue of how such new
holding companies should be supervised. Under existing law, the
Fed acts as the “umbrella” supervisor of all bank holding companies.
As such, the Fed has the authority to obtain reports from and
examine any bank holding company or subsidiary of a bank holding
company and to take enforcement action against any such company
or subsidiary for violations of law or unsafe or unsound practices.
To assure that bank holding companies have adequate resources to
support their operations, the Fed also has adopted capital adequacy
guidelines that require bank holding companies to maintain adequate
levels of capital on a consolidated basis.

48. See Banking Report, supra note 1, § 103. The National Council would consist of
the Secretary of the Treasury, the Chairman of the Fed, the Chairperson of the FDIC, the
Comptroller of the Currency, the Chairman of the SEC, the Chairman of the Commodity
Futures Trading Commission, and four individuals appointed by the President with the
advice and consent of the Senate. See id. at § 121. Of the four individuals appointed by the
President, one must have experience with state securities regulation, one must have
experience with state banking regulation, and two must have experience with state
insurance regulation. See id.

49. See Commerce Report, supra note 2, § 103.
1. Need for Prudent Level of Umbrella Supervision

Some, including trade groups for the securities and insurance industries, have expressed concern that the existing bank holding company supervisory framework may not be the appropriate model for supervising holding companies engaged in a wide range of financial activities. They claim that a financial services holding company and its subsidiaries should be subject to regulation solely on a functional basis. Under such a functional regulation scheme, the bank subsidiaries of a financial services holding company would be regulated by the appropriate federal banking agency; any securities or investment adviser affiliate of the holding company would be regulated solely by the SEC; and any insurance affiliate would be regulated solely by the appropriate state insurance authority. The parent financial services holding company, however, would not be subject to supervision on a consolidated basis.

According to proponents of such a system, the functional regulation of activities would continue to allow the federal banking regulators to protect a subsidiary bank from risks arising in other parts of the holding company through the imposition of capital requirements or restrictions on the subsidiary bank itself. In addition, proponents assert that a system based on functional regulation would obviate the risk that an umbrella supervisor would adopt duplicative, costly and burdensome regulations affecting nonbank subsidiaries that are regulated by another federal or state agency. Some also have expressed concern that an umbrella regulator could significantly interfere with the operations of a securities or insurance affiliate by imposing more severe capital, reporting or examination requirements on the affiliate than those imposed by the affiliate’s functional regulator.

In the view of Chairman Greenspan, Paul Volcker, former Chairman of the Fed, and the General Accounting Office, some form of umbrella supervision of a financial services holding company with a significant banking presence is necessary to protect the financial system and guard against the misuse of bank resources.\(^{50}\)

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\(^{50}\) See House Subcommittee Hearings, supra note 26, at 441-42 (statement of Alan Greenspan) and 567 (statement of Paul A. Volcker, Chairman, James D. Wolfensohn, Inc.); Financial Modernization, supra note 27, at 8 (testimony of James L. Bothwell, Chief
Supervisory experience demonstrates that most holding companies operate as integrated organizations, both for operational and risk-management purposes. Thus, holding companies increasingly utilize centralized risk-management systems and procedures to monitor and manage the risks facing the holding company on a consolidated basis. Because a financial services holding company also would likely utilize centralized risk-management systems to monitor its exposure on a consolidated basis, some form of umbrella oversight is necessary to allow federal supervisors to adequately understand and evaluate the potential risks facing the holding company and its subsidiary banks.

In addition, as the recent experience of Barings PLC illustrates, financial troubles at one affiliate of a holding company can quickly spread to other affiliates. Umbrella supervision provides the federal supervisory agencies with the ability to identify problems within the organization as a whole, or at an affiliate of an insured bank, at an early stage and to develop strategies to protect the insured bank before significant harm occurs. Although "firewalls" such as sections 23A and 23B of the Federal Reserve Act\(^1\) are extremely important in protecting against the misuse of a bank's insured deposits, experience has shown that such firewalls are not always fully effective, particularly in times of financial stress.\(^2\) The effective enforcement of these firewalls, moreover, requires that federal supervisors have the ability to monitor both sides of transactions between an insured bank and its affiliates.

Finally, it is possible that many of the concerns expressed by members of the securities and insurance industries with respect to

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\(^2\) For example, in December 1986, the Comptroller authorized Continental Illinois National Bank and Trust Company of Chicago (Continental Bank) to acquire First Options of Chicago, Inc. (First Options). In connection with this approval, the OCC imposed a condition that the bank's investment in and loans to First Options not exceed the amount that the bank could lend to an unaffiliated entity under 12 U.S.C. § 24. Following the stock market crash of October 19, 1987, First Options experienced severe financial difficulties. Continental Illinois responded to this crisis by providing First Options with an unsecured loan of approximately $130 million, even though this loan violated the funding "firewall" imposed by the OCC and even though the OCC informed the bank before the loan was made that the transaction would violate the firewall. See Volatility in Global Securities Markets: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce, 100th Cong. 10 (1988) (statement of Emory W. Rushton, Deputy Comptroller of the Currency for Multinational Banking).
consolidated supervision may be based on a lack of familiarity with how the Fed exercises its current supervisory authority over bank holding companies. Although the Fed currently has the statutory authority to examine and require reports from the nonbank subsidiaries of bank holding companies, the Fed does not conduct routine or periodic examinations of nonbank affiliates under the BHC Act or require reports from such affiliates (other than section 20 subsidiaries). In addition, although the Fed has adopted prudent capital requirements for bank holding companies which apply on a consolidated basis, the Fed has not promulgated capital adequacy regulations for nonbank affiliates of bank holding companies.

2. Current Legislative Proposals

The Banking Committee and Commerce Committee bills seek to strike an appropriate balance between the need for some form of umbrella supervision and the desire of all parties to avoid the unnecessary regulation of financial services holding companies and their nonbank affiliates. Both the Banking Committee and Commerce Committee bills would continue the Fed’s traditional role as umbrella supervisor of holding companies that control banks. In addition, although both bills would continue the Fed’s authority to receive reports from and examine and adopt capital guidelines for bank holding companies, the bills contain several restraints on this authority. These restraints, which are generally consistent with the Fed’s current supervisory practices, are designed to minimize potential disruptions to the activities of functionally regulated nonbank affiliates.  

53. The Fed obtains periodic reports from section 20 subsidiaries to monitor the subsidiaries’ compliance with the 25% revenue limitation imposed pursuant to section 20 of Glass-Steagall Act. As noted above, however, both the Banking Committee and Commerce Committee bills would repeal section 20 of the Glass-Steagall Act.


55. S. 298 would take a more limited approach to the supervision of financial services holding companies than both the Banking Committee and Commerce Committee bills. Under S. 298, no federal agency would have the ability or authority to supervise a financial services holding company on a consolidated basis. The authority of the federal banking agencies would generally be limited to examining and supervising the subsidiary depository institutions of a financial services holding company, although they could obtain reports from or examine a nonbank affiliate to assure compliance by a depository institution with specified provisions of federal law. See S. 298, 105th Cong. § 101(f)(3) (1997).
For example, both the Banking Committee and Commerce Committee bills would allow the Fed to require reports from financial services holding companies. To avoid unnecessary costs, however, the bills require that the Fed accept, to the fullest extent possible, the reports filed by a financial services holding company with other federal or state supervisors, such as the SEC, the Commodity Futures Trading Commission or state insurance authorities. Both bills would also require that the Fed, to the fullest extent possible, use information that is otherwise publicly available in lieu of any reporting requirement.

The bills would specify that the Fed may conduct an examination of a financial services holding company or a subsidiary thereof only for purposes of informing the Fed of the nature of the operations and financial condition of the company or subsidiary, or to inform the Fed of the nature of the financial and operational risks within the holding company system that may pose a threat to the safety and soundness of a subsidiary depository institution and the systems for monitoring and controlling such risks. Both bills, moreover, would require that the Fed limit the focus of any examination to the parent financial services holding company and those of its affiliates that, for specified reasons, may have a materially adverse effect on the safety and soundness of the holding company’s subsidiary depository institutions. In addition, both

addition, S. 298 would prohibit the federal banking agencies from directly or indirectly imposing any capital requirement on a financial services holding company. See id. § 101(d)(3).

56. See Banking Report, supra note 1, § 131; Commerce Report, supra note 2, § 111. The Commerce Committee bill also would authorize the Fed to receive reports from the subsidiaries of a financial services holding company.

57. See Banking Report, supra note 1, § 131; Commerce Report, supra note 2, § 111. The Fed also could conduct an examination of a financial services holding company or a subsidiary to monitor compliance by the company with the BHC Act and the provisions of federal law governing transactions between depository institutions and their affiliates. See Banking Report, supra note 1, § 131; Commerce Report, supra note 2, § 111.

58. Under the Commerce Committee bill, the Fed could not examine a nonbank subsidiary of a financial services holding company that was registered with the SEC as a broker or dealer, or was subject to supervision by a state insurance authority unless (1) the Fed had reasonable cause to believe that the subsidiary was engaged in activities that pose a material risk to an affiliated depository institution, or (2) the Fed had reasonable cause to believe that the subsidiary was not in compliance with the BHC Act or the laws governing transactions with affiliated depository institutions and the Fed could not determine such compliance through the examination of the holding company or its subsidiary depository institutions. See Commerce Report, supra note 2, § 111.
bills would require that the Fed accept, to the fullest extent possible, reports of examinations prepared by a nonbank affiliate’s appropriate functional regulator.

Finally, both bills would prohibit the Fed from imposing any capital adequacy requirements on any nonbank affiliate of a financial services holding company that is an insurance company or registered broker or dealer, provided that the affiliate is in compliance with applicable capital requirements of its appropriate state insurance authority or the SEC, respectively. The Banking Committee bill would also prohibit the Fed from imposing any capital adequacy guidelines on financial services holding companies that were not based on appropriate risk-weightings of the companies’ assets.

D. Securities Activities of Banks

One of the more technical and contentious issues related to financial modernization is the extent to which the securities activities of banks should be functionally regulated and thus subject to SEC supervision. Currently, banks are excluded from the definition of “broker” and “dealer” in the Securities Exchange Act of 1934 (Exchange Act). As a result, banks may conduct those securities activities permissible under federal or state banking laws without registering as a broker or dealer with the SEC and without complying with the capital and other regulations adopted by the SEC for registered brokers and dealers. Instead, bank securities activities are primarily regulated by their appropriate federal or state banking supervisors.

The blanket exemption for banks from the definitions of broker and dealer was enacted by Congress in 1934. At that time, following passage of the Glass-Steagall Act, the securities activities

59. See Banking Report, supra note 1, § 133; Commerce Report, supra note 2, § 111.
60. 15 U.S.C. § 78c(a)(4)-(5) (1994). The Exchange Act defines a “bank” to mean any national bank, any state bank that is a member of the Federal Reserve System and any other banking institution a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted national banks. See id. at § 78c(a)(6). Affiliates and subsidiaries of banks are not considered “banks” for purposes of the Exchange Act and, accordingly, must register as brokers or dealers if engaged in securities activities.
61. Bank securities activities are, however, subject to the general antifraud provisions of the federal securities laws.
of most banks were limited to executing brokerage transactions for their trust or fiduciary accounts or for other customers on an accommodation basis. Since 1934, however, banks have become increasingly active in the securities business. For example, many banks today offer brokerage services to the general public; engage in the sale of mutual funds; assist issuers in the private placement of their securities; issue asset-backed securities representing interests in loans originated or purchased by the bank; or act as principal in the sale of derivative instruments that may have certain characteristics of a security.

The growth of bank securities activities has occurred largely in response to the natural development of traditional bank services and bank efforts to stem the loss of their valued corporate customers to nonbank competitors. For example, banks today provide a wide variety of securities processing services in connection with their role as trustee or custodian for corporations, mutual funds, public and private retirement, profit-sharing and stock purchase plans. In addition, banks developed the ability to privately place securities as a mechanism to retain their relationships with major corporate clients, who were increasingly satisfying their need for operating capital by issuing commercial paper rather than obtaining short-term bank loans.

1. Calls for Functional Regulation

The substantial growth of bank securities activities has led the SEC and certain other groups to call for the elimination of the bank exemption from the definitions of broker and dealer in the Exchange Act. Proponents of such a change contend that the securities activities of banks should be functionally regulated, i.e., subject to the federal securities laws and SEC regulations to the same extent as the securities activities of nonbanking organizations. According to proponents of this view, functional regulation is necessary to assure that all purchasers of securities benefit from the consumer protection provisions applicable to registered brokers and dealers. These rules include the SEC’s minimum net capital requirements and the Rules of Fair Practice adopted by the National Association of Securities Dealers, which impose certain qualification and training obligations
on securities sales personnel. Subjecting bank securities activities to these rules and regulations, it is argued, would enhance consumer protection and create a level playing field among all entities engaged in securities activities.

Although the debate on this issue is frequently characterized as one pitting “functional regulation” against the desire of the banking industry to retain an outdated exception to the securities laws, the debate in reality is considerably more limited and focused. The banking industry for the most part has acknowledged that the blanket exemption provided banks in the Exchange Act may no longer be appropriate. Banks, however, insist that any revocation of this blanket exemption must be accompanied by changes that permit banks to continue to conduct those securities activities that are integrally related to traditional bank functions—such as trust, custody and safekeeping operations—within the bank. Accordingly, the current debate focuses on the types of securities transactions that a bank should be permitted to engage in without registering as a broker or dealer.

2. Legislative Responses

Both the Banking Committee and Commerce Committee bills would eliminate the blanket exemption provided banks from the definitions of “broker” and “dealer” in the Exchange Act. Instead, both bills would allow a bank to avoid registration as a broker or dealer only if the bank limited its securities activities to specified types of “exempted” transactions or activities. As they say, however, the devil is in the details.

The exemptions provided by the Banking Committee bill are fairly broad and would encompass most of the securities activities conducted by banks in connection with their traditional banking operations. For example, the Banking Committee bill would allow banks, without registering as a broker or dealer, to privately place securities with accredited investors; engage in securities

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62. Under the Banking Committee bill, the term “accredited investor” would have the same meaning given that term by the SEC under the federal securities laws. See Banking Report, supra note 1, §§ 201, 202. Thus, the term would include institutional investors and individuals that meet specified financial criteria. See 17 C.F.R. § 230.501 (1997).
transactions in connection with their trust, safekeeping, custodial, clearing, settlement and securities lending operations; effect transactions for employee or shareholder benefit plans, such as pension, retirement, and stock purchase and option plans; and sell asset-backed securities representing interests in obligations originated or purchased by the bank or any of its affiliates to accredited investors. The Banking Committee bill also would authorize banks to purchase and sell traditional banking products, such as deposit instruments, letters of credit, loan participations and swap agreements without registering as a broker or dealer, and would authorize the Fed to determine whether future products constituted banking products for these purposes.

The Banking Committee bill also provided two exemptions that many small banks found particularly useful. First, the bill would permit banks, without registering as a broker, to effect securities trades solely as an accommodation for their customers, provided that the bank did not publicly solicit securities transactions or receive incentive compensation in connection with the transactions. Second, the bill would allow banks that do not have a broker-dealer affiliate to avoid registration even if they acted as a broker in a de minimis number of securities transactions per year (up to 1000) that did not qualify for certain other exemptions provided by the bill. Although the banking industry generally was willing to accept the securities-related amendments contained in the Banking Committee bill, the SEC believed that the amendments continued to exempt too many bank activities from the agency's jurisdiction.

In response to the concerns of the SEC and others, the Commerce Committee bill narrowed the list of exempted transactions contained in the Banking Committee bill. For example, the Commerce Committee bill placed additional restrictions on the manner in which banks could conduct securities transactions in connection with their trust, custody, safekeeping or other banking operations without registering as a broker with the SEC. Several of these restrictions are inconsistent with the manner in which many

63. See Banking Report, supra note 1, §§ 201, 202.
64. See id. § 201.
65. See Commerce Report, supra note 2, § 201.
banks currently conduct their trust, custody and safekeeping activities. In addition, the Commerce Committee bill would require that a bank engaged in private placement activities register with the SEC as a broker if the bank is \textit{affiliated} with a registered broker or dealer for more than one year, or if the bank privately places securities with any person that is not a "qualified investor." The bill would not include individuals or most corporations, regardless of their financial resources, in the definition of "qualified investor," even though brokers and dealers may privately place securities with individuals and corporations that meet certain financial criteria specified in SEC regulations.\textsuperscript{66} Many banks have asserted that these restrictions would unnecessarily require banks to shift their traditional private placement activities to an affiliated broker-dealer, or place banks at a competitive disadvantage vis-a-vis their competitors in the private placement market.\textsuperscript{67}

Furthermore, the Commerce Committee bill eliminated the exemption provided by the Banking Committee bill for trades effected by a bank solely as an accommodation for its customers. The Commerce Committee bill also reduced the \textit{de minimis} exemption provided in the Banking Committee bill for transactions that do not qualify for other exemptions from 1000 transactions per year to 500 transactions per year.

Because many banks would be unable or unwilling to comply with the conditions contained in the Commerce Committee bill, the bill would have the practical effect of requiring many banks to transfer or "push out" their existing securities operations to an affiliated entity.\textsuperscript{68} This is because banks cannot feasibly comply with

\textsuperscript{66} See \textit{id.} § 206. Under the Commerce Committee bill, certain types of corporations, such as investment companies or small business investment companies, would be considered "qualified investors." Individuals with a net worth in excess of $1 million, or corporations with assets in excess of $5 million, would not be considered qualified investors under the bill, even though such persons and corporations are considered "accredited investors" under SEC regulations. See 17 C.F.R. § 230.501(a)(3), (5).

\textsuperscript{67} Although the Commerce Committee bill would allow banks to engage in transactions in "banking products" without registering as a broker or dealer, the bill would give the SEC the authority to determine whether new products developed by banks in the future are, in fact, banking products. See \textit{Commerce Report}, supra note 2, § 206. Several banking organizations have expressed fear that this provision could allow the SEC to stymie the development of new and innovative banking products and harm the competitiveness of the banking industry.

\textsuperscript{68} S. 298 would prohibit any insured bank that is affiliated with a financial services
the SEC’s minimum net capital rules and, therefore, cannot satisfy the SEC’s requirements for registration as a broker or dealer.\textsuperscript{69}

The banking industry contends that the Commerce Committee bill would disrupt the traditional operations of many banks. As noted above, many of the securities transactions conducted by banks are integrally related to, and connected with, traditional bank functions, such as trust, custody and safekeeping operations. Requiring banks to transfer the securities-related segments of such activities to a separate organization, it is argued, would result in the artificial bifurcation of these functions and impose unnecessary additional costs on many banks.

\textit{E. Insurance Activities of Banks}

The insurance provisions of the proposed bills are clearly the most contentious. Because of the passions raised by previous attempts to address the insurance activities of banks and their affiliates, Congressman Leach had originally considered proposing legislation that was silent or at least "neutral" on the question of insurance activities and affiliations. In the end, however, the issues could not be avoided, and a resolution of the insurance issues continues to be elusive.

At heart are two basic questions regarding the insurance activities of banks: what is insurance, and to what extent should the insurance activities of national banks be subject to state insurance regulation. The insurance industry approaches these issues from the perspective of the McCarran-Ferguson Act,\textsuperscript{70} which has reserved to the states the authority to define and regulate insurance activities. Insurance agents are concerned that any erosion or preemption of state insurance regulation—including rules governing licensing, continuing education and sales practices—by a federal banking holding company from engaging in any securities activities, either as principal or agent, except for transactions in United States obligations or transactions that may be conducted by a national bank’s trust department. See S. 298, 105th Cong. § 101(g) (1997). Accordingly, S. 298 would explicitly require that many insured banks transfer or "push out" their non-trust-related securities activities to a separately incorporated affiliate.

\textsuperscript{69} See 17 C.F.R. § 240.15c3-1. Because the SEC’s net capital rules are generally based on measures of liquidity, they would impose economically prohibitive capital requirements on banks, which hold a significant volume of loans and other illiquid assets.

agency could put insurance agents at a competitive disadvantage. Insurance companies worry that differences between insurance and bank capital requirements and regulation could similarly give banks that choose to underwrite insurance products directly an advantage over insurance companies, particularly as new products are developed that may be hybrids of banking and insurance products. These concerns are much like those expressed by the SEC and some members of the securities industry concerning the securities activities of banks, with the SEC and members of the securities industry concerned that banks may derive a competitive advantage in conducting securities brokerage and dealing activities because banks are exempt from the federal securities law requirements governing registered broker-dealers.

The banking industry, on the other hand, approaches these issues armed with two Supreme Court decisions that allow national banks to conduct insurance agency activities despite state statutes prohibiting affiliations between banks and insurance companies or agents, and that could permit the Comptroller to determine what products constitute “insurance” for purposes of the NBA. The banking industry has been adamant that legislation not erode these decisions. In particular, the banking industry is concerned that allowing full functional regulation of bank insurance activities by state insurance supervisors could permit certain states to adopt onerous regulation designed effectively to prohibit banks from conducting insurance activities. Banks, like the insurance industry, are also aware that the financial marketplace is rapidly changing, and are concerned that banks not be frozen out of developing new banking products that might have some of the aspects of, or be replacements for, insurance products.

1. Legislative Responses

Both the Banking Committee and Commerce Committee bills would permit subsidiaries of national banks to engage in general insurance agency activities. The Commerce Committee would

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72. See Banking Report, supra note 1, § 141; Commerce Report, supra note 2, § 121.
require a bank that is not currently engaged in insurance agency activities in a new state to begin its insurance agency activities in that new state by acquiring a company that has been licensed for at least two years to conduct insurance agency activities in that state.73

Both bills would also prohibit a national bank and its subsidiaries from underwriting non-credit related insurance. This prohibition raises the important question: what is insurance? Both committee bills begin with the same core definition. Insurance is defined as any product that was regulated under state law as insurance as of January 1, 1997, and any annuity that qualifies for tax deferral status.74

The difference in the bills centers on how to treat new products developed after January 1, 1997. The Banking Committee bill defines insurance to include any new form of an old insurance product.75 Thus, any new product offered by a bank that is found by a state insurance supervisor to be a variation of an existing insurance product could not be offered by a national bank as principal.

This definition and its attendant prohibition on new products brings into stark relief the tension caused by the interplay between state insurance laws and the proposed federal modernization bills. A state insurance supervisor may have valid reasons for defining a new product to be an insurance product, including allowing insurance companies to offer that product under the supervision of the state. However, a consequence of that determination under the Banking Committee bill would be that national banks might be forbidden from offering the same product as principal—even if banks had originally developed the product. This problem is particularly acute for bankers because at worst it is unclear how an insurance supervisor’s decision in one state would affect a bank’s business in another state, and at best the definition creates the potential for a patchwork of state insurance definitions that would make it extremely difficult for a bank to offer its products on an interstate basis.

Because the insurance definition is key to the development of

73. See Commerce Report, supra note 2, § 305.
74. See Banking Report, supra note 1, § 151; Commerce Report, supra note 2, § 304(e).
75. See Banking Report, supra note 1, § 151.
future products for both the insurance and the banking industry, it is bound to result in definitional disputes. Attempting to establish a dispute resolution process meant grappling with the question whether any agency should be granted deference in interpreting the statutory definition of insurance. The banking industry was loathe to give up the success achieved in several recent Supreme Court decisions that confirm that the Comptroller is entitled to deference in interpreting banking laws under the Comptroller’s jurisdiction.\(^7\) On the other hand, the insurance industry demanded that any dispute resolution process be neutral.

To address this, the Banking Committee bill established a process within the NBA that allowed any state insurance supervisor to petition the newly created National Council for review of any decision by the Comptroller that a new product is permissible for a national bank to provide as principal.\(^7\) Upon the filing of a petition for review, the National Council is required to refer the matter to the Fed for a determination as to whether a substantial question is raised. If the Fed determines that a substantial question is raised, the National Council is required to review the matter and may hold a hearing. Any affected party may then appeal the National Council’s decision to a U.S. court of appeals. At the insistence of the insurance industry, the Banking Committee bill required the U.S. court of appeals to review the matter \textit{de novo}.

In the banking industry’s view, the Banking Committee bill appeared to favor the insurance industry on the definition of insurance. As explained below, the Banking Committee bill balanced this favoritism with strong provisions overriding state anti-affiliation laws, to the benefit of the banking industry.

The Commerce Committee version, which came several months and many hours of negotiation after the Banking Committee bill, made several revisions to both the definition of insurance and the dispute resolution process. The Commerce Committee added an exclusion from the definition of insurance for any new product that is a core banking product (that is, a deposit, loan, letter of credit, other extension of credit, trust or fiduciary service, financial guaranty or

\(^7\) See, e.g., VALIC, 513 U.S. 251.

\(^7\) See Banking Report, \textit{supra} note 1, § 151.
qualified financial contract) unless the new product would qualify for treatment as insurance under designated provisions of the Internal Revenue Code.\textsuperscript{78} The addition of this exclusion took away some of the advantage gained by the insurance industry in the original definition and would allow the banking industry to continue to develop and offer as principal new products that are related to core banking products, even if these products were found by the states to be insurance products. It is still unclear whether this approach will resolve the dispute between the banking and insurance industries about future products.

The Commerce Committee bill also revised the process for resolving disputes about the definition of insurance. The Commerce Committee bill dropped the administrative review process (along with the National Council) and, instead, provided for expedited review of disputes in the U.S. district courts.\textsuperscript{79} Thus, the Commerce Committee bill substituted a lower court’s review for an administrative review process.

Because of concern that the courts would defer to the interpretation of the federal bank supervisory agencies on the question of whether a new product was a banking product, the Commerce Committee bill enacted the insurance provision as a free standing provision (not as an amendment to the NBA, the Federal Deposit Insurance Act or the BHC Act) and required the court to review \textit{de novo} any definition question presented under state or federal law “without unequal deference.”\textsuperscript{80}

Interestingly, the Commerce Committee bill appears to be more favorable to the banking industry on the definition of insurance than the Banking Committee bill. However, the insurance agents won concessions to the anti-affiliation provisions in the Commerce Committee bill that are less favorable to the banking industry than

\textsuperscript{78} See Commerce Report, \textit{supra} note 2, § 304(c)(2). The exclusion is very complex. It excludes from the definition of insurance any new product that is a core banking product (as described above) \textit{unless} (1) the product would qualify as life insurance under the Internal Revenue Code if the product were offered by an insurance company, or (2) the product is a deposit, trust or fiduciary product or service that would qualify as any other type of insurance contract under the Internal Revenue Code if offered by an insurance company.

\textsuperscript{79} See id. § 307.

\textsuperscript{80} See \textit{id}.
the anti-affiliation provisions of the Banking Committee bill.

The anti-affiliation provisions in the two bills arose in the context of agreement between the two committees that banks should be permitted to affiliate with insurance companies and insurance agencies in a holding company structure. As noted above, both the Banking Committee bill and the Commerce Committee bill would repeal the provisions of the 1982 Garn-St. Germain Act that currently prevent bank holding companies from engaging through a nonbanking affiliate in insurance agency and insurance underwriting activities. This would allow the broad affiliation of banks and insurance underwriters, agents and brokers.

Because some states have laws that prevent the affiliation of banks and insurance companies or insurance agencies, both the Banking Committee bill and the Commerce Committee bill contain provisions that override these state anti-affiliation laws. This override, which may be found in section 104 of both bills, contains two parts: one that addresses affiliation, and a second that addresses regulation of activities that are conducted by a bank either directly or in conjunction with an affiliate. This second part affects the ability of states to regulate the direct insurance activities of banks.

Both the Banking Committee bill and the Commerce Committee bill override state laws that "prevent or restrict" the affiliation of insured depository institutions and uninsured wholesale financial institutions (WFIs),81 on the one hand, and insurance underwriters, insurance agencies, securities firms, merchant banking firms and companies engaged in financial activities, on the other hand. The Banking Committee bill goes further to override all state laws that would "prevent or restrict" affiliations between an insured depository institution or WFI and any company authorized under any other provision of law. This override provision has been preferred by many in the banking industry because it prevents states from prohibiting or restricting any affiliation that would be permissible under the NBA, the BHC Act, the Home Owners Loan Act or any other law, thereby extending the override to a broad range of activities.

81. Both bills would authorize the creation of WFIs as a new form of depository institution. WFIs could receive deposits only in amounts of $100,000 or more (except on an incidental and occasional basis) and such deposits would not be insured by the FDIC.
The second part of the override provisions in both committee bills addresses state laws that regulate the activities of banks. There are several important differences between the Banking and Commerce Committee bills in this area.

The Banking Committee bill adopts the same broad approach to overriding state laws that attempt to govern the direct activities of insured depository institutions as the bill uses for overriding anti-affiliation laws. In particular, the Banking Committee bill would override any state law that "prevents or restricts" any insured depository institution or WFI from engaging directly—or with any affiliate—in any activity authorized under the bill or any other provision of law. As with the anti-affiliation provision, this override applies to all insured depository institutions and overrides state laws governing any type of activity that a depository institution is otherwise authorized to conduct under any law. For example, this appears to override any state law that "prevents or restricts" a national bank from engaging in any activity permitted under the NBA—including insurance activities. The Banking Committee bill leaves room to argue that various types of state insurance regulation may "restrict" a bank from conducting insurance activities that are otherwise authorized for the bank.

The insurance industry was concerned that the Banking Committee bill provided an override that was arguably broader than even the Barnett Bank decision. In response to these concerns, the Commerce Committee bill is more limited in several important respects. First, it applies only to national banks and WFIs, leaving state banks to contend with all state laws that govern the activities of state banks. Second, the override applies to a more limited list of activities (primarily securities, insurance, merchant banking and financial activities) and does not, as does the Banking Committee bill, sweep in any activity that is permitted under the NBA or other law. Third, this provision rejects the override of laws that "restrict" the activities of banks and attempts to codify the standard in Barnett Bank that addresses laws that "prevent or significantly interfere with" the ability of a national bank to conduct an activity.

The Commerce Committee also added several other provisions that affect the scope of the override contained in section 104. For example, the Commerce Committee bill requires any
person selling insurance to be "functionally regulated" and prohibits any person or entity from providing insurance as principal or agent unless the person or entity is licensed by the appropriate State insurance regulator. These provisions appear to conflict with the override contained in section 104. As a result, these provisions were opposed by the banking industry, though a compromise was under discussion at the time Congress recessed that would reconcile these provisions with cross-references to section 104.

2. Conclusion Regarding Insurance Provisions

The insurance issues pose the most difficult obstacle to the passage of financial modernization legislation. The differences between the insurance provisions of the Banking Committee and the Commerce Committee bills reflect an evolution in the discussions between members of the banking and insurance industries as the legislative process has proceeded and different attempts have been made to reach a compromise. However, the issues have so far proven to defy resolution.

Progress made in this area may be the bellwether for financial modernization legislation as a whole. Indeed, many believe that the other issues in the Banking Committee and Commerce Committee bills could be resolved relatively quickly if a solution to the insurance puzzle could be worked out.

82. See Commerce Report, supra note 2, §§ 302, 303.

83. S. 298 would prohibit any insured depository institution subsidiary of a financial services holding company from directly underwriting insurance. See S. 298, 105th Cong. § 101(g) (1997). The bill, however, does not attempt to define what constitutes "insurance" for these purposes, nor does it create a procedure for resolving disputes regarding the scope of the term. With respect to state regulation of the insurance activities of banks and their affiliates, the bill would specifically preempt any state law that (1) prevents or impedes a subsidiary insured depository institution of a financial services holding company from being affiliated with an insurance company or insurance agent, or (2) prevents a subsidiary insured depository institution from engaging in cross-marketing activities with any affiliated insurance company or insurance agent. See id. at § 101(f). The legislative history of the bill indicates, however, that the bill is not intended to preempt any state insurance approval, examination, licensing or reporting requirements that do not discriminate against banks or bank-affiliated entities.
F. Operating Subsidiaries

Another issue that has engendered considerable debate is whether national banks should be permitted to engage indirectly through a so-called “operating subsidiary” in activities that national banks are not authorized to conduct directly. Although expanding the range of permissible activities and affiliations of bank holding companies would greatly reduce the need to resolve this issue legislatively, recent administrative actions by the Comptroller have kept this question on the forefront of Congressional debates on financial modernization.

1. Precipitating Actions of the Comptroller

In 1997, the Comptroller adopted regulations authorizing national banks to establish operating subsidiaries to engage in activities that a national bank cannot engage in directly. Acting under this new regulation, the Comptroller in December 1997, approved the application of a national bank to engage, through an operating subsidiary, in underwriting and dealing in municipal revenue bonds—an activity that the Glass-Steagall Act prohibits a national bank from conducting directly. The Comptroller also is considering two proposals by another national bank to establish operating subsidiaries to engage in real estate development and real estate leasing activities, and the Comptroller’s regulation is broad enough to permit operating subsidiaries of national banks to engage in other types of financial or nonfinancial activities.

Several members of Congress have criticized the Comptroller’s actions in this area and have questioned whether existing law permits a national bank to control a subsidiary that engages in activities that the bank cannot conduct directly. The Fed also has expressed serious doubts that Congress intended to create a statutory scheme that would allow the Comptroller to override

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express statutory prohibitions on the activities of national banks by
administrative action.\textsuperscript{86} Although some observers believe that the
Fed's position on this matter represents merely a "turf" battle with
the Comptroller, the Comptroller's operating subsidiary regulation
has serious public policy implications related to the proper role of the
federal safety net.

In light of the unique function that banks serve in the
American economy, banks, unlike other forms of business
organizations, benefit from the direct and indirect government
guarantees provided through the federal safety net, which refers to
FDIC deposit insurance and access to the Federal Reserve's discount
window and payments system. While these governmental guarantees
protect depositors and reduce the likelihood of damaging bank runs,
they also allow banks to borrow funds at a lower cost than other
nonbank entities. Although some contend that this funding benefit is
offset by the special regulatory costs imposed on banks,\textsuperscript{87}
Chairman Greenspan has testified that access to the federal safety net, and the
explicit and implicit government guarantees associated therewith,
provide banks with a net subsidy that is not available to other
organizations.\textsuperscript{88}

Operating subsidiaries that are established or funded with
low-cost funds raised by the parent bank also benefit indirectly from
the federal safety net. Accordingly, the Comptroller's proposal to
permit operating subsidiaries of national banks to engage in activities
impermissible for banks to conduct directly could result in the
indirect expansion of the federal safety to cover a range of activities
that Congress has decided should not be protected by governmental
guarantees. In addition, operating subsidiaries that are funded with

\textsuperscript{86} See Letter from William W. Wiles, Secretary of the Federal Reserve Board, to the
Honorable Eugene Ludwig, Comptroller of the Currency (May 5, 1997).

\textsuperscript{87} See, e.g., Bevis Longstreth and Ivan E. Mattei, Organizational Freedom for Banks:
banks do not receive a net subsidy from their access to the federal safety net and concluding
that the ultimate value of the safety net is marginal, if not negative, to all but the smallest of
banking institutions).

\textsuperscript{88} See House Subcommittee Hearings, supra note 26, at 72-74 (statement of Alan
Greenspan). A recent study by economists at the Federal Reserve Board also concluded
that banks receive a net subsidy through their access to the federal safety net. See MYRON
L. KWAST & S. WAYNE PASSMORE, THE SUBSIDY PROVIDED BY THE FEDERAL SAFETY NET:
THEORY, MEASUREMENT AND CONTAINMENT (1997).
low-cost funds raised by the parent bank would have an unfair competitive advantage over other business organizations that lack access to the federal safety net.

Furthermore, allowing operating subsidiaries of national banks to engage in activities that are not permissible for national banks could increase the risk of loss to the bank and the FDIC insurance funds. In this regard, a national bank would likely face significant pressure to support an operating subsidiary in financial difficulty. This is especially true because any losses at the subsidiary would have to be consolidated with the parent bank’s financial statements under generally accepted accounting principles and, thus, would have a negative impact on the bank’s consolidated earnings and financial reports provided to investors and the public. Even if a parent bank did not provide financial support to an operating subsidiary in distress, any publicity concerning the financial difficulties of the subsidiary could cause depositors or creditors to lose confidence in the parent bank.

The Comptroller contends that these risks and concerns are adequately addressed by limitations or conditions contained in the proposal, including a requirement that transactions between a national bank and its operating subsidiary comply with sections 23A and 23B of the Federal Reserve Act, and a requirement that a national bank deduct its equity investment in an operating subsidiary from its capital and total assets for purposes of determining the bank’s compliance with regulatory minimum capital guidelines.\(^9\)

The Comptroller’s proposal, however, does not subject a national bank’s equity investment in an operating subsidiary to the limits contained in section 23A and, thus, would not limit the amount of low-cost capital that a national bank could downstream to an operating subsidiary. Moreover, sections 23A and 23B do not today cover the complete range of financial relationships that may exist between a national bank and an operating subsidiary and, as noted above, are not always fully effective in protecting a bank from the risks arising from transactions with affiliates, especially in times of financial stress.\(^90\) The restrictions proposed by the Comptroller also

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90. See supra note 52 (discussing supervisory experience with the First Options subsidiary of Continental Bank).
would not fully address the contagion risks that necessarily arise from allowing a national bank to control and manage an operating subsidiary whose financial condition will necessarily be reflected in the parent bank’s public financial statements, *i.e.* the risk that losses at the operating subsidiary will cause depositors or creditors to lose confidence in the subsidiary’s parent bank.

Furthermore, although the Comptroller’s proposal would require that a national bank’s equity investment in an operating subsidiary be deducted from the bank’s capital and total assets for purposes of determining the bank’s regulatory capital, it is unclear whether the proposal would require a similar deduction for the retained earnings of the operating subsidiary. Under generally accepted accounting principles, the retained earnings of a subsidiary would be consolidated with the capital account of the parent bank. Accordingly, if the Comptroller’s proposal does not require that the operating subsidiary’s retained earnings be deducted from the parent bank’s capital, then a significant portion of the bank’s regulatory capital could consist of the retained earnings of an operating subsidiary and, thus, be at risk to losses incurred by the operating subsidiary.

2. Legislative Responses

The Banking Committee bill would authorize national banks to control operating subsidiaries engaged in certain activities that a national bank cannot engage in directly, including underwriting and dealing in all types of securities. The Banking Committee bill also would permit the operating subsidiaries of national banks to engage in any other activity that the National Council determined to be financially related. The bill would, however, prohibit any operating subsidiary of a national bank from underwriting noncredit-related insurance or engaging in real estate development or merchant banking activities.

To mitigate the potentially adverse effects of the proposal, the Banking Committee bill would impose certain “firewalls” on the

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91. See Banking Report, supra note 1, § 141. S. 298 does not directly address the issue of whether national banks may control operating subsidiaries engaged in activities that are impermissible for national banks to conduct directly.
relationship between a national bank and its operating subsidiaries. For example, the bill would require that any extensions of credit by national banks to their operating subsidiaries comply with sections 23A and 23B of the Federal Reserve Act, but would exempt a national bank’s equity investment in an operating subsidiary from the quantitative limits contained in section 23A of the Federal Reserve Act.\(^\text{92}\) The bill would also require that a national bank deduct its equity investment in an operating subsidiary from its tangible equity and assets for purposes of determining the bank’s compliance with regulatory capital requirements. These restrictions are similar to those contained in the Comptroller’s operating subsidiary proposal.

In addition, to address the risks inherent in the parent-subsidiary relationship, the Banking Committee bill would provide that, notwithstanding any other law, a national bank (or other insured depository institution) could not be held liable for the obligations of its subsidiaries or affiliates by “piercing the corporate veil” between such entities.\(^\text{93}\) In effect, this provision would prohibit any party, including the creditors or customers of an operating subsidiary, from obtaining redress against the parent bank of an operating subsidiary for obligations undertaken or damages caused by the subsidiary.

The Commerce Committee bill, on the other hand, would generally prohibit subsidiaries of national banks from engaging in any activity that national banks are not permitted to conduct directly, unless otherwise specifically authorized by a federal statute.\(^\text{94}\) Thus, a national bank would continue to have the authority to control Edge Act corporations. In addition, the bill would specifically authorize national banks to control operating subsidiaries engaged in general insurance agency activities.\(^\text{95}\) Agency activities generally involve little risk and require only minimal capital investments. Authorizing operating subsidiaries to engage in general insurance agency activities thus would not appear to significantly increase the risks to the deposit insurance funds or create significant funding advantages for national banks.

The Commerce Committee also believed it was improper to

\(^{92}\) See id. § 143.
\(^{93}\) See id. § 113.
\(^{94}\) See Commerce Report, supra note 2, § 121.
\(^{95}\) See id.
prohibit consumers, creditors or the general public from "piercing the corporate veil" between a bank and its subsidiaries or affiliates under all circumstances, including when such action may be appropriate to redress fraud or other injustices under established principles of American law. Accordingly, the Commerce Committee deleted the provisions of the Banking Committee bill that would have prohibited any court or authority from "piercing the corporate veil" for purposes of holding an insured depository institution liable for the debts of a subsidiary or affiliate.

G. Merger of Thrift and Banking Charters

One goal of some proponents of financial modernization is to rationalize the legal structure of the banking industry, which for historical reasons is divided between organizations with bank charters and organizations with thrift charters. Proposals to merge the thrift and banking charters, however, have sparked significant controversy and conflict between the banking and thrift industries.

1. Background to Debate

The severe financial difficulties experienced by the thrift industry in the 1980s substantially depleted the federal deposit insurance fund that insured thrift deposits and forced Congress to engineer a comprehensive bailout package for the thrift industry, including moving the thrift deposit insurance fund to the FDIC and renaming it the Savings Association Insurance Fund (SAIF). During this period, Congress also established a new special purpose corporation, the Financing Corporation (FICO), which raised billions of dollars to partially finance the thrift bailout by issuing long-term bonds, the last of which matures in 2019. The interest on these bonds was to be paid by the thrift industry through FDIC assessments on the SAIF-insured deposits of thrifts.

By the mid-1990s, however, the SAIF insurance fund remained significantly below its legislatively required level of reserves, despite the fact that the FDIC's assessment rate for SAIF-insured thrifts was measurably higher than the assessment rate for banks, whose deposits are insured by the separate Bank Insurance
Fund (BIF). In light of this assessment rate differential, many institutions began exploring ways to shift their deposits from the SAIF to the BIF. The weak financial condition of the SAIF, and the runoff in SAIF-insured deposits, raised the distinct possibility that the thrift industry would be unable to pay the approximately $780 million in annual interest due on the FICO bonds.

To respond to this new thrift crisis, Congress passed the Deposit Insurance Funds Act of 1996 (1996 Act).\(^9\) The 1996 Act imposed a special one-time assessment on the SAIF-insured deposits of thrifts to bring the fund up to its required level of reserves. The 1996 Act also required that banks pay a significant portion of the interest on the FICO bonds.\(^7\) Not unexpectedly, the banking industry initially opposed Congressional efforts to require banks to pay a portion of the continuing costs of the savings and loan bailout.

As a general matter, the banking industry believed that it was inequitable to require healthy banks to pay a portion of the tab for the losses incurred by their thrift competitors during the 1980s. Nevertheless, the banking industry eventually agreed to accept partial liability for the interest on the FICO bonds and did not object to passage of the 1996 Act.

Many in the banking industry, however, believe their agreement to accept partial responsibility for repaying the FICO bonds was based on an understanding with members of Congress and the thrift industry that Congress would eliminate the thrift charter and require thrifts to convert to banking charters in the near future. Representative Leach is reported to have indicated that such an understanding was, in fact, reached in connection with the 1996 Act\(^8\) and the text of the 1996 Act indicates that Congress contemplated the elimination of the thrift charter by 1999.\(^9\) In light of this avowed

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97. Under the 1996 Act, the banking industry will pay approximately $322 million of the annual interest on the FICO bonds through the year 1999, and approximately $608 million of the bonds’ annual interest thereafter.


99. Specifically, the 1996 Act called for the merger of the SAIF and BIF insurance funds on January 1, 1999, but provided that the merger of insurance funds could occur only
understanding, the banking industry and certain members of Congress have sought to ensure that any financial modernization legislation includes provisions eliminating the thrift charter.

The thrift industry, on the other hand, has generally taken the position that no understanding was reached in 1996 regarding the elimination of the thrift charter. The thrift industry also has expressed concern that the mandatory conversion of thrifts to banks could eliminate the special powers that currently are enjoyed by thrifts and thrift holding companies but that are not available to national banks or bank holding companies. For example, unlike national banks, thrifts are permitted to own subsidiary service corporations that may engage in general insurance agency activities and a wide variety of commercial activities, including investing in and developing real estate. Thrifts also may branch nationwide without restriction, and the OTS has taken the position that most state laws that regulate the lending or deposit-taking operations of a federal thrift are preempted. In addition, unitary thrift holding companies, unlike bank holding companies, currently are permitted to engage in commercial activities to an unlimited extent.

2. Legislative Responses

The bills passed by both the Banking Committee and the Commerce Committee would eliminate the thrift charter within two years of enactment. Both bills provide that all federal savings associations in existence two years after the date of enactment shall be converted into national banks by operation of law. In addition, the bills provide that all state savings associations in existence on that date would be treated as state banks for purposes of federal banking law.

Both bills also seek to limit the impact these changes would

\[\text{if the thrift and banking charter were merged before that date. See 1996 Act, supra note 96, § 2704.}\]

100. See Olaf de Senerpont Domis, supra note 98, at 2 (citing president of America's Community Bankers).


102. S. 298, on the other hand, would not abolish the thrift charter and, thus, would continue the separate existence of the thrift industry.

103. See Banking Report, supra note 1, § 311; Commerce Report, supra note 2, § 411.

104. See Banking Report, supra note 1, § 321; Commerce Report, supra note 2, § 421.
have on thrifts and thrift holding companies by bestowing certain
grandfather rights on existing thrifts and thrift holding companies.
For example, both bills would generally permit any federal savings
association that converts to a national bank to continue to engage in
those activities (including the holding of any asset) that the savings
association was lawfully engaged in prior to conversion. 105 Both bills
would also grandfather the activities of thrift holding companies that
become bank holding companies upon the conversion of their
subsidiary thrifts. In particular, both bills would permit a thrift
holding company to engage, after conversion to a bank holding
company, in any activity that was permissible for the thrift holding
company to engage in prior to conversion. 106 Thus, both bills would
accord grandfather rights to an activity that a thrift holding company
commences after its conversion to a bank holding company, so long
as that activity would have generally been permissible for thrift
holding companies prior to conversion.

Although the thrift provisions of the Banking Committee and
Commerce Committee bills are generally similar, two differences are
worthy of mentioning. First, the Banking Committee bill would
permit a converting thrift holding company to retain its grandfather
rights even if the company acquires additional banks through
merger.107 Under this authority, a unitary thrift holding company
with extensive, grandfathered commercial activities could acquire
control of additional banks and thereby acquire a significant banking
presence. In light of this possibility, some have noted that the
Banking Committee bill could permit a small number of
grandfathered thrift holding companies to gain a significant
competitive advantage over other players in the financial services
industry. To address these concerns, the Commerce Committee bill
provides that a converting thrift holding company will lose its
grandfather rights if it acquires control of additional banks through

105. See Banking Report, supra note 1, § 313(a); Commerce Report, supra note 2,
§ 413(a).
106. See Banking Report, supra note 1, § 316; Commerce Report, supra note 2, § 416.
107. See Banking Report, supra note 1, § 316. To avoid losing its grandfather rights,
the thrift holding company must merge any bank acquired into the company’s subsidiary
national bank, and continue to operate its subsidiary national bank in accordance with the
QTL test.
Second, certain provisions of the Banking Committee bill could be interpreted to grant all national banks the powers and privileges of federal savings associations. Some have expressed concern that, if the Banking Committee bill was interpreted in this manner, the bill would have the effect of continuing the thrift charter by simply fusing its characteristics onto the national bank charter. For example, some note that this provision could grant all national banks the power to open de novo branches nationwide, a result which would appear contrary to the limits imposed by the Riegle-Neal Interstate Branching and Efficiency Act of 1994 on the de novo branching of national banks.

Moreover, because federal savings associations are permitted to engage in a wide variety of commercial activities through service corporations—including investing in real estate, owning and operating nursing homes and hotels, and investing in air conditioning and solar heating companies—opponents of mixing banking and commerce have generally resisted proposals that would allow all national banks to “charter up,” i.e. receive the powers of federal savings associations. To avoid ambiguities regarding this matter, the Commerce Committee bill eliminated those provisions of the Banking Committee bill that could be interpreted as granting all national banks the powers and privileges of federal savings associations.

H. Consumer Protection

Proposals to expand the permissible activities of banking organizations promise to offer consumers greater choices, convenience and flexibility in the purchase of financial services. Consumer groups, however, have expressed concern that the expansion of bank activities could create conflicts of interests that endanger the ability of banks to make vital credit decisions in an

109. See Banking Report, supra note 1, § 322.
impartial manner, result in public confusion regarding the uninsured status of any securities or insurance products sold by a bank or a bank affiliate, or weaken the commitment of banks to their local communities. The challenge facing Congress is how to assure that financial modernization occurs in a manner that minimizes the potential for these adverse effects without subjecting banks or their affiliates to unnecessary or overly burdensome regulation.

Under both the Banking Committee and Commerce Committee bills, a bank holding company can qualify as a financial services holding company, and thus affiliate with a broad range of securities, insurance and other financial firms, only if all of the company’s banking subsidiaries have a “satisfactory” or better record of meeting community credit needs under the Community Reinvestment Act of 1977 (12 U.S.C. § 2901 et seq.). Unlike the Commerce Committee bill, the Banking Committee bill would also require that the subsidiary banks of a bank holding company seeking broad financial powers have a demonstrable record of providing low-cost “lifeline” bank accounts.

In addition, under the Banking Committee bill, a bank holding company that directly or indirectly underwrites or sells annuities or insurance contracts may benefit from broad financial affiliations only if the company is not in violation of the Fair Housing Act (FHA) or any consent decree or settlement agreement arising from an alleged violation of the FHA. This requirement has proven very controversial, as members of the insurance industry have expressed concern that it could foreshadow efforts to subject the insurance industry in general to the FHA or a similar statutory scheme. In light of these concerns, the Commerce Committee bill did not include a similar FHA-compliance requirement for financial services holding companies.

Both the Banking Committee and Commerce Committee bills would also authorize the federal banking agencies to impose

111. See Banking Report, supra note 1, § 103; Commerce Report, supra note 2, § 103. Both bills provide a limited exception from this requirement for subsidiary banks that were recently acquired by the bank holding company. See Banking Report, supra note 1, § 103; Commerce Report, supra note 2, § 103.

112. See Banking Report, supra note 1, § 103.

113. See id.
restrictions on transactions between banks and their affiliates to prevent conflicts of interest or other abuses, or to enhance the privacy of bank customers. Although both bills would authorize the Fed to adopt such prudential safeguards for the bank subsidiaries of bank holding companies, the Banking Committee bill would also permit the three federal banking agencies (the Fed, Comptroller and the FDIC) to adopt similar safeguards for any bank within their primary jurisdiction.\footnote{See Banking Report, \textit{supra} note 1, § 111; Commerce Report, \textit{supra} note 2, § 114.}

Both bills also require that the federal banking agencies adopt consumer protection regulations governing the retail sale of certain nondeposit investment products by banks or on bank premises.\footnote{See Banking Report, \textit{supra} note 1, § 112; Commerce Report, \textit{supra} note 2, § 308.} The bills include an extensive list of matters that must be addressed in these regulations, including the prohibition of coercive practices, the physical separation of banking and nonbanking activities and the establishment of a consumer grievance process. In addition, the regulations must require that consumers receive disclosures concerning the uninsured status of, and the investment risks associated with, a nondeposit investment product, such as statements that the product is "NOT FDIC-INSURED" and is "NOT GUARANTEED BY THE BANK."

The Banking Committee bill requires that the consumer protection regulations promulgated by the banking agencies cover the sale of all nondeposit investment products by banks or on bank premises.\footnote{See Banking Report, \textit{supra} note 1, § 112.} Because the Commerce Committee bill would give the SEC jurisdiction over many of the securities activities of banks, the Commerce Committee bill would require that the regulations adopted by the federal banking agencies cover only the retail sale of insurance products by banks or on bank premises.\footnote{See Commerce Report, \textit{supra} note 2, § 308.}

Finally, the Commerce Committee bill would require that the federal banking agencies issue regulations prohibiting insurance underwriters or agents from discriminating against victims of domestic violence by taking into account a person's status as a victim in connection with the underwriting, renewal or pricing of insurance
products. This provision, which was offered by Representative DeGette of Colorado and added to the Commerce Committee bill by a voice vote at the markup, would govern only those insurance products sold by an insured depository institution or at the offices of an insured depository institution.

IV. CONCLUSION

As the foregoing illustrates, the web of issues and interests facing Congressional efforts to reform this nation’s financial laws is formidable. Although the Banking Committee and Commerce Committee each have made significant progress in addressing many of these issues and balancing the relevant interests, the differences between the bills reported out by these committees only highlight the problems that members of Congress will have in forging an acceptable compromise in the final session of the 105th Congress. Any compromise must address several contentious disputes—including the questions regarding bank insurance and securities activities and the elimination of the thrift charter—that have successfully evaded the conciliation efforts of many over the years. Nevertheless, hope springs eternal that the 105th Congress will overcome these challenges and fashion financial modernization legislation that not only satisfies the necessary political interests, but also places this nation’s financial system on sound footing for entering the 21st century.

118. See id. § 308.

119. As a general matter, S. 298 would not impose, or require the federal banking agencies to promulgate, special consumer protection requirements. See S. 298, 105th Cong. (1997).