Incidental Paper

Competitive Uses of Regulation in the Financial Services Arena

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Program on Information Resources Policy

Harvard University

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Executive Summary

This report gives a preliminary overview of the financial services arena in the United States. It provides a summary look at major players, regulators and current and emerging issues. In particular, it focuses on the manner in which competitors may use, or attempt to use, regulatory mechanisms and processes to attain competitive advantage.

Companies in the financial services industry *try* to use regulatory processes to impede competitors.

Regulated companies in the financial services industry frequently compete against companies that operate under different regulatory regimes. Players seem more likely to seek regulatory intervention in battles with competitors outside their immediate industry sector. Commercial banks, for example, are more likely to seek regulatory intervention in conflicts with insurance companies or securities firms than with other commercial banks.

The greater frequency of inter-sector regulatory battles stems from a number of sources, the leading one being the convergence of financial services markets. The lack of major intra-sector regulatory conflicts probably stems from historical conditions in the banking sector.

There is one obvious exception to the preceding conclusion: commercial banks (and thrifts) have warred with each other for decades on the issue of interstate branching.

Unlike the telecommunications industry, where the FCC has regulatory authority over most major competitors at the federal level, financial services regulation is divided among many agencies, with each agency having responsibility for a particular sector. This sectoral division (and legislated objectives for each regulatory body), tends to make regulators champions of their own sector, frequently feuding with other industry regulators to protect the interests of the sector being regulated.

Because of the fragmented nature of financial services regulation, invoking regulatory intervention appears to be a less profitable corporate strategy than in the telecommunications industry.

Regulatory fragmentation means that cross-sectoral competitive conflicts in the financial services industry are more likely to be resolved by courts and Congress rather than any regulatory body. Regulatory fragmentation also is reflected in the divided jurisdiction of congressional committees.

There have been regular proposals to "simplify," or "rationalize" financial services regulation. The history of industry regulation in many fields suggests that combining such regulatory functions may well move competitive conflicts from the legislative domain to the regulatory one. Regulatory "rationalization" might make the financial services industry look more like the traditional telecommunications world.

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Chapter One

Introduction and Observations

Over the past twenty years, Harvard University's Program on Information Resources Policy (PIRP) has tracked and analyzed competitive and regulatory dynamics in a variety of "information businesses." In many of these businesses, and particularly in the telecommunications industry, PIRP authors and other observers have noted the tendency of companies within the industry to invoke regulatory intervention in order to gain competitive advantage.[1] MCI, Sprint and other Interexchange Carriers (IXCs), for example, frequently petition the Federal Communications Commission (FCC) to review AT&T's latest tariffs and service offerings. Similarly, any local telephone company filing new tariff or service offerings with a state public utilities or public service commission can expect a multitude of competitors to intervene in the regulatory process.

Since its inception, PIRP has considered the financial services sector to be an integral portion of the "information business," and many of the Program's research projects over the years have examined the interplay of information technologies and financial services. More recently, PIRP has been expanding its analyses of financial services in the belief that the tools and techniques used by the Program in other sectors might be useful in illuminating private and public decisions about financial services. (See **Appendix C** for a listing of other PIRP studies of the financial services sector.)

This report gives a preliminary overview of the financial services arena in the United States. It provides a summary look at major players, regulators and current and emerging issues. In particular, it focuses on the manner in which competitors may use, or attempt to use, regulatory mechanisms and processes to attain competitive advantage.

Our observations can be summarized as follows:

1. Companies in the financial services industry *try* to use regulatory processes to impede competitors.

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[1]See for example, Robert A. Leone, *Who Profits: Winners, Losers and Government Regulation*, Basic Books, New York, 1986.

2. Regulated companies in the financial services industry frequently compete against companies that operate under different regulatory regimes. Players seem more likely to seek regulatory intervention in battles with competitors outside their immediate industry sector. Commercial banks, for example, are more likely to seek regulatory intervention in conflicts with insurance companies or securities firms than with other commercial banks.

3. The greater frequency of inter-sector regulatory battles stems from a number of sources, the leading one being the convergence of financial services markets. The lack of major intra-sector regulatory conflicts probably stems from historical conditions in the banking sector. These include:

a. Monopolistic antecedents for thrifts and commercial banking. Local franchises, state chartering and the Federal Reserve System's Regulation Q limited direct competition among most players,

b. Fairly detailed and comprehensive regulations govern competition within each sector, thus providing less room for maneuver and conflict, and

c. The lack of head-to-head competition and regulatory oversight encouraged and sanctioned extensive self-regulation.

4. There is one obvious exception to the preceding conclusion: commercial banks (and thrifts) have warred with each other for decades on the issue of interstate branching.

5. Unlike the telecommunications industry, where the FCC has regulatory authority over most major competitors at the federal level, financial services regulation is divided among many agencies, with each agency having responsibility for a particular sector:

Commercial banks are regulated by the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or any two or three of these,

Thrift institutions are regulated by the Office of Thrift Supervision,

Securities firms are regulated by the Securities Exchange Commission, except for commodities firms which are regulated primarily by the Commodity Futures Trading Commission,

Leasing and finance firms are partially regulated by the Securities and Exchange Commission (SEC), and

Insurance companies have no federal regulators.

This sectoral division (and legislated objectives for each regulatory body), tends to make regulators champions of their own sector, frequently feuding with other industry regulators to protect the interests of the sector being regulated.

6. Because of the fragmented nature of financial services regulation, invoking regulatory intervention appears to be a less profitable corporate strategy than in the

telecommunications industry. The Securities and Exchange Commission may be sympathetic to the complaints of securities firms about commercial banks marketing mutual funds, but the banking regulators, charged with protecting the soundness of commercial banks, may be loath to restrict the practice.

7. Regulatory fragmentation means that cross-sectoral competitive conflicts in the financial services industry are more likely to be resolved by courts and Congress rather than any regulatory body. Regulatory fragmentation also is reflected in the divided jurisdiction of congressional committees.

8. There have been regular proposals to "simplify," or "rationalize" financial services regulation. Some of these proposals envision combining the SEC and Commodities and Futures Trading Commission (CFTC), or creating a single body to oversee banks and thrifts, thereby combining the regulatory functions of the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Controller of the Currency, the Office of Thrift Supervision, etc. The history of industry regulation in many fields suggests that combining such regulatory functions may well move competitive conflicts from the legislative domain to the regulatory one. Regulatory "rationalization" might make the financial services industry look more like the traditional telecommunications world.

The following pages detail and illustrate these observations through discussion of some recent and perpetual policy issues in the financial services arena. This is not a catalog of financial services industries, or their regulators, but a quick overview, emphasizing patterns and trends. In the interest of readability, we have pushed some of the details into appendices. We have tried to make these easily accessible, but while our appendices provide additional details, we readily acknowledge that we are skimming the surface of a very complex field.

PIRP reports are intended to be accessible to "the educated layman," as well as experts in a given field. With this in mind, **Chapter Two** provides a general introduction to government regulation and financial services, plus a recap of some of the major forces and trends shaping the financial services world. **Chapter Three** describes the major financial institutions, and **Chapter Four** describes the bodies that regulate those institutions.

Those readers familiar with the financial services industry and its regulators are invited to skip ahead to **Chapter Five**, Regulatory Skirmishes in the Financial Services Industry.

Chapter Two

Overview and Background

General Background on Government Regulation

In the financial services arena, as in many other sectors of economic activity, governments may "regulate" participants through the use of numerous policy levers including taxation, antitrust litigation, export controls, government procurement polices, etc. "Regulation" in this sense might be thought of more accurately as "political" or "governmental intervention."

Governments also regulate business activities through "generic" regulations that apply to multiple industries. In the U.S. there are nationwide regulations pertaining to workplace health and safety, collective bargaining, employment discrimination, sexual harassment and deceptive advertising that apply to financial services institutions, but also apply to scores of other industries.

For the purposes of this report, unless noted otherwise, we use "regulation" to describe industry-specific regulation as normally embodied in the operation of an independent regulatory commission.

The distinction between "regulation," specifically, and "political or governmental intervention," generally, is important for our purposes. Any corporation in any industry can seek political or governmental intervention in business conflicts; all corporate players have access to state and federal courts for judicial intervention in disputes. Local Arkansas pharmacies can sue Wal-Mart for predatory pricing.

Similarly, all individuals and corporations have a constitutional right to petition Congress (and state legislatures) for redress of grievances; anyone can lobby state or federal legislators to pass a new law. All you have to do to get new laws passed is hire battalions of lawyers and lobbyists, and create associations, alliances, political action committees and grass-roots organizations. With good luck and several years of effort, you might succeed in getting your desired legislation enacted.[2]

By contrast, "regulated" companies, or companies competing with "regulated" companies, may use the industry-specific regulatory process as a "fast-track" access to public policymakers. United Parcel Service and Federal Express, for example, routinely intervene in Postal Rate Commission proceedings with the objective of forcing the U.S. Postal Service to raise rates in markets where they compete. MCI and Sprint continually challenge AT&T's rate and service filings with the Federal Communications Commission. Sometimes such challenges may cause regulators to order specific changes in prices and services. Regulatory intervention may lead to lengthy administrative proceedings which delay market implementation of new rates and services, or force disclosure of competitive intelligence and marketing strategies. Legislated access to regulatory proceedings thus becomes a competitive tool.

In the U.S., the concept of independent regulatory commissions dates back to the 1880s. The concept was an adjunct of the "Good Government" and "Populist" movements and closely intertwined with civil service reform and the reduction of patronage appointments in the federal government. States began establishing such commissions to regulate railroads, telegraphy and telephony. The federal government established the Interstate Commerce Commission in 1887 to regulate railroads. President Roosevelt's New Deal launched dozens of such commissions in the 1930s, many involved with the financial services industry.

The idealized independent regulatory commission oversaw the operations of a monopolistic or oligopolistic industry, regulating prices, services and corporate behavior, attempting to foster "the public interest." Congress legislated a specific domain for each regulatory authority. To some degree, the extent frequently litigated, the commission was seen as exercising the oversight that Congress itself might exercise, if Congress had the time and expertise to do so.

The commissioners were "experts," supported by a staff of other experts, who examined the financial records of the regulated entities, held open hearings on proposed rate increases, etc. Typically, the commissioners were nominated by the President and confirmed by the Senate. The "independence" of the commission supposedly stemmed from (1) legislated limits

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[2] "For Citicorp, Which has Largest Lobbying Force In Banking Industry, Victories Are Won Quietly," Kenneth H. Bacon, *The Wall Street Journal*, December 14, 1993.

on the number of appointees from each political party and (2), the staggering of commission appointments so that some appointees' terms overlapped those of the appointing President.[3]

As noted, much of the regulatory structure of the 1990s stems from the very different political world of the 1930s. The Congress that enacted the Communications Act of 1934, for example, employed less than 12,000 clerks, secretaries and staff professionals, compared to 38,000 in 1990.[4] It might well be argued that, since the 1930s, Congress has acquired the resources and expertise to take a more active role in direct oversight of particular industries.

Independent regulatory commissions also provide a means for Congress to avoid public voting on controversial issues. Until 1970, for example, postage rates were established by Congress. Given typical congressional procedures, this meant that the postal committees in the House and Senate crafted the details of postage rates, but all members had to vote to increase rates. Allegations of bribery of postal committee members by mailers, followed by indictments and convictions, led many members of Congress to pass the Postal Reorganization Act of 1970, moving rate setting responsibility to the new Postal Rate Commission.[5]

The distinction between "regulation" in its broadest sense, as "governmental intervention," and its narrower sense, as involving an industry-specific regulatory commission, is worth stressing because of the frequent proposals to develop or reform regulatory mechanisms in the financial services arena. Such proposals are discussed in **Chapter Nine**.

General Background on Financial Services

Financial services occupy the center of economic activity. Finance is the science of credit, banking and money. Financial services revolve around the lending and borrowing of money, whether through direct loans, or the sale of securities or other financial instruments. All

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[3]The idea of disinterested government experts protecting an unsuspecting public from rapacious corporate interests has been widely questioned in more recent times. Since the 1960s James Buchanan, Gordon Tullock, William Niskanen, Mancur Olson, and several other economists and political scientists have developed and promoted a group of ideas frequently described under the rubric of Public Choice Theory. Public Choice Theory asserts that politicians and bureaucrats are no less interested in private gain than other players, but that they simply use other methods.

[4]U.S. Bureau of the Census, *Historical Statistics of the United States from Colonial Times to 1970*, 1975, Series Y-316, p.1102 and *Statistical Abstract of the United States: 1992 (112th Edition)*, Table 514, p.330.

[5]John T. Tierney, *Postal Reorganization: Managing the Public's Business*. Auburn House, Boston, 1981, Chapter 5.

financial transactions involve elements of speculation and risk. Historically, all capitalist societies have attempted to regulate or control financial services with three objectives in mind:

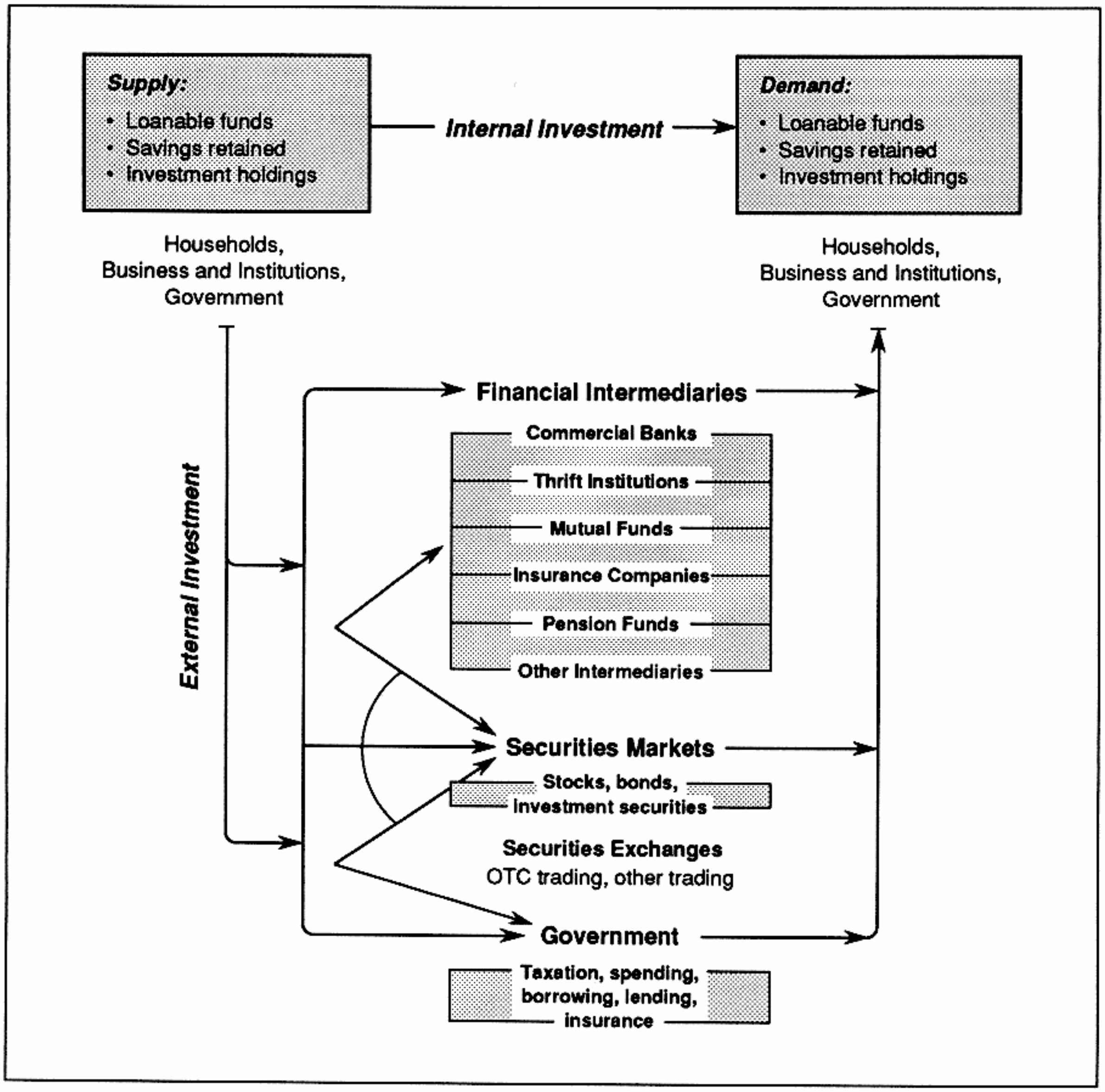
1. Allowing or encouraging the free flow of capital toward wealth creating enterprises,

2. Protecting the unwary public (borrowers and investors) from criminal fraud and theft, and

3. Protecting the society's (or government's) interests in financial activities, whether through taxes, currency valuation, trade, economic development, etc.

Money, by definition, is the ultimate fungible good, therefore financial services, by whatever name, are highly interchangeable. A company seeking to raise capital for its expansion might borrow money from a bank, issue commercial paper to a nonbank commercial enterprise, or sell equities (stocks or bonds) to a broader public. An individual seeking capital might seek a personal loan from a commercial bank or finance company, secure a first or second mortgage on their home, borrow against an insurance policy (or other financial holdings), or use credit card charges. Because of the basic fungibility of money and credit, there is inevitable overlap between the activities of financial services vendors.

In pursuit of their three objectives, governments traditionally have attempted to differentiate financial institutions, largely on the basis of credit risks involved. In the U.S., for example, savings and loan companies (S&Ls, or "thrifts") for decades were allowed to lend for residential mortgage loans only, traditionally a very low risk business. Commercial banks lent primarily to businesses, which involved more risk, but higher profits. Brokerage houses marketed stocks and bonds for businesses, and most buyers of these securities were assumed to know that they were accepting higher risks for the potential of higher returns. Trading in commodities and futures was categorized as a highly speculative activity, normally limited to specialized and expert investors and thus regulated separately.



Source: William A. Lovett, *Banking and Financial Institutions Law*, West Publishing Company, St. Paul, 1988, p. 297. Used by permission.

Figure 1

Financial Intermediation and Securities Markets

Major Forces and Trends

The financial services sector witnessed significant changes during the 1980s and more are in store. Some of the key forces and trends reshaping the industry are:

A. Improved credit information and enhanced information systems have allowed many potential lenders to enter new markets. Corporate borrowers, once the primary customers of commercial banks, have turned increasingly to commercial paper, securities, and other institutions (such as pension funds) to meet their credit needs. This disintermediation of the commercial banking sector has led the commercial banks to seek new markets while they also mount legal and regulatory challenges to competitors.

B. The inflationary surge of the late 1970s caused all lenders to pursue higher risk investment strategies and caused potential borrowers to "shop" more intensively to meet credit needs. The failure of many high risk investments (particularly Third World bank loans, real estate and construction loans and some "junk-bond" issues) caused massive loan write-offs by commercial banks and the collapse of the savings and loan industry. This led to enactment of The Financial Institutions Reform, Recovery, and Enforcement Act of 1991 (FIRREA) and a host of subsequent proposals for restructuring the regulation of the financial services industry.

C. While financial services have always transcended national boundaries, the 1980s witnessed an explosion in international financial competition. This cross-border competition has triggered a host of new regulatory issues including:

1. International standardization of capital requirements for banks and securities firms,
2. National treatment of foreign financial institutions and,
3. The locus of responsibility for banking supervision of foreign firms.

D. Financial services firms continue to introduce new products that defy classical definitions used for regulatory purposes. The growth of "derivatives," in particular, has created considerable debate about the adequacy of the current regulatory structure.

E. As a matter of national policy, the U.S. government has intensified efforts to enforce the Community Reinvestment Act (CRA) and other equal opportunity lending statutes. The commercial banking industry maintains that these efforts, coupled with extended regulatory oversight following the savings and loan debacle, places the commercial banking sector at a marked competitive disadvantage in the financial services marketplace, and is leading to the creation of a "parallel" financial system.

Most of these developments are discussed in greater detail below, in the context of specific issues.

Chapter Three

The Major Players

The major components of the financial services industry are:

1. Commercial Banks
2. Thrift Institutions
3. Securities Firms (Investment Banks, Brokerage, Commodity and Mutual Fund Firms)
4. Lease and Finance Firms
5. Insurance Companies

This chapter provides a brief description of these industry sectors, names some of the major corporate players, and notes some of the major regulatory conflicts within and between sectors.

Commercial Banks

The United States currently has about 12,500 commercial banks, including 4,049 national banks, 1016 state banks that are members of the Federal Reserve System, and 7,371 state banks that are not, but are insured through the Federal Deposit Insurance Corporation (FDIC). As of June 30, 1993, the ten largest commercial banks had assets of approximately $820 billion.[6]

"Commercial banks," such as Citibank and Bank of America, were originally described as such because they provided most of the commercial credit used by businesses. Traditionally, commercial banks gathered funds through a retail network of branches offering savings accounts and checking accounts to individuals and small businesses. During the 1970s and 1980s, banks expanded their fund gathering through extensive marketing of certificates of deposit (CDs). Banks then made loans against these accumulated deposits.

Commercial banks engaged in retail lending in the form of auto loans, mortgages, and personal loans. Most bank lending, however, was directed to businesses to finance inventories, construction or commercial expansion. Much of this lending was conducted on a

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[6] *American Banker*, September 9, 1993, p.10.

local or regional basis. A commercial banker in Cleveland, for example, was assumed to have a unique advantage in evaluating the credit worthiness and profit potential of a Cleveland-based business firm.

Large banks in money centers like New York frequently collected deposits far in excess of local lending demand. Such banks lent their excess deposits either through loans to large businesses operating on a national or international basis, or through syndicates with smaller banks in areas where loan demand exceeded local lending capacity.

Prior to the erosion of the McFadden Act in the 1970s, banks were prohibited from operating deposit collection activities in more than a single state. Some states, such as Illinois, even prohibited banks from establishing branches. Banks were commonly allowed to *lend* money across state lines with few restrictions. This division created a situation wherein a bank like First Chicago was restricted to collecting deposits at its single depositary facility in downtown Chicago, while operating loan origination offices in cities across the U.S. and overseas.

Until the 1980s, the rate of interest that banks were allowed to pay on deposits was regulated by the Federal Reserve Board (under Regulation Q).[7] Since all banks offered depositors the same interest for their deposits, retail competition among banks normally focused on customer convenience, as reflected in the escalating proliferation of branches and Automated Teller Machines (ATMs).

Prior to the Glass-Steagall Act of 1933, banks also performed capital formation functions by underwriting large blocks of stocks and bonds. Glass-Steagall split banking into two parts and prohibited commercial banks from engaging in investment banking activities.

Since 1933, commercial banks (and Thrifts, see below) have been unique players among financial institutions because the federal government (through the Federal Deposit Insurance Corporation) insures the deposits of their customers. (Each depositor is currently insured for deposits up to $100,000 in any insured bank.) This insurance can be seen as an advantage for commercial banks in competing for funds against other financial intermediaries. But federal

[7]Regulation Q, which set ceilings on interest rates on deposits was phased out between 1980 and 1986. For one discussion of the process and its results, see "Bank Capital: Lessons from the Past and Thoughts for the Future." Remarks by Wayne D. Angell. 27 *Wake Forest Law Review* 603, Fall 1992.

deposit insurance also has its costs. Insured banks are subject to periodic examination and extensive regulation of capital reserves and lending practices. Also, since FDIC insurance premiums are assessed uniformly on bank assets, sound, well managed banks feel that they may be overcharged to make up for the sins of less well managed banks.[8]

Commercial Banks and Competition

Until the 1960s, many commercial banks lacked effective competition. Federal and state regulators, hoping to avoid banking panics, limited creation of new banks. The prohibition on interstate banking, restrictive state chartering practices, and regulation of interest rates made many areas of the commercial banking world protected enclaves. As in-state and interstate branching has been expanded over the years, banks have competed increasingly with each other in the pursuit of retail deposits.

Commercial banks and thrifts historically competed for retail deposits, with both offering federally insured accounts. The Federal Reserve Board's Regulation Q allowed thrifts to pay depositors a higher interest rate than commercial banks (normally a differential of one-quarter or one-half of one percent), but thrifts offered only savings accounts and were more limited in branching. The emergence of NOW (Negotiable Orders of Withdrawal) accounts in the 1970s, effectively allowed thrifts to offer checking (or demand) accounts, thus placing them on a more competitive footing with commercial banks. Further deregulation of thrifts made many of them the effective equivalent of commercial banks, but also led to the S&L scandal and extensive governmental restructuring of the industry.

In theory, banks' retail deposit collection activities have always competed with uninsured investment vehicles, whether stocks, bonds, mutual fund shares, or commodity contracts, or insurance policies and annuities. Much of this competition was only theoretical. For legions of small and unsophisticated customers, scalded by the experience of the Great Depression, insured bank accounts offered a welcome certainty compared to other investment vehicles. This scene has changed dramatically in recent years. Baby Boomers, raised in an environment of rising equity markets, and a host of seniors, accustomed to 10% yields on CDs, have moved in massive numbers to more speculative investment vehicles. This movement has heightened the competition between banks and vendors of uninsured investment products.

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[8] "Time to Leave: A Survey of World Banking," Brooke Unger, *The Economist*, May 2, 1992, p.17.

During the 1970s and 1980s, commercial banks encountered a multitude of competitors on the lending side of their business. Larger businesses increasingly met their credit needs by issuance of securities and commercial paper; by the end of the 1980s, companies raised as much money through commercial paper as they did from banks."[9] Insurance companies expanded private placements for medium and small size firms.[10] Lease and finance companies moved aggressively into commercial and industrial lending. As a result, finance companies, insurance companies, and corporations themselves (through the sale of commercial paper) provide over 78% of the commercial credit extended in the United States, compared to 22% for commercial banks.[11]

As a result of increasing competition on multiple fronts, commercial banks account for an ever-shrinking portion of the financial services industry:

> In 1980, commercial banks held 37 percent of all financial assets. Savings and loans, savings banks, and credit unions held an additional 21 percent, bringing the total for all deposit intermediaries to 58 percent. By 1990, the commercial bank share had dropped to 32 percent, and the total for all deposit intermediaries had dropped to 48 percent.[12]

Thrift Institutions (Savings and Loans, Savings Banks, Credit Unions)

Savings and Loans, Savings Banks, and Credit Unions are institutions created to encourage savings through deposits and to foster special purpose lending to depositors. Collectively, they are known as thrift institutions, or "thrifts."

Savings and Loans (S&Ls) raise funds like commercial banks, by seeking customer deposits. Unlike commercial banks, they are heavily concentrated in residential mortgage

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[9]Brooke Unger, "Time to Leave: A Survey of World Banking," *The Economist*, May 2, 1992, p.17.

[10]"Private placement" means the sale of stocks, bonds or other investments directly to an institutional investor like an insurance company. A private placement does not have to be registered with the Securities and Exchange Commission, as a "public offering" does, if the securities are purchased for investment as opposed to resale. John Downes and Jordan Elliot Goodman, *Barron's Dictionary of Finance and Investment Terms*, Third Edition, 1991.

[11]"Are Banks Obsolete?" *Time*, June 28, 1993, p. 50. See also, "World Banking : Convalescence Under Way," John Gapper, *Financial Times*, September 24, 1993 and Fred R. Bleakley, "Loan Demand Will Remain Sluggish Even if Economy Improves, Survey Says," *Wall Street Journal*, October 20, 1993.

[12]Eugene A. Ludwig, Controller of the Currency, Remarks before the Merrill Lynch Financial Services Conference, September 13, 1993.

loans. Because of their special purpose, S&Ls were granted some advantages. The Federal Reserve Board's Regulation Q had a built-in differential so that savings associations could pay a slightly higher rate of interest on deposits than commercial banks.

In the late 1970s and early 1980s, funds began to flow out of S&Ls and into money market mutual funds because of rampant inflation and very high interest rates. Money market funds were not subject to interest rate limitations. A phase-out of deposit interest rate controls followed in order to try to stem the tide. This had the effect of significantly raising the cost of funds over the return S&L's were getting on existing 30 year mortgages. Savings and Loans began to fail.

The Garn-St. Germain Depository Institutions Act of 1982 tried to solve the disparity between the cost of funds and the S&Ls' operating income by greatly expanding the types of loans S&Ls could make. Now they could invest in non-residential real estate and commercial loans. States such as Texas, California, Florida, and Arizona went even further in allowing state-chartered banks unsupervised investment freedoms. The end result was the largest crisis in financial institutions since the Great Depression.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1991 (FIRREA) mandated a supervisory environment for S&Ls similar to that of commercial banks. In addition, S&Ls must comply with the Qualified Thrift Lender Test, which designates that about two-thirds of an association's assets must be related to residential mortgages, and a few other specified investments.

Savings Banks

Savings banks were originally established as sort of philanthropic organizations designed to encourage savings by working people. There are approximately 400, and they are concentrated in the Northeast, especially Massachusetts, New York, and Connecticut. Savings Banks are considered "Thrifts" like S&Ls, but were traditionally insured by the FDIC.

Credit Unions

Credit Unions are also categorized as "thrifts," but can only be chartered by "members" who have a common interest or enterprise, including working for a company, living in a neighborhood, or some other identifiable common activity as set forth in their charters. There are over 20,000 Credit Unions, and they range in size from several thousand dollars to the

Navy Federal Credit Union which has several billion dollars in assets.

The National Credit Union Administration oversees federal credit unions and provides for deposit insurance. Allowable investments by credit unions are strictly controlled.

Securities Firms (Investment Banks and Brokerage, Commodity and Mutual Fund Firms)

Investment banks, brokerage houses, commodities dealers, and mutual fund managers are financial intermediaries. They buy and sell stocks, bonds, currencies, commodities and other financial instruments, both for their own investment purposes, and on behalf of retail and institutional investors. The majority of investment banks also maintain broker-dealer operations and provide investment advisory services.[13]

The five largest U.S brokerage and commodity firms in 1992 were:[14]

Merrill Lynch, Salomon Brothers, Morgan Stanley, Paine Webber Group and Bear, Stearns & Co.

The five largest U.S. mutual fund managers in 1992 were:[15]

Fidelity, Vanguard Group, Merrill Lynch, Dreyfus Group and Capital Group.

Lease and Finance

Companies in this category come in many different flavors. The category includes personal finance companies such as Beneficial Corporation, Household Finance, and H&R Block that specialize in unsecured loans and as a group provide about 20% of consumer credit.[16] This category includes the credit card operations of non-bank card issuers such as American Express and Sear's Discovery. It also includes equipment leasing companies such as GATX and Ryder Systems, plus the financial subsidiaries of General Electric, General Motors, Ford, AT&T, and IBM. Many of these companies provide commercial and industrial

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[13]*Barron's Dictionary of Finance and Investment Terms*, Third Edition, 1991.

[14]"The 45th Annual Report on American Industry: Financial Services," Matthew Schifrin, *Forbes*, January 4, 1993, p.146.

[15]"Only Perform: A Survey of Investment Management," Merril Stevenson, *The Economist*, November 27, 1993, p. 13.

[16]"Time to Leave: A Survey of World Banking," Brooke Unger, *The Economist*, May 2, 1992, p.17.

(C&I) loans which compete directly with corporate lending by commercial banks.

Insurance

Forbes categorizes insurance companies into four groups:

1. Life and health. Examples include Equitable Companies, American General and Aflac.

2. Property and casualty. Examples ITT, Xerox, and Continental Corporation.

3. Brokerage. Examples include Marsh & MeLennan Companies and Alexander & Alexander.

4. Diversified (having some elements of each type). Examples include Sears-Roebuck, Cigna and American International Group.[17]

Effectively, all insurance companies collect a stream of policy revenues from individuals and institutions against the actuarial likelihood of an event happening, or not happening. The insurance company invests the revenue stream to provide income against future claims of its policy holders. By creating pools of capital for investment, insurance companies compete directly with the lending activities of commercial banks. Insurance companies such as Equitable, Metropolitan, and Prudential are major lenders in the private placement market and compete extensively with banks in construction and realty lending.[18]

Insurance companies and commercial banks also compete in fund collection activities. Insurance companies market life insurance policies, annuities and guaranteed investment contracts (GICs) that compete with consumer investment products of banks such as interest-bearing accounts and CDs. Commercial banks are pushing to expand their own insurance activities.

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[17]"The 45th Annual Report on American Industry: Insurance," Carolyn T. Geer, *Forbes*, January 4, 1993, p.146.

[18]"If in Doubt, Downgrade It!" Laura Jereski, *Forbes*, January 7, 1991, p. 52.

Chapter Four

The Regulators and Their Roles

Government regulation of the financial services arena is complex and frequently confusing. Many activities are regulated at both the federal and state level. The following is a summary look at the primary federal regulatory bodies involved. (See **Appendix A** for additional details.)

The descriptions of the federal bodies are excerpted from their self-descriptions in *The United States Government Manual, 1993/94*, U.S. Government Printing Office, July 1, 1993. Page references follow citations.

Regulation of Depositary Institutions:

Banking

A. The Federal Reserve System (the Fed), or Federal Reserve Board (FRB)

The Federal Reserve System, the central bank of the United States, is charged with administering and making policy for the Nation's credit and monetary affairs. Through its supervisory and regulatory banking functions, the Federal Reserve helps to maintain the banking industry in sound condition, capable of responding to the Nation's domestic and international financial needs and objectives.

. . . their major responsibility is in the execution of monetary policy.

The Board determines general monetary, credit, and operating policies . . . The Board's principal (sic) duties consists of monitoring credit conditions; supervising the Federal Reserve Banks, member banks, and bank holding companies; and regulating the implementation of certain consumer credit protection laws. (p. 604)

B. Office of the Comptroller of the Currency (OCC), Department of the Treasury

The Comptroller, as the administrator of national banks, is responsible for the execution of laws relating to national banks and promulgates rules and regulations governing the operations of approximately 3,600 national banks. Approval of the Comptroller is required for the organization of new national banks, conversion of State-chartered banks into national banks, consolidations or mergers of banks where the surviving institution is a national bank, and the establishment of branches by national banks. The (OCC) exercises general supervision over the operations of national banks, including trust activities and overseas operations. Each bank is examined annually . . . (p. 499)

C. Federal Deposit Insurance Corporation (FDIC)

The FDIC promotes and preserves public confidence in banks and protects the money supply by providing insurance coverage for bank deposits and periodic examinations of insured State-chartered banks that are not members of the Federal Reserve System. . . . The FDIC also administers the Savings Association Insurance Fund (SAIF) . . . (which replaced) the Federal Savings and Loan Insurance Corporation (FSLIC) as the insurer of deposits in savings and loan associations. (p. 582)

Thrifts

A. Office of Thrift Supervision (OTS), Department of the Treasury

The Office of Thrift Supervision was established . . . in August 1989 . . . as part of a major reorganization of the thrift regulatory structure mandated by the Financial Institutions Reform, Recovery and Enforcement Act. In that act, Congress gave OTS authority to charter Federal thrift institutions, and serve as the primary regulator of approximately 2,000 Federal- and State-chartered thrifts belonging to the Savings Association Insurance Fund (SAIF). OTS carries out this responsibility by adopting regulations governing the savings and loan industry, by examining and supervising thrift institutions and their affiliates, and by taking whatever action is necessary to enforce their compliance with Federal laws and regulations. . . . OTS also regulates, examines, and supervises companies that own thrifts and controls the acquisition of thrifts by such holding companies. (p. 512)

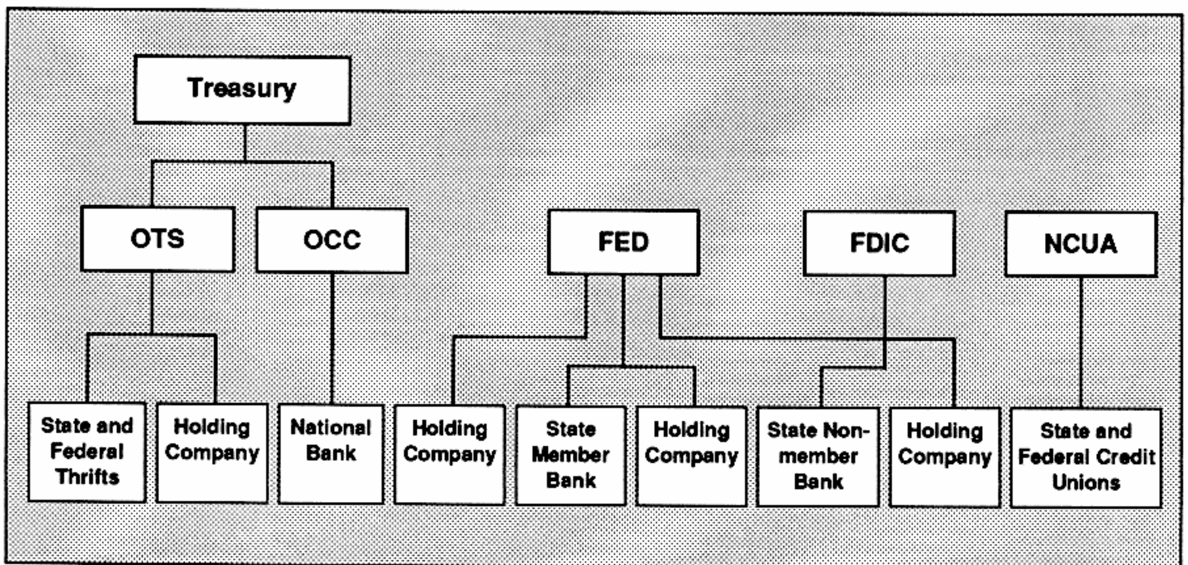
B. Resolution Trust Corporation (RTC)

The RTC was established to manage and resolve failed savings associations that were insured by the Federal Savings and Loan Insurance Corporation (FSLIC) before the enactment of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989 . . . The Corporation will terminate all functions no later than December 31, 1996. (p. 720)

C. National Credit Union Administration (NCUA)

The NCUA Board is responsible for chartering, insuring, supervising and examining Federal credit unions and administering the National Credit Union Share Insurance Fund. (p.664)

These federal regulatory relationships are summarized in **Figure 2**.



Source: From Treasury Department, "Modernizing the Financial System," February 1991.

Figure 2

Current Federal Regulation and Supervision of Insured Depositories and Their Holding Companies

Securities Firms (Investment Banks and Brokerage/Commodity/Mutual Funds)

A. Securities and Exchange Commission (SEC)

The SEC administers Federal securities laws that seek to provide protection for investors; to ensure that securities markets are fair and honest; and, when necessary, to provide the means to enforce securities laws through sanctions.

Activities (include): Full and Fair Disclosure, Regulation of Securities Markets, Regulation of Mutual Funds and Other Investment Companies, Regulation of Companies Controlling Utilities, Regulation of Investment Advisers, Rehabilitation of Failing

Corporations, and Representation of Debt Securities Holders.

The Securities Exchange Act of 1934 assigns to the Commission broad regulatory responsibilities over the securities markets, the self-regulatory organizations within the securities industry, and persons conducting a business in securities. (pp. 723-6)

B. The Commodity Futures Trading Commission (CFTC)

The Commission regulates trading on the 12 U.S. futures exchanges, which offer active futures and options contracts. It also regulates the activities of numerous commodity exchange members, public brokerage houses (futures commission merchants), Commission-registered futures industry salespeople, and associated persons, commodity trading advisers, and commodity pool operators.

The Commission's . . . efforts are designed to ensure that the futures trading process is fair and that it protects both the rights of customers and the financial integrity of the marketplace.

Futures contracts for agricultural commodities were traded in the United States for more than 100 years before futures trading was diversified to include trading in contracts for precious metals, raw materials, foreign currencies, financial instruments, commercial interest rates, and U.S. Government and mortgage securities. Contract diversification has grown in exchange trading, in both traditional and newer commodities. (p. 554)

4. Lease and Finance

Primary federal regulation is through the Securities and Exchange Commission, above. Several of the leading finance companies are supervised by the New York State Banking Department as Article 12 companies.[19]

5. Insurance

Primarily state regulation. National harmonization and regulatory coordination is exercised through the activities of the National Association of Insurance Commissioners, a group

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[19] "Comment: Banks Should Get Same Leeway The 'Parallel System' Enjoys," Martin E. Lowy, *The American Banker*, July 6, 1993, p.4.

representing insurance regulators from all 50 states.[20]

Other Regulation

Companies in the financial services arena are subject to other kinds of regulation, besides those specific to their industry. Probably the most important cross-industry regulation stems from enforcement of antitrust statutes, discussed in **Appendix A.**

[20]"Regulators Seek Tighter Rules on Insurers' Investments," Greg Steinmetz, *The Wall Street Journal*, October 25, 1993. See also, "American Insurers; Surer," *The Economist*, May 15, 1993, p. 98. and "If in Doubt, Downgrade It!" Laura Jereski, *Forbes*, January 7, 1991, p.52.

Chapter Five

Regulatory Skirmishes in the Financial Services Industry

A Sampling of Current Regulatory Disputes

1. Commercial Banks vs. the Securities Industry

The Glass-Steagall Act of 1933 attempted to separate the functions of commercial banks (commercial lending and business services) and investment banks (capital formation through underwriting large blocks of stocks and bonds). Likewise, the Bank Holding Company Act of 1956 prohibits a bank holding company from engaging in any nonbanking activity, except where the Fed, under Section 4(c)8, determines that the activity is closely related to banking.

While banks were prohibited from underwriting mutual funds under Glass-Steagall, they were allowed to sell and administer them. Over time, moreover, the Fed and the Office of the Comptroller of the Currency have loosened commercial bank securities restrictions through rulings and interpretations. In 1987 the Federal Reserve Board permitted a number of bank holding companies to establish nonbank subsidiaries ("section 20 subsidiaries") to underwrite and trade in different types of municipal revenue bonds, mortgage related securities, commercial paper, and consumer-related receivables. In April 1992 the Fed allowed bank holding companies to sell, solely as agents or brokers, shares of "proprietary mutual funds" (an investment company for which the bank holding company or one of its subsidiaries acts as an investment adviser), and to provide investment advice to customers.

The easing of restrictions on commercial banks has provoked a number of competitive and regulatory conflicts between the commercial banking and securities industries. Two of these, bank sales of mutual funds and "tying" of banking and securities services, are explored below.[21]

a. Sale of Mutual Funds

Declining interest rates on bank deposits and growth in defined contribution pension plans (as opposed to defined benefit plans) has fueled dramatic growth in mutual fund investing.

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[21]See Appendix B for further details on regulation.

Mutual funds net assets grew from $240 billion in 1981 to $1.4 trillion in 1992 and $1.9 trillion in 1993. Part of this growth came at the expense of banks: "Perhaps $500 billion of the $900 billion increase in funds assets (in the 1980s) came from savings pulled out of banks and thrifts."[22]

But banks have fought back by offering "collective investment funds," and proprietary funds. "Banks accounted for one-third of all net sales (in 1992); their funds hold 11% of mutual-fund assets, up from 2% in 1987."[23] "Banks proprietary mutual-fund assets rose from $169 billion in September 1992 to $209 billion a year later - a 24% rise compared with a 16% gain for all mutual funds over the period."[24] Banks have been expanding mutual funds sales through acquisition of mutual fund management companies.[25] This trend hit a new high in December 1993 when Mellon Bank agreed to acquire Dreyfus Corporation, a mutual fund operator, for $1.7 billion.[26]

Some banks are attempting to use their networks of Automated Teller Machines (ATMs) to pursue mutual fund customers. Since August 1993 Wells Fargo has allowed its mutual fund customers to buy and sell funds through its 1,700 ATMs. While a customer cannot initiate investment in a fund by ATM (SEC regulations require customers to see a prospectus first), existing customers can redeem shares, switch funds, or buy additional shares in an existing account.[27]

The securities industry has responded to commercial bank competition by seeking congressional and regulatory intervention. Securities firms complain that bank customers believe mutual funds sold by banks enjoy the same federal insurance protection as bank deposits. In November 1993, SEC Chairman Arthur Levitt released an SEC survey which

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[22]"American Mutual Funds: Arming," *The Economist*, May 2, 1992, p.73. See also, "Up and Up Until it Popped," *The Economist*, August 14, 1993, p.92.

[23]"Up and Up Until it Popped," *The Economist*, August 14, 1993, p.74.

[24]"Banks and Mutual Funds: Variable Pleasures," *The Economist*, November 6, 1993, p.104.

[25]"First Union to Acquire Lieber As More Banks Shop for Mutual Funds," Emory Thomas, Jr., *The Wall Street Journal*" October 19, 1993.

[26]"Mellon to Buy Dreyfus for $1.7 Billion," *The Wall Street Journal*, December 17, 1993.

[27]"Hole in the Wall," *The Economist*, September 4, 1993, p.72.

concluded that 66% of people who purchased mutual fund shares through commercial banks thought that money market mutual funds were federally insured. (It should be noted that 49% of the same respondents thought that mutual funds purchased through a stockbroker were also federally insured.)

This study led SEC Chairman Levitt to call for "two remedial actions: a physical separation of bank facilities that accept deposits from those that sell mutual funds; and a ban against banks selling funds with names that are similar to their own. . . . *Though requiring such steps by banks is outside the SEC's purview* (emphasis added), Mr. Levitt said he is working with Comptroller of the Currency Eugene Ludwig to develop more safeguards for investors who buy securities at banks."[28]

It seems likely that the SEC Chairman's effort will meet with a cool reception at the OCC. The Comptroller of the Currency, concerned about the soundness of the commercial banking sector, wants banks to have more latitude in offering "a full range of securities and investment services."[29] OCC "cheered on" commercial banks in developing proprietary mutual funds.[30]

The mutual funds issue appears to be typical of many disputes in the financial services arena. The SEC, charged with protecting investors and the soundness and integrity of the securities industry, champions the industry against competition from commercial banks. The OCC (and the Fed), charged with protecting the soundness of the commercial banking system, want banks to participate in profitable and growing financial services, such as mutual funds. Given the fragmented nature of federal regulation of financial services, the ultimate resolution of the mutual funds dispute, if there is one, will be found in the courts or Congress.

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[28]"Most Holders of Money-Market Funds Have Wrong Ideas on Bank Insurance," Christi Harlan, *The Wall Street Journal*, November 11, 1993. See also, " Many Investors Unaware of Mutual Fund Risks," Albert R. Crenshaw (Washington Post), *The Boston Globe*, November 14, 1993, "Mutual Fund Rules Mulled by Congress," Kenneth H. Bacon, *The Wall Street Journal*, October 20, 1993, and "California Banks: Home Truths," *The Economist*, August 14, 1993.

[29]"U.S. Comptroller Favors Letting Banks Sell Insurance, Other Financial Services," Kenneth H. Bacon, *The Wall Street Journal*, September 14, 1993.

[30]"American Mutual Funds: Arming," *The Economist*, May 2, 1992, p.73.

b. "Tying" of Banking and Securities Services

The Glass-Steagall Act prohibited banks, under the "subtle hazards" doctrine, from providing both commercial and investment services. The Bank Holding Company Act Amendments of 1970 prohibit the "tying" of credit to other products and services.[31] "Tying" is considered an anti-competitive practice and a violation of antitrust law.

The potential for abuse with large customers has mainly to do with illegal overlap between commercial banking and investment banking:

> The Corporate Director of Financing at a top ten Fortune service company reported that he was told by a commercial bank that the company's continued access to credit under a revolving credit agreement was dependent upon the inclusion of the bank's affiliate as co-manager on some of the company's debt issues. The company's ability to access its revolving credit line was vitally important, because the company, with approximately $10 billion in commercial paper, believed it would be unable to roll over all of its commercial paper if its rating dipped by even a single rank. Access to the line of credit was believed by the company to be critical to avoiding that possibility, and so the bank's affiliate was included as co-manager on future issues.[32]

As illustrated by the following excerpts of 1992-1993 news stories, appeals to regulatory authorities evoke different responses from different regulatory regimes.

> The (tying) issue heated up this summer (1992) when Morgan Stanley & Co. sent data on the activities of five banks to the Federal Reserve Board in response to another rule proposal. The data, according to Philip Lacovara, managing director and general counsel of the investment bank, alleged a "suspiciously high correlation" between the provision of letters of credit and underwriting services by bank affiliates. (See **Appendix B**, 3. Mutual funds/securities sales by commercial banks (Glass-Steagall Restrictions), for an explanation of the legal basis for commercial banks engaging in underwriting activities.) . . . Morgan Stanley's survey focused on negotiated municipal revenue and industrial revenue issues between January 1987 and May 1992 that were handled by J.P. Morgan Securities Inc., Bankers Trust Co., Citicorp, Chemical Bank, and Chase Manhattan Corp. In 66 deals, one or more of the banks was either lead manager or co-manager while also providing a letter of credit or other credit enhancement for the issuer. In 34 of the 66 deals, one of the banks was sole underwriter and exclusive provider of credit enhancement.

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[31]Pub. L. No. 91-607 Section 106, 84 Stat 1768, 12 U.S.C. Sections 1971-1978 (1988).

[32]Keith R. Fisher, "Reweaving the Safety Net: Bank Diversification Into Securities and Insurance Activities," 27 *Wake Forest Law Review* 1(1992), p.222. quoting Hearing before the Economic and Commercial Law Subcommittee on the Judiciary. 102d Congress, Session, 2-3,5 (1991).

Richard Breeden, Chairman of the Securities and Exchange Commission, said Congress should consider giving the right to sue to securities firms harmed by illegal bank "tying" arrangements. . . . Mr. Breeden made his recommendation in a letter to Rep. John Dingell, D-Mich., Chairman of the House Energy and Commerce Committee. . . . "Current law does not give the SEC the means to police bank 'tying' arrangements, but it does give the banking regulators authority to address such abuses," Mr. Breeden wrote. "To date, I am not aware of any such cases that have been brought by the bank regulatory agencies." He said current law permits a bank customer to sue a bank for illegal tying. But firms competing with the bank cannot sue, even though they may be affected most by tying.[33]

The Federal Reserve Board is investigating allegations that banks are illegally linking their loans to underwriting assignments, according to Fed Chairman Alan Greenspan.[34]

Federal regulators are casting a wide net to determine whether banks are illegally tying traditional lending products to investment banking assignments. Federal Reserve Board officials have met with the Securities and Exchange Commission to discuss complaints the SEC has received about the issue, Richard Roberts, an SEC commissioner, said in an interview Thursday . . . The Office of the Comptroller of the Currency confirmed this week that it is investigating charges that some banks provide letters of credit to municipal bond issuers only if these banks can participate in the underwriting. Such contingencies would violate "anti-tying" provisions of the Bank Holding Company Act of 1970.

I don't mind them (commercial banks) competing with us on a level playing field, Thomas Harris, senior managing director for Alabama-based Merchant Capital Corp., wrote Mr. Roberts in a June 2 letter. "That's where the best man wins, and we usually do, nine out of 10 times. But when they tie one service to the other, then the playing field is not level." . . . Mr. Harris also complained that, once a bank has an issuer "hostage on the credit side, they can do what they damn well want to on the other side.

Owen Carney, senior adviser for investments at the Comptroller's office, said agency employees met last week to determine the validity of such complaints. "Do the complaints warrant more inquiry?" he asked. "The answer is probably yes." However, he warned, "just offering a variety of services at one time" is not necessarily illegal.[35]

Investigators at the Comptroller's Office and the Federal Reserve Board have concluded that tying 'is not a national problem,' Mr. Ludwig said. . . Regulators found only one example of tying . . . (and) the matter was settled privately. 'If you think of the theory of tie-ins, isn't that the way we sell lots of things?' he (Mr. Ludwig) asked. 'Why isn't that

[33] "Breeden: Brokers May Need Right to Sue Banks over 'Tying'," Vicky Stamas, *The American Banker*, October 19, 1992, p.38.

[34] "Fed Probing Alleged Ties Of Loans to Underwriting," Kelley Holland, *The American Banker*, October 13, 1992, p.1.

[35] "U.S. Probing Illegal Tie-ins In Bond Deals," Kelley Holland, *The American Banker*, October 2, 1992, p.1.

appropriate in financial services?'[36]

The SEC Chairman concludes that tying is a serious problem, meriting legislation. The Comptroller (OCC) and Fed conclude that it isn't, and if it were, legislation should allow more of it. Not untypically, Morgan Stanley, an investment bank, found sympathy at the SEC, and a cold-shoulder at OCC and the Fed.

2. Commercial Banks vs. the Insurance Industry

Despite a multitude of restrictions placed on commercial banks, they have long sought expanded entry into the insurance business. Over the years, a number of states have allowed state-chartered banks to sell insurance. Rulings by the OCC on what constitutes "the business of banking," and Federal Reserve Board rulings and court decisions regarding the Bank Holding Company Act have allowed commercial banks to extend their insurance activities. (See **Appendix B**, Insurance and Annuity Sales by Commercial Banks.)

As a result, the OCC estimates that some 75 banks have the right to sell insurance in small towns across 25 states. KeyCorp plans on selling insurance in its 875 branches. Chase Manhattan now sells life insurance policies in 380 branches across four states. Norwest acquired a specialist broker of farm insurance and Chase Manhattan has entered a joint-venture with GNA Corp, an annuity and insurance broker-dealer.[37] Fleet Financial has launched a proprietary variable annuity in conjunction with American Skandia.[38]

As of 1993, commercial banks accounted for only 1% of the $84 billion life insurance premiums paid each year, but their efforts are growing. Citibank now offers insurance in 58 New York area branches. It underwrites and markets it own term insurance policies up to $250,000. It uses third-party carriers, including Prudential, for larger term policies, disability policies and variable life insurance.[39]

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[36]"Banks May Get Break on Tying Some Activities," Kenneth H. Bacon, *The Wall Street Journal*, September 22, 1993.

[37]"Banks as Insurers: An American Dream?" *The Economist*, May 8, 1993, p.84.

[38]"Banks and Mutual Funds: Variable Pleasures," *The Economist*, November 6, 1993, p.105.

[39]"Banks Push Insurance; Public May Profit," Steven Lipin and Greg Steinmetz, *The Wall Street Journal*, October 5, 1993.

While some insurance companies welcome new outlets for their products, much of the insurance industry has fought the banks' incursions both in courts and before Congress. Insurers won court reversal of major portions of a Delaware law liberalizing banking entry into insurance. They also played a critical role in defeating the Bush Administration 1991 bank reform legislation because it would have enabled banks to compete more freely.[40]

Many insurers contend that banks will succeed in selling insurance by "tying" insurance products to bank credit. (See discussion of "tying," above.) Banks contend that their commission cost for selling insurance products are much lower than those of traditional insurance companies; lower costs are reflected in lower policy premiums, thus benefiting the ultimate consumer.[41]

"Regulatory" intervention in this dispute is asymmetrical, since insurance companies are not regulated by the federal government. Insurers complain and protest to federal bank regulators, but those regulators seem disposed to letting banks sell more insurance products, not less. According to the current Comptroller of the Currency; " . . . the argument that selling insurance creates safety and soundness problems for banks simply lacks credibility, while the argument that selling insurance would benefit consumers seems virtually self-evident."[42] Given their concerns for safety and soundness of commercial banks, and given increased global banking competition, bank regulators also fear that restrictions on insurance sales put U.S. banks at a disadvantage in competing with European and Canadian banks which are not similarly restricted.[43]

In the absence of any federal agency regulating (and championing) the insurance industry, insurers wage most of their battles with the commercial bankers in Congress and the courts.

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[40]"Banks as Insurers: American Dream?" *The Economist*, May 8, 1993, 9.84. See also, "America's Banking Battles," *The Economist*, October 30, 1993, p.81.

[41]"Banks Push Insurance; Public May Profit," Steven Lipin and Greg Steinmetz, *The Wall Street Journal*, October 5, 1993, and "Bankers as Insurers; American Dream?" *The Economist*, May 8, 1993, p.85.

[42]Eugene A. Ludwig, Controller of the Currency, Remarks before the Merrill Lynch Financial Services Conference, September 13, 1993.

[43]"Time to Leave: A Survey of World Banking," Brooke Unger, *The Economist*, May 2, 1992, pp.36-42, and "Canadian Banks Set Their Sights on Insurance Business,' Larry M. Greenberg, *The Wall Street Journal*, October 28, 1993.

Chapter Six

The Parallel Banking System

Commercial Banks vs. Other Financial Services

The conflicts among commercial banks and the securities and insurance industry, discussed in the previous chapter, revolve upon market entry, a staple in regulated industry disputes. A related but separate theme of many of the policy wars in the financial services arena is the disparity between the regulatory burden of commercial banks and their nonbank competitors. This disparity has led to speculations about the emergence of a "parallel banking system," wherein banks (as insured depositaries), compete with other financial institutions under different, and purportedly unfair rules. This chapter describes some of the issues at the heart of this debate and some of the political and regulatory responses of the commercial banking sector.[44]

As mentioned earlier, commercial banks (and thrifts) benefit by virtue of federal deposit insurance. In return for their federal depositors' insurance, banks carry a substantial regulatory burden:

1. All insured banks are subject to periodic financial examination and extensive regulatory reporting procedures,

2. Insured commercial banks are subject to the Community Reinvestment Act (CRA) of 1977, designed to promote equal opportunity lending. Increasing federal emphasis on CRA and enforcement has resulted in Federal Reserve Board denial of a bank acquisitions, plus specific penalties on banks,

3. Insured banks are subject to regulator-imposed capital requirement ratios,

4. Insured banks are required to pay increasing deposit insurance premiums,

5. Commercial banks, operating under the McFadden Act, still face serious restrictions on interstate expansion. Most of their nonbank competitors do not.

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[44]For a useful summary of some of the issues involved in this debate, see "Comment: 'New Deal' Correctives Needed to Stem Risks in Free-for-All Financial System," Jane D'Arista and Tom Schlesinger, *The American Banker*, April 2, 1993, p.4, and "Comment: Banks Should Get Same Leeway The 'Parallel System' Enjoys," Martin E. Lowy, *The American Banker*, July 6, 1993, p.4.

Not surprisingly, commercial banks are unhappy with this situation. In a cry familiar to observers of other public policy arenas, banks continually campaign for "a level playing field." (The demand for "a level playing field" in other regulated sectors has become so common that one Congressman once described it, only a little cynically, as the demand for "a fair advantage.")[45] A brief look at each of these issues illustrates some of the political and regulatory dynamics involved.

Regulatory Burden: Following the collapse of the savings and loan industry, and faced with increased concerns for the health of the banking industry, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991(FIDCIA).[46] Many bankers have complained that these new regulations have increased their workload. "For more than a year, the ABA has waged a high-profile, high-stakes campaign against the increasing load of paperwork and compliance requirements that bankers say has put them at a distinct disadvantage with their competitors. No issue weighs more heavily on the minds of bankers than the regulatory burden."[47] The regulatory burden "reportedly cost American bankers $10.7 billion in 1991."[48] A number of banks have sought to switch their charters among federal and state regulators, at least partially driven by hopes of reducing regulatory costs.[49]

Community Reinvestment Act (CRA): The Community Reinvestment Act of 1977 came about as a congressional response to allegations of "redlining," the failure of banks to provide loans and other services to specific low-income and minority city neighborhoods. The CRA obligates commercial banks and thrifts to "meet the credit needs of the local community in which they are chartered consistent with the safe and sound operation of such institutions." The premise behind CRA is that public policy concerns are a proper focus for regulation of

[45] I have been unable to identify the source of this quotation. It may be apocryphal, but it has been repeated widely in the 1970s and '80s.

[46] "U.S. Comptroller Favors Letting Banks Sell Insurance, Other Financial Services," Kenneth H. Bacon, *The Wall Street Journal*, September 14, 1993.

[47] "Olgilvie Sees Victories Ahead In War on Regulatory Burden," Robert M. Garsson, *The American Banker*, November 8, 1993, p.3.

[48] "Racism? No Good Business Sense," Steve Salerno, *The Wall Street Journal*, December 12, 1993.

[49] "Continental Bank Is Seeking to Switch To a State From a Federal Regulator," Steven Lipin, *The Wall Street Journal*, November 22, 1993.

the banking industry by virtue of the fact that banks receive special advantages and subsidies from the federal government—that is, subsidization through the operation of federal deposit insurance and access to the Fed as a "lender of last resort."[50]

The CRA provides a number of enforcement and oversight mechanisms. First, it provides standing for community associations and neighborhood groups to comment on and participate in bank expansion application proceedings, including most merger and acquisition requests by depository institutions. It has been estimated that since 1978 fifteen expansion requests have been denied on CRA grounds, and that there have been fifty to sixty cases of conditional grants which imposed CRA requirements.[51] By late 1993 CRA enforcement actions were accelerating.[52]

Community activist groups often utilize the mechanism to extract voluntary concessions from banks, independent of government enforcement. For example, in late 1991, when BankAmerica Corp. sought to acquire Security Pacific Corp. to create one of the four largest banking organizations in the country, BankAmerica committed to $12 billion dollars in CRA lending over a period of ten years.[53]

The CRA also provides for periodic ratings of depository institutions compliance with the Act. The government agency charged with regulating and overseeing a particular type of depository institution must rate compliance as outstanding, satisfactory, or poor. In practice, depository institutions were required to prove the absence of discriminatory patterns of lending by maintaining appropriate documentation. For example, the Federal Financial Institutions Examination Council issued a Policy Statement in 1991 specifically requiring each depository institution to prepare analyses of the geographic distribution of credit applications,

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[50]Allen J. Fishbein, "The Community Reinvestment Act After Fifteen Years: It Works, But Strengthened Federal Enforcement Is Needed," 20 *Fordham Urban Law Journal* 293, Winter, 1993.

[51]Ibid. at 297.

[52]See, for example, "Comptroller's Office to Use Stricter Test In Probing Mortgage Discrimination," Kenneth H. Bacon and David Kansas, *The Wall Street Journal*, November 8, 1993, "Federal Regulators Draft New Rules for Community Investment by Banks," Kenneth H. Bacon, *The Wall Street Journal*, November 16. 1993 and "Lending Standard: Fed Gives Bias Laws New Clout as It Blocks A Bank Acquisition," Kenneth H. Bacon and John R. Wilke, *The Wall Street Journal*, November 17, 1993.

[53]Broderick and Teitelbaum, "Recent Developments Under the Community Reinvestment Act: 1991-1992," 48 Bus. Law. 1063 (May 1993).

denials, and extensions of credit in all of its major product lines, overlaid with demographic patterns such as income levels and minority-population densities.[54]

Critics of the CRA argue that banks have been steadily losing market share in credit and financial services to nonbank bank competitors, and that CRA shackles depository institutions with administrative costs and bad loan costs that worsen an already difficult situation. Critics note that the United States has a long history, e.g. in telecommunications and transportation, of "trying to avoid open and direct subsidies by trying instead to force regulated firms to provide the same transfers through internal cross-subsidy, policies that are more open and transparent are surely a superior form of government." Increasing competition "among banks and between banks and non-bank providers of financial services is eroding the above-normal profits that banks may have previously earned in their protected market-niches and must doom any scheme that relies on internal cross-subsidy."[55]

Capital Requirements: In 1989, as part of a worldwide effort to ensure the stability of banks, U.S. banking authorities have adopted the risk based capital standards recommended by the Basle Committee.[56] U.S. banks have encountered two major problems with adherence to these standards:

> The Federal Reserve, the OCC and the FDIC have applied them differently to the banks which each regulates. This places some banks at a competitive disadvantage with each other.[57]
>
> Despite extensive negotiations, the Basle Committee has yet to agree with the international securities industry on similar standards. As a result, commercial banks continue to face a

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[54]Ibid. at 1064.

[55]Lawrence J. White, "The Community Reinvestment Act: Good Intentions Headed In the Wrong Direction," 20 *Fordham Urban Law Journal* 281, (Winter 1993).

[56]For a fuller discussion of the Basle capital standards, see "New Tricks to Learn; A Survey of International Banking," Andrew Freeman, *The Economist*, April 10, 1993, and "Time to Leave: A Survey of World Banking," Brooke Unger, *The Economist*, May 2, 1992.

[57]"OCC Moves To Ease Capital Rules," *The FDIC Watch*, August 30, 1993, Vol. 3; No. 32; Pg. 3. Disagreements on capital standards have also become a factor in banks seeking to change their chartering authority. See, "Continental Bank Is Seeking to Switch To a State From a Federal Regulator," Steven Lipin, *The Wall Street Journal*, November 22, 1993.

competitive disadvantage vis-a-vis investment banks and brokerage houses.[58]

Deposit Insurance: Banks pay to insure their accounts. As a result of earlier bank failures, premiums paid to the FDIC have increase from 8.3 cents per $100 of deposits in 1988 to 23 cents in 1992. They may move higher. The higher premiums can place banks at a disadvantage in competing with nonbank lenders. The uniform insurance rate also divides banks against each other. Large, well capitalized banks complain that they are paying inflated premiums to cross-subsidize some of their less capable brethren.[59]

Interstate Branching: The United States' "dual banking system," whereby states and the federal government share authority for banking regulation, has hindered banks from establishing branches across state lines. The McFadden Act of 1927 requires national banks to comply with the same branching powers accorded to state banks by their own state laws. The Bank Holding Company Act of 1956 states that the interstate acquisition of banks is controlled by state law.

States also tend to prohibit "De novo" (new) entry across state lines as well. Banks generally must purchase a "going concern" to do business in another state. The result has been that larger banks doing business in a number of states normally need to operate a separate company for each state they enter, with all of the attendant administrative and legal overhead. Nevertheless, interstate expansion has continued and has been largely a matter of acquisition. In 1980, only the state of Maine permitted out-of-state holding companies to acquire its banks. By 1990, forty-five states allowed the acquisitions, with some safeguards and limitations, to take place.[60]

Bankers feel particularly persecuted on the subject of interstate branching. "Wal-Mart can go national, Merrill Lynch can go national," says John McCoy, the head of Banc One. "What's so different about banking?"[61] Dozens of other bank executives voice similar

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[58] "Comment: An Rx to Spur Global Financial Services," Gary N. Kleiman, *The American Banker*, August 9, p.19 and "Tough Time Making a Level Playing Field," Richard Waters, *The Financial Times*, May 4, 1993, p.19.

[59] "Time to Leave: A Survey of World Banking," Brooke Unger, *The Economist*, May 2, 1992, p.17.

[60] Peter S. Rose," "Interstate Banking: Performance, Market Share, and Market Concentration Issues," *The Antitrust Bulletin*, Fall 1992.

[61] "America's Banking Battles," *The Economist*, October 30, 1993, p.81.

sentiments, substituting American Express, Prudential, Fidelity, and Sears as their examples.

Banks believe that they pay a very high price for being insured depositaries. Before discussing the regulatory and political responses of the commercial banking industry to these challenges, it is worth noting that banks' insured status does have very real value; it has the effect of enabling institutions to gather funds more cheaply than if a major portion of their funds were not federally insured. Deposit insurance is "typically regarded as one of the banking industry's most powerful competitive edges as well as a government subsidy to the industry that is costing $20 billion a year.'"[62]

[62]"The Future of Banking," *Business Week*, April 22, 1991, p.72. (No source or explanation of the $20 billion is provided.)

Chapter Seven

Levelling the Playing Field: Banker Strategies

The issues discussed in **Chapters Five and Six** are central to the future of the commercial banking industry. The strategic response of various players in the industry, not surprisingly, appears to be a mixed bag. As in other regulated sectors, the industry's responses might be summarized as "escape, evasion, and entrapment." "Escape," describes efforts of bankers to avoid regulation. "Evasion," refers to bankers' efforts to remain within the system, but to move some activities beyond the grasp of regulators. "Entrapment," describes bankers' efforts to subject their competitors to their own regulatory burdens. As appropriate and relevant, each of these strategies is described in revisiting the policy issues described in the two preceding chapters.

Regulatory Burden

ENTRAPMENT: "Last week, the ABA wrote to a half-dozen key lawmakers, urging that mutual funds, insurance companies, and other financial service providers be required to make the same kind of 'truth-in-savings' disclosures as banks." [63]

ESCAPE: "The centerpiece of the ABA's efforts is a regulatory relief bill introduced by Rep. Jim Bacchus, D-Fla., and Rep. Doug Bereuter, R-Neb. The bill, which the ABA played a big role in drafting, has enlisted more than 250 co-sponsors in the House - a decisive majority of the 435-member chamber. The support is so strong that congressional sources say House Banking Committee chairman Henry B. Gonzalez, who is at best skeptical of the industry's claims, may schedule a vote on a package including regulatory relief."[64]

Community Reinvestment Act (CRA)

ENTRAPMENT: "The Chairman of the House Banking Committee and the chief executive of BankAmerica Corp. both want financial institutions other than banks to comply with the

[63]Ibid.

[64]"Ogilvie Sees Victories Ahead In War on Regulatory Burden," Robert M. Garsson, *The American Banker*, November 8, 1993, p.3.

Community Reinvestment Act. The anti-redlining law currently applies only to banks and thrifts insured by the Federal Deposit Insurance Corp. Most of them complain that the law is excessively burdensome. (Chairman Gonzalez) said the law should be amended to apply to credit unions and "nonbank" banks such as mortgage and insurance companies."

Speaking at the same conference, Richard M. Rosenberg, the chairman and CEO of BankAmerica, echoed the congressman's view. "The government should recognize the vast resources that nonbank financial institutions, which are not bound by the Community Reinvestment Act, can bring to the CRA arena," he said. "As part of any consideration of banking reforms, Congress ought to consider expanding the scope of CRA to bring these institutions under its umbrella . . . Mutual funds, finance companies, and commercial paper markets should be included in the "big tent" of the reinvestment act," he said.[65]

Rosenberg later explained, "The financial services industry is vastly different than it was in 1977, when the CRA was drafted. Sixteen years later, General Electric, Sears, and AT&T operate subsidiaries that are huge providers of consumer, real estate, and small-business credit. Mutual funds and brokerages take in billions of dollars of deposits that traditionally went to banks. In fact, nonbanking financial institutions now hold about $3 trillion in assets, about $1 trillion more than banks hold in deposits."[66] Rosenberg is not alone; "Terrence Murray, chairman and chief executive of Fleet Financial, has long criticized what he regards as a double standard. 'Why should banks be subject to CRA while Wall Street firms, insurance companies, mutual funds and other are not?'"[67]

Not surprisingly, the securities industry and its regulators are not enthused about being drawn into CRA-type regulation. "Mr. Rosenberg's comments have raised the fund industry's hackles. Matthew P. Fink, chairman of the Investment Company Institute, said his members were in an uproar when they saw a transcript of Mr. Rosenberg's remarks. "A number of Institute members, including some major bank members, were astonished," he said. "It's an

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[65]"Gonzalez, Bank of America Want CRA to Cover NonBanks, Claudia Cummings, *The American Banker*, August 26, 1993 p.1.

[66]"BankAmerica's Arguments for Putting Nonbanks Under CRA," *The American Banker*, September 28, 1993, p.12.

[67]"Lending Standard: Fed Gives Bias Laws New Clout as It Blocks A Bank Acquisition," Kenneth H. Bacon and John R. Wilke, *The Wall Street Journal*, November 17, 1993.

extreme idea," Mr. Fink added. He has pledged to fight any efforts to expand reinvestment-act requirements to mutual fund companies. The fund companies appear to have the backing of a key member of the Securities and Exchange Commission. Commissioner Mary L. Schapiro has argued that the policy reasons for imposing the act on banks simply don't apply to mutual funds. Banks are chartered to serve the needs and convenience of their communities; funds are not, she pointed out in a May letter to the Treasury Department."[68]

During Senate Banking Committee hearings in September 1993, former Securities and Exchange Commission Chairman Richard Breeden, opined that CRA "may make perfectly good sense for banks. It is a concept that is utterly foreign and almost impossible to conceive of how or why it would apply to mutual funds."

ESCAPE: During the same Senate hearings, former Federal Deposit Insurance Corp. Chairman L. William Seidman opposed the idea on different grounds. Rather than extending CRA to other sectors, commercial banks should be freed from its strictures: "CRA is antiquated, out of date, and no longer ought to apply to the banking industry either."[69]

Capital Requirements

ENTRAPMENT: All bankers support the efforts of the world's central bankers (through the Basle Committee) to arrive at capital standards that will apply to securities dealers and other financial institutions. The International Organization of Securities Commissions has rejected proposals to date, and negotiations have become enmeshed in a multitude of other issues.[70]

ESCAPE: As mentioned in **Chapter Six** earlier, a number of banks have filed to change their charters, seeking a less burdensome regulatory regime. Similarly, some banks have sought charter changes seeking better regulatory terms for capital standards. While the three federal bank regulators (the Fed, FDIC and the OCC) have moved to harmonize their capital

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[68]"BankAmerica Revives Call for Nonbank CRA," Debra Cope, *The American Banker*, September 20, 1993, p. 14.

[69]"Why Ex-Regulators Oppose Extending CRA to Nonbanks," *The American Banker*, October 5, 1993, p.12.

[70]"Comment: An Rx to Spur Global Financial Services," Gary N. Kleiman, *The American Banker*, August 9, p. 19 and "Tough Time Making a Level Playing Field," Richard Waters, *The Financial Times*, May 4, 1993, p. 19.

requirement standards, differences remain.[71]

Deposit Insurance

ESCAPE: Some bankers have suggested that the restrictions that accompany deposit insurance are so onerous that they would be willing to depart the system. Edward E. Crutchfield Jr., chairman and chief executive of First Union Corp., has stated, "This is controversial to say, but for myself, I would be willing to give up deposit insurance . . . I would give it up if banks, in return, were allowed to compete virtually unrestricted for any and all financial services."[72] "Several years ago, Chase threatened to turn in its charter and operate as a financial services company. Chase officials charged that its income from deposit-taking had declined while profits from other activities such as credit cards and foreign exchange had escalated. The banking company launched an extensive and expensive study on the worth of its charter. So far, Chase has opted to remain a bank."[73]

EVASION: "J.P. Morgan and Republic, two of the nation's strongest banks, have issued uninsured notes that are similar to deposits. The market interest rate is slightly higher, but the overall cost of such notes is lower because they incur no FDIC premium."[74]

Interstate Branching

ENTRAPMENT: The uncertainties surrounding the interstate branching powers of thrifts created a controversy in January 1992. The Office of Thrift Supervision published a draft proposal allowing federally chartered thrift institutions to branch across state lines, regardless of state law. The Independent Bankers Association of America (IBAA) and other bank groups protested strenuously. A group of 19 Senators, supporting the IBAA, wrote the Director of OTS to object. "The Senators did not contend that the OTS lacks legal authority to adopt the

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[71]"OCC Moves To Ease Capital Rules," *The FDIC Watch*, August 30, 1993, Vol. 3; No. 32; Pg. 3. Disagreements on capital standards have also become a factor in banks seeking to change their chartering authority. See, "Continental Bank Is Seeking to Switch To a State From a Federal Regulator," Steven Lipin, *The Wall Street Journal*, November 22, 1993.

[72]"First Union's Crutchfield Confident Of Victory in Struggle with Nonbanks," Kenneth Cline, *The American Banker*, September 16, 1993.

[73]"Butcher: Banks Tied to Charters By LDC Debt," Barbara A. Rehm, *The American Banker*, November 18, 1988, p.2.

[74]"Time to Leave: A Survey of World Banking," Brooke Unger, *The Economist*, May 2, 1992, p. 17.

proposal," but they said, "we believe it is imprudent for the OTS to exercise that authority."[75]

ESCAPE: Large banks and federal banking legislators continue to seek legislation to allow unlimited interstate branching.[76] Many small banks continue to resist, supported by much of the insurance industry. Recent legislative proposals by the Clinton Administration would liberalize interstate branching rules, but they fall far short of bankers' hopes. War on the legislative front will continue.[77]

EVASION: Thrift institutions potentially can engage in unlimited interstate branching. Wells Fargo, the nation's seventh largest commercial bank, recently explored the possibility of converting to a thrift charter. One of the conjectured rationales was that the conversion would facilitate nationwide branching. Reportedly, Wells abandoned its plans because bank "regulators feared that a charter conversion by such a prominent bank could start a stampede by other banks and raise the ire of Congress."[78]

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[75]"Geographic Expansion: Senators, Trade Groups Attack OTS Proposal On Interstate Branching," *Banking Policy Report*, February 17, 1992, p.8.

[76]"Congress Opens Hearings on Interstate Branching With Fed Endorsement," *Banking Policy Report*, Vol. 12 No. 13, July 5, 1993.

[77]"America's Banking Battles," *The Economist*, October 30, 1993. See also, Kenneth H. Bacon, *The Wall Street Journal* "Clinton Backs Bank Policy That Includes Nationwide Branches, Help Overseas," October 22, 1993, "Bentsen Wants Law Aiding U.S. Banks And Other Financial Firms Overseas," October 26, 1993, "Administration Proposes Combining Four U.S. Agencies' Banking Functions," November 24, 1993.

[78]"Wells Planned Switch To a Thrift Charter; Dropped Idea When Regulators Balked," Robyn Meredith, *The American Banker*, October 29, 1993, p.1.

Chapter Eight

Regulating Derivatives Trading

Regulators vs. the Financial Services Industry?

While the traditional regulatory battles over interstate banking, securities dealing, etc., continue, the 1990s has witnessed the emergence of a major new topic in financial services regulation: What is to be done in regulating derivatives? The explosion of new derivative products has highlighted the fragmentation of the federal regulatory structure for the financial services industry. Efforts to revise regulatory oversight of the derivatives market may change the entire regulatory game.

Background

Christi Harlan of *The Wall Street Journal* provides the following overview:

> Derivatives are financial arrangements whose values derive from some underlying asset, such as stocks, bonds, currencies or commodities. So-called over-the-counter derivatives are traded privately among banks and their large customers — mainly corporations and big institutions — and essentially are exempt from regulation. The CFTC, meanwhile, regulates certain exchange-listed derivatives contracts, including financial futures and commodity futures.
>
> In struggling to come to grips with the multitrillion-dollar market in private derivative contracts, U.S. regulators have been frustrated by the fact that these instruments fall under nobody's clear jurisdiction. Because they combine traditional assets in complex, new ways, they span territory policed not only by the CFTC, but also by federal banking, securities and insurance regulators. And the highly flexible, global nature of the derivatives markets means that any crackdown by U.S. regulators would risk merely driving that activity beyond their reach into offshore markets, said John M. Damgard, president of the Futures Industry Association, a Washington trade group.
>
> Meanwhile the SEC's Mr. Beese . . . disputed critics who have called derivatives 'the next S&L crisis.' 'While there certainly are lessons to be learned from prior experiences, there are "cops on the beat" with regard to derivatives,' Mr. Beese said. The SEC, CFTC, Federal Reserve, Comptroller of the Currency and Federal Deposit Insurance Corp. 'All have rigorous regulatory regimes.'
>
> Others emphasized the need for greater international coordination among regulators. 'My members are doing business all over the world,' he (Mr. Damgard) said. 'Regulators need

to be very, very conscious of what their counterparts around the world are doing.'[79]

Current Regulation of Derivatives

Commodities and Futures Trading Commission (CFTC)

While an ever greater number of financial institutions move into derivatives trading, the regulatory scene is confused at best. As Ms. Harlan noted above, "The CFTC . . . regulates certain exchange-listed derivatives contracts, including financial futures and commodity futures," but over-the counter trading is exempt from regulation. Chicago's futures exchanges have been seeking a similar exemption, claiming that regulation and reporting requirements put them at a disadvantage in competing with OTC rivals.[80]

The CFTC's budget and stature have not matched the growth of the derivatives markets. It's very existence has been in question for years. It has been accused of being too closely linked with the exchanges it regulates, and not sufficiently knowledgeable of the fast-moving derivatives business. As of November 1993, it had no chairman and only two of its normal four commissioners, both holdover Republicans, because the Clinton Administration has failed to name replacements. *The Economist* called CFTC "toothless watchdogs."[81]

Securities and Exchange Commission (SEC)

The 1990 collapse of securities house Drexel Burnham Lambert heightened concerns about the regulation of derivatives trading. In 1992 the SEC won the right to examine the affiliates of securities houses dealing in the instruments.[82] Former SEC Chairman Richard Breeden sought broader authority; Breeden "thinks futures and cash markets should be supervised by one body to avoid risks of regulatory arbitrage. His bid to grab regulation of derivatives

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[79]"CFTC Ducks the Issue of How to Regulate Derivatives," Christi Harlan, *The Wall Street Journal*, Oct. 27, 1993.

[80]"CFTC Stalls Over Regulation Until Reinforcements Arrive," Laurie Morse, *The Financial Times*, November 1, 1993.

[81]"Toothless Watchdogs," *The Economist*, October 9, 1993, p.86. See also, "Departing Regulator," *The Economist*, January 16, 1993, p.72. and "CFTC Stalls Over Regulation Until Reinforcements Arrive," Laurie Morse, *The Financial Times*, November 1, 1993.

[82]"SEC Seeks Comment on Capital Rules," Martin Dickson, *The Financial Times*, May 6,1993, p. 26.

markets from the CFTC upset the Chicago futures exchanges, the CFTC and influential congressmen." Breeden's successor, Arthur Levitt, had not taken a position on the subject as of October 1993.[83]

The SEC has attempted to write new capital rules for derivatives. "In May (1993), the SEC outlined an approach that would allow capital requirements to be set according to the net exposure dealers face in their entire derivatives portfolio . . . " The effort has been delayed continually as industry participants, particularly the Chicago Board Options Exchange and the Securities Industry Association, request more time to respond to the agency's proposal. Progress will be slow because the SEC's proposal "involves many market participants outside the agency's direct line of oversight."[84]

Bank Regulators (FRB, OCC, FDIC)

Banks have vastly increased trading in over-the-counter (OTC) derivatives, with a small group of large bank-holding companies dominating the business. "The seven biggest players account for about 90% of all American Bank exposures. These banks have derivatives contracts equivalent to, on average, to twice their capital (though the current cost of replacing the contracts, not their size, is the measure of banks' true risk)."[85] While no one has documented a derivatives disaster that has threatened insured banks, banking regulators "fret about the prospect of a financial meltdown with an out-of-control derivatives operation as the hot core. Their instincts tell them banks need more capital protection."[86]

An October 1992 derivatives study by the Basle Committee urged "banks to improve their risk management and regulators to get tougher." A joint study by the Fed, OCC and FDIC, submitted to Congress in February 1993, "gave banks' derivatives operations a cautious thumbs-up" and concluded new legislation is not required.[87] A September 1993 study by the

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[83]"Departing Regulator," *The Economist*, January 16, 1993, p.72, and "Toothless Watchdogs," *The Economist*, October 9, 1993, p. 86.

[84]"Derivatives Rule Stalled at the SEC," *The FDIC Watch*, September 27, 1993, p. 4.

[85]"Derivatives: Stop Swapping?" *The Economist*, March 13, 1993, p.94.

[86]"New Tricks to Learn; A Survey of International Banking," Andrew Freeman, *The Economist*, April 10, 1993, p. 34.

[87]"Derivatives: Stop Swapping?" *The Economist*, March 13, 1993, p. 94.

Group of 30 (G30) concluded that the hedging quality of derivatives actually helped to reduce risk in the banking system.[88] In October 1993, the Treasury undersecretary for domestic finance said, "concerns that derivatives could perpetrate a financial meltdown are overblown."[89]

While these comments suggests that most financial regulators have a fairly sanguine view of the derivatives business, there are notes of concern among even the most relaxed:

> The financial services industry has a history of excesses. Third World loans, realty lending and junk bond purchases were profitable businesses for some of the sophisticated lenders who were early entrants in these markets. Seeing rivals profiting in these fields, smaller and less sophisticated lenders rushed in. As lending competition increased, both early entrants and the late arrivals piled on riskier deals, with the inevitable defaults. Regulators worry that this pattern could be repeated in the derivatives market.
>
> Derivatives trading is complex. Trading institutions need very sophisticated information systems to track, assess, and simulate their market exposures. Regulators are concerned that (1) some new entrants lack the information systems required to play in the derivatives market, and (2) the mushrooming derivatives market may be moving faster than the information systems of even sophisticated dealers.[90]

Time for Reregulation?

Many members of Congress, international bank regulators, and other observers are not reassured by these studies, or the SEC's Mr. Beese's conclusion that "there are cops on the beat."[91] At a conference in London in October 1993, Henry Kaufman said that "derivatives pose real threats. A troubled bank or broker might fail and trigger a chain-reaction through the financial system. The implications are ominous, not least for the ability of governments to conduct an effective monetary policy." Mr. Kaufman called for "a complete overhaul of regulation which recognizes the international nature of much financial activity, including

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[88]"Derivatives: Profit of Doom," *The Economist*, October 23, 1993, p. 97.

[89]"U.S. Issues Guidelines on 'Derivatives' Obliging Banks to Mull Customer Needs," Kenneth H. Bacon, *The Wall Street Journal*, October 28, 1993.

[90]"Time to Leave: A Survey of World Banking," Brooke Unger, *The Economist*, May 2, 1992, p. 17, and "Derivatives: Stop Swapping?" *The Economist*, March 13, 1993, p. 94.

[91]"CFTC Ducks the Issue of How to Regulate Derivatives," Christi Harlan, *The Wall Street Journal*, Oct. 27, 1993.

derivatives."[92]

Kaufman's concerns are shared by Bundesbank president Hans Tietmeyer. "EC guidelines on capital adequacy for banks and securities houses represent a compromise at the level of the lowest common denominator," Tietmeyer said. The guidelines, passed in March, are intended to limit market risks in derivatives business from 1996 by imposing minimum capital requirements. "We very much hope the Basle Banking Supervisory Committee and the International Organization of Securities Commissions still bring stricter common recommendations into effect in the end."[93]

Many members of Congress, still paying the multibillion dollar bill for the savings and loan bail-out, share these concerns. Representative Jim Leach is "preparing legislation to tighten regulation of derivatives." Mr. Leach's legislation would establish "a new interagency commission to develop comparable accounting, capital and disclosure rules for the banks, brokerage firms and insurance companies that deal in derivatives."[94] Senator Riegle, chairman of the Senate's banking committee, continually has questioned the adequacy of federal regulation of banks' derivatives operations.[95]

Barring a derivatives trading disaster, it is impossible to predict when and how Congress might move. Obviously the timing and direction of new legislation depends partially on the resistance of the financial services industry and its current regulators.

Commercial banks and the securities industry have voiced concerns about Congress and regulators "micromanaging" a growing and, thus far, highly profitable business. The insurance industry worries about adding a new layer of federal regulation. A spokesman for the OCC has already noted that Leach's recommendations are "very clear departures" from those made by the comptroller and other bank regulators.[96] The Federal Reserve has stressed

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[92]"Derivatives: Profit of Doom," *The Economist*, October 23, 1993, p. 97.

[93]"Tietmeyer Wants International Rules on Derivatives," *Reuters*, BC Cycle, October 15, 1993.

[94]"Congress Is Getting Serious About Rules for Derivatives," Kenneth H. Bacon, *The Wall Street Journal*, November 23, 1993.

[95]"Derivatives: Stop Swapping?" *The Economist*, March 13, 1993, p.94.

[96]"Congress Is Getting Serious About Rules for Derivatives," Kenneth H. Bacon, *The Wall Street Journal*, November 23, 1993.

the need for "broader international efforts to improve information about OTC derivatives. Decisions about any new rules will come later."[97] Some representatives of the commodities industry "now murmur that life might be simpler with a single super-regulator for all financial markets."[98]

There is little evidence in reports to date to suggest the emergence of a broad consensus on legislative action.

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[97]"Derivatives: Stop Swapping?" *The Economist*, March 13, 1993, p.94.

[98]"Toothless Watchdogs," *The Economist*, October 9, 1993, p.86 and "Departing Regulator," *The Economist*, January 16, 1993, p. 72.

Chapter Nine

Legislative Rationalization of Financial Services Regulation

Launching new legislative initiatives in any area invites lobbying efforts to use the new legislation as an opportunity to refight other issues. In November 1993 the Clinton Administration proposed legislation to restructure bank regulation at the federal level. The proposed legislation was drawn quite narrowly, reportedly with a view toward avoiding some older financial services disputes. The simple existence of an administration banking bill, however modest, has already triggered alternative and more aggressive proposals.[99] Whether in reaction to the Administration's proposal, or as part regulators' own efforts to regulate derivatives trading, it seems likely that the entire regulatory regime for the financial services arena will continue to be up-for-grabs in the mid-1990s.

Part of the ongoing legislative debate will be the need to "rationalize" and "consolidate" financial services regulation. While proposals to "rationalize, consolidate and simplify" the existing fragmented structure may sound logical, all the players can be expected to approach them with caution or active resistance. Even the modest proposals of the Administration to "consolidate" banking regulation have evoked resistance from the Federal Reserve and the Independent Bankers Association. It is not accidental that nine attempts to consolidate bank-regulatory agencies since World War II have failed.[100]

Proposals for more ambitious plans to consolidate all financial services regulation in a single agency face at least three enormous hurdles:

1. The industries to be regulated, whether happy or unhappy with the current regime, would face tremendous uncertainties in any new plan. Would commercial banker interests dominate the new agency, to the competitive detriment of insurers and securities brokers?

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[99] "America's Banking Battles," *The Economist*, October 30, 1993. See also, Kenneth H. Bacon, *The Wall Street Journal* "Clinton Backs Bank Policy That Includes Nationwide Branches, Help Overseas," October 22, 1993, "Bentsen Wants Law Aiding U.S. Banks And Other Financial Firms Overseas," October 26, 1993, "Administration Proposes Combining Four U.S. Agencies' Banking Functions," November 24, 1993.

[100] "Administration Proposes Combining Four U.S. Agencies' Banking Functions," Kenneth H. Bacon, *The Wall Street Journal*, November 24, 1993.

Would a consolidated regulatory structure enhance competitors' abilities to entrap other players in regulatory proceedings? Would a new agency favor big players at the expense of small ones? Would a single agency, confronted with a massive array of issues and conflicting interests become a monument to bureaucratic paralysis, hindering all U.S. financial services firms in the international market? Would concentration of regulatory authority concentrate the risk of making a disastrous mistake, compared to the current decentralized system?[101]

2. Existing regulatory agencies will not be anxious to be consolidated and simplified into oblivion. One need not be a devotee of C. Northcote Parkinson, Aaron Wildavsky and other scholars of bureaucratic behavior to guess the regulators' reactions. They will find scads of reasons, many of them good ones, to protect the *status quo*.

3. Congress, itself, has many incentives to maintain the current fragmented regulatory structure. Moving issues from the legislative arena to a regulatory one reduces the importance of Congress, its myriad committees and subcommittees, and individual members. In the House of Representatives, for example, jurisdiction for different sectors of the industry is spread across multiple committees. The Committee on Agriculture overseas the commodities exchanges. The Committee on Banking, Finance and Urban Affairs (Rep. Henry B. Gonzalez, Chairman), oversees depositary institutions through the Subcommittee on Financial Institutions, Regulation and Deposit Insurance (Rep. Stephen L. Neal, Chairman), and the Subcommittee on Consumer Credit and Insurance (Rep. Joseph P. Kennedy, Chairman). The Committee on Energy and Finance (Rep. John Dingell, Chairman) and the Subcommittee on Telecommunications and Finance (Rep. Edward J. Markey) are responsible for legislation concerning the SEC and the securities industry.[102]

This is only a sampling. A host of other committees and subcommittees would be involved, at least tangentially, in any serious effort to consolidate and rationalize regulation of financial services; the scene in the Senate is only slightly less convoluted. It does not take a specialist in congressional politics to understand that none of the aforementioned chairmen

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[101]For some of the conflicting arguments over the risks of overcentralizing U.S. banking regulation, see: "The Blob That Killed Bank Reform," Robert B. Glauber, *The Wall Street Journal*, December 13, 1993. "No Single Regulator for Banks," Alan Greenspan, *The Wall Street Journal*, December 15, 1993. "Piecemeal Banking Control," Taegan D. Goddard and "The Real Issue in Whitewater," David Warsh, *The Boston Globe*, January 11, 1994.

[102]*1993 Congressional Staff Directory/1*, Staff Directories, Ltd., Mount Vernon, VA, 1993.

will happily and voluntarily surrender, or share, his jurisdiction in the name of some vaguely more desirable goal of "consolidation, rationalization or simplification."

All the politicians and bureaucrats involved will be only too happy to hold hearings on a slew of legislative proposals in this sector. After all, "there are powerful incentives for politicians and regulators - like dishonest stockbrokers - to churn the account, changing the rules on a regular basis to maintain their power. Change, not stability, creates political power. . . . it creates winners and losers. Without winners to appeal to and losers to placate, there is no need for political action."[103]

Proponents of massive re-regulation of the financial services industry seem destined for disappointment, barring a calamity in the industry.

[103]"The Iron Law of Public Policy," Robert W. Poole, *The Wall Street Journal*, August 4, 1986, in a review of Robert A. Leone, *Who Profits: Winners, Losers and Government Regulation*, Basic Books, New York, 1986.

Appendix

Appendix A

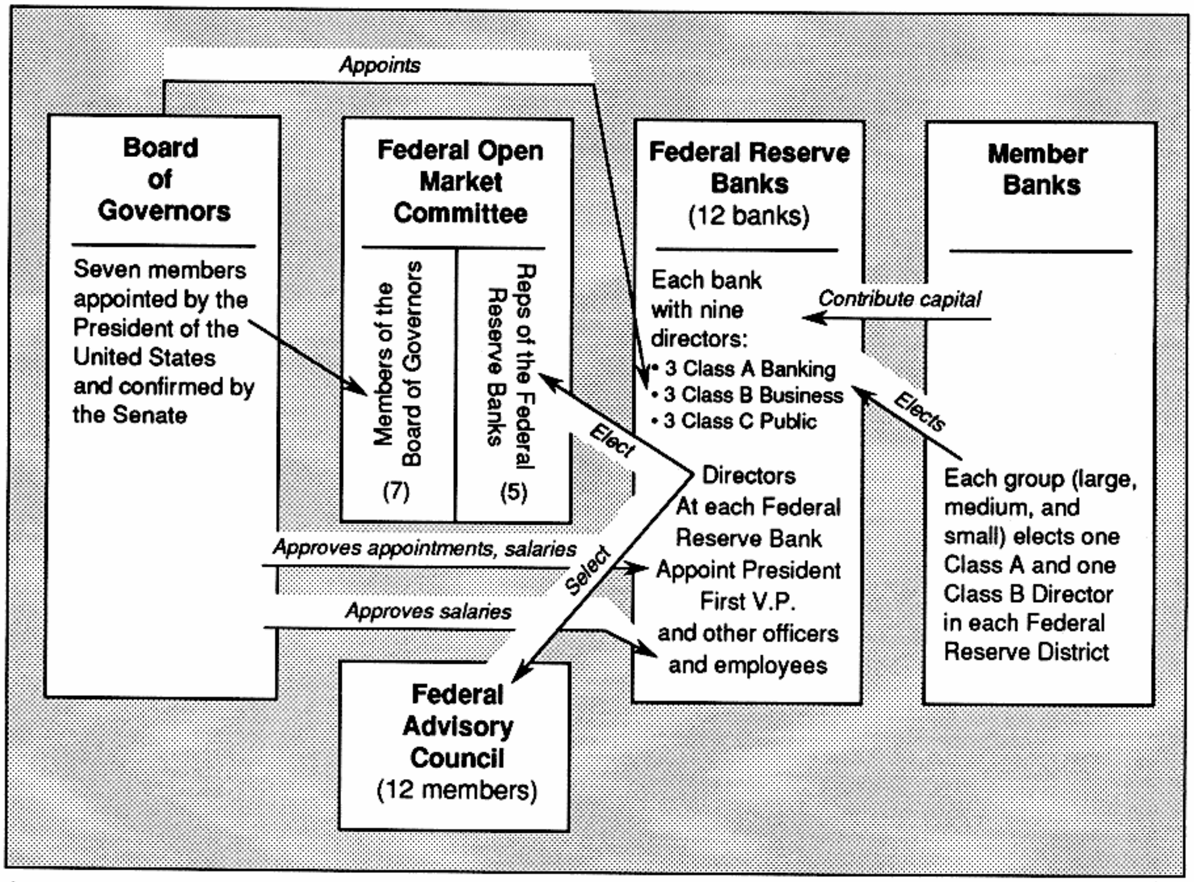
Basic Regulation: Regulators and Their Roles

1. The Federal Reserve System (The Fed)
2. The Federal Deposit Insurance Corporation (FDIC)
3. The Office of The Comptroller of The Currency (OCC)
4. The Office of Thrift Supervision (OTS)
5. The Department Of Justice (DOJ) Antitrust Division
6. The Securities Exchange Commission (SEC)
7. The Commodity Futures Trading Commission (CFTC)
8. State Insurance Regulators

The Federal Reserve System

The Federal Reserve System in effect sets monetary and economic policy, regulates and facilitates the flow of credit, and supervises the banking industry in the United States. The Fed is designed to be insulated from political pressure. It sets monetary and economic policy independent of the President or Congress. In many other countries, central bankers cannot set interest rates without the approval of political bodies. The Bank of England, for example, cannot raise interest rates without approval from the Cabinet of the Prime Minister. The same general relationship between elected politicians and the central bank exists in Japan, France, and Italy. Germany, in contrast is patterned on the American model.[104]

[104] William Greider, *Secrets Of The Temple: How The Federal Reserve Runs The Country*, Simon and Schuster, Inc. New York, 1987, p.51.



Source: Board of Governors of the Federal Reserve System, *The Federal Reserve System: Purposes and Functions*, Washington D.C., 1963, p.23.

Figure A-1

The Federal Reserve System: Organization

Congress established The Federal Reserve System with the Federal Reserve Act of 1913 in order to furnish an elastic currency, to facilitate rediscounting of commercial paper, and institute more effective banking supervision.[105] From the very beginning, however, there was an understanding that the Federal Reserve had broader objectives: "to help counteract inflationary and deflationary movements, and to share in creating conditions favorable to a sustained, high level of employment, a stable dollar, growth of the country, and a rising level of consumption."[106]

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[105]Pollard, Ellis, and Daly, *Banking Law In The United States*, Butterworth Legal Publishers (1993) p.4-11.

[106]*The Federal Reserve System: Purposes and Functions*, Board Of Governors of The Federal Reserve System, Washington, D.C. 1963 p.1.

The Fed is a hybrid entity, a combination of government and private interests, and has always been a controversial institution. Critics have challenged its constitutionality, its independence from elected government, its secrecy, and its right to exist.

Early drafts of the Federal Reserve Act sought to create a "privately controlled network of regional reserve banks that would be given governmental powers."[107] President Woodrow Wilson accepted the basic architecture of those proposals with one critical difference. He proposed that there be a Federal Reserve Board in Washington that would be appointed by the President to represent the public interest (and also guarantee that the President had some power to make monetary policy). Another compromise was struck by creating regional banks to be a part of the Fed, thereby at least in theory limiting the power of eastern money center banks.

The Federal Reserve System includes:

- The Board Of Governors, made up of seven members who are appointed by the President, confirmed by the Senate, and serve 14 year terms. The Board regulates all aspects of bank holding company activities including chartering, new lines of business (both banking and nonbanking) and mergers and acquisitions, essentially placing the Board at the hub of regulation for the largest banking institutions in the U.S..The Board performs an oversight role in the inspection and examination of banks, although it relies heavily on both state agencies and the Office of the Comptroller of the Currency.The Board has the power to pursue criminal penalties. It administers a variety of consumer protection laws such as the Truth in Lending Act, the Mortgage Disclosure Act, and the Equal Credit Opportunity Act. The Board oversees foreign banking activities in the U.S. along with the comptroller of the Currency and also U.S. bank holding company activity overseas.

- Twelve Federal Reserve Banks situated in most of the major cities in the United States with nine directors in each bank. In a complex arrangement some directors are appointed by the Board of Governors, and some are elected by private member banks.

- The Federal Open Market Committee which includes the seven members of the Board Of Governors, and five representatives of the Federal Reserve Banks. Core questions of regulating the money supply are debated and voted on in the FOMC.

- The Federal Advisory Council, made up of twelve bankers, elected by the member banks in each federal reserve district. They meet in secret with the Federal Reserve Board four times a year to discuss Fed policy and how it should change.

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[107]William Greider, *Secrets Of The Temple: How The Federal Reserve Runs The Country*, Simon and Schuster, Inc. New York, 1987, p.277.

- Member Banks of the Federal Reserve System.

The Fed influences and regulates the overall expansion of debt, the supply of money, and the total reserves of the banking system with three major levers.

1. Each bank is required to hold a proportion of its total deposits in reserve, which must be deposited at one of the twelve Federal Reserve Banks or held as cash in the bank's vault.

2. The Fed lends directly to banks through the discount window at one of the Federal Reserve Banks.

3. The Fed purchases and sells U.S. government securities at the Open Market Desk at the New York Federal Reserve Bank.

The Fed has been accused by some as being partisan, a protector of the interests of the large commercial banks which are regulated by it. Some of the most severe criticism of the Fed has come from Nobel Prize winning economist Milton Friedman who believes that banking has been a highly protected and sheltered industry because the banks have been the constituency of the Federal Reserve. He has stated:

> The Federal Reserve System is a political institution, and like every political institution, it is seeking to retain its own power, its own decisions, its own prestige. To what end do politicians want to maintain their positions? To what end does a CEO of a business concern want to run that concern for profit? Because the coin he is interested in is both income and power. In the same way, people who are in the Fed want to maintain their position. Their coin is influence and power.[108]

Defenders of the Fed point out that it has been one of the most stable of Federal regulatory institutions ever created, surviving more or less intact since 1913. They offer the fact that there has not been another great depression or a major run on banks in over fifty years.

Champions of the Federal Reserve, and of central banking systems generally, have expressed concerns that the declining role of commercial banks in the financial world limits government

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[108]Ibid. p.92-93.

influence over monetary policy.[109] Others think that the Fed and other central bankers do not understand that the current financial system has already outrun the central bankers ability to manipulate monetary supplies. Walter Wriston, former Chairman and CEO of Citicorp wrote in 1992:

> For better or worse, the day is long past when a little club of central bankers can affect a currency's value on anything but a monetary basis. If it wasn't clear before, it is now, thanks to the near-collapse last week of Europe's troubled system of economic coordination, marked by the inability of Britain and Italy to defend the value of their currencies.
>
> When foreign exchange markets were small, a relatively large buy or sell decision of central banks could influence prices, but today the global market is so huge and so integrated that a day's transactions overwhelm any efforts to control prices. Indeed, a brand new international monetary system has been created.
>
> No matter what formal decisions a government makes, the 200,000 screens in the world's trading rooms will light up, the news will march across the tube, traders will make judgments and a value will be placed on a currency that will be known instantly all over the globe. Traders at their screens, examining America's policies, will continue to determine what the dollar is worth.[110]

The Federal Deposit Insurance Corporation

The FDIC was created after the 1929 stock market crash, and the subsequent suspension of operations of over 9,000 banks as depositors sought to withdraw their money. The primary purpose of the quasi-governmental body is to ensure the public's confidence that its deposits are safe in banks through a system of insurance of bank deposits and increased supervision.

When deposit insurance was first instituted in 1934, deposits were insured up to $2500. Deposits are now insured up to as much as $100,000. Significant commentators have noted that in effect "deposit insurance has evolved from small depositor protection to almost universal protection of all depositors,[111] marking a fundamental change in the function of

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[109] "Derivatives: Profit of Doom," *The Economist*, October 23, 1993, p.97 and "Tietmeyer Wants International Rules on Derivatives," *Reuters*, BC Cycle, October 15, 1993.

[110] "The Decline of the Central Bankers," Walter Wriston, *The New York Times*, September 22, 1992.

[111] "Bank Capital: Lessons from the Past and Thoughts for the Future," Wayne D. Angell, 27 *Wake Forest Law Review* Number 3, Fall 1992 p.66. Remarks by Wayne D. Angell, Member, Board of Governors of the Federal Reserve System.

bank capital. Prior to the creation of the FDIC, sufficient bank capitalization was the only factor that could protect a depositor, a system that weathered a number of significant depressions before the Great Depression of 1929 did its damage.

As modified in the Financial Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the FDIC is managed by a five member Board of Directors comprised of the Comptroller of the Currency (OCC), the Director of the Office of Thrift Supervision (OTS), and three members appointed by the President.

The FDIC does not insure banks, it insures depositors. But in order to exercise that duty it must evaluate the institutions it will insure for safety, soundness, and proficiency of management. Once a bank is chartered by federal or state authorities, a bank must obtain a certificate of insurance from the FDIC and demonstrate the history and skills of the management team, ability to meet community needs, and future prospects — or it may not operate.

The Federal Deposit Insurance Corporation Improvement Act of 1991 significantly changed the role of the FDIC, and substantially eroded the "dual banking system" of federal and state regulation. This centralization of power came about as a result of the Savings and Loan Crisis of the late 80s, and the painful lesson that the federal taxpayer is the ultimate insurer of bank deposits.

The FDIC was given the authority to:

override powers authorized for state-chartered banks either by legislators or regulators,
have standby authority for enforcement actions if another agency fails to act,
receive audit reports of bank compliance with federal law,
oversee capital at banks,
act on greatly expanded grounds to place a bank in conservatorship or receivership,
set standards for banks ranging from credit criteria to compensation guidelines,
take on new powers and responsibilities in chartering decisions.

The Office of The Comptroller of The Currency (OCC)

The Office of the Comptroller of the Currency (OCC) is part of the Treasury Department, and is the oldest federal banking regulator in the United States, instituted as part of the National Currency Act of 1863. The Comptroller is appointed for a five year term. Since the creation of the Fed, the OCC has had a much diminished role regarding the issuance and regulation of currency, and has been primarily responsible for the general administration of the national banking laws and may prescribe rules and regulations governing the chartering, business practices, supervision, and dissolution of national banks. The OCC has a staff of over 2,000 bank examiners located in six district offices which perform the key function of examining national banks.

The Office of Thrift Supervision (OTS)

As a result of the Savings and Loan debacle of the late 1980's, the Office of Thrift Supervision (OTS) and the Resolution Trust Corp (RTC) were created by the Financial Institutions Reform, Recovery, and Enforcement Act of 1991 (FIRREA).

FIRREA abolished the Federal Home Loan Bank Board, and OTS became the overseer of the Federal Home Loan System which charters and supervises federal savings and loan associations. OTS also became the operating head of the Savings Association Insurance Fund (SAIF) which replaced the Federal Savings and Loan Insurance Corp (FSLIC). OTS was established under the Authority of a Director, as a bureau of the Treasury Department. Its mission is to regulate both federal and state chartered associations.

The RTC was established to resolve all savings and loan associations that fell through August, 1992. The time period was then extended to October, 1993.

The Department Of Justice (DOJ) Antitrust Division

The Department of Justice performs a significant role in governmental review of potential anticompetitive effects of proposed bank mergers and acquisitions.

The DOJ reports that it reviews between 1,300 and 2,000 transactions each year — virtually every proposed bank, thrift, or bank holding company merger, consolidation or acquisition, including RTC and FDIC transactions involving failed or troubled institutions.[112]

Many issues concerning competition are the mutual responsibility of the DOJ and bank regulatory agencies. The DOJ notes that it "has made substantial efforts to establish and maintain good working relationships with bank regulatory agencies to facilitate effective and coordinated review of bank mergers."[113]

Most issues are settled during the agency review process where the DOJ may advise that a transaction is likely to be approved if certain branches, loans, or assets are divested.

The DOJ and bank regulatory agencies don't always agree, however, and those cases may become the subject of investigation, advisory letters, or a filed complaint. Some recent examples, where the Federal Reserve Board approved and the DOJ opposed proposed mergers, are First Hawaiian, Inc. and First Interstate of Hawaii; Society Corporation and Ameritrust Corporation; and Fleet/Norstar Financial Group, Inc. and New Bank of New England.[114]

On April 2, 1992 the DOJ and the FTC published their "Revised 1992 Horizontal Merger Guidelines" which describe a five step analytic framework for review. The first three steps are:

1) product and geographic market definition and measurement of concentration;
2) possible anticompetitive effects of the acquisition in the defined markets;
3) analysis of entry and its potential market effects.

Step three and four take into account possible justifications for mergers presumed to be otherwise anticompetitive:

4) "efficiencies" analysis — the theory that a merger benefits society if it results in an efficiency such as an increase in competitiveness, reduction of operating costs, better new

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[112]Guerin-Calvert and Ordover, "The 1992 Agency Horizontal Merger Guidelines and the Department of Justice's Approach to Bank Merger Analysis," *The Antitrust Bulletin* VOL. XXXVII, No. 3 Fall 1992 p.669.

[113]Id.

[114]Sunshine, "Clearing a Bank Merger Through The Department of Justice: The 1992 Horizontal Merger Guidelines," *The Banking Law Journal* May-June 1993, p.189.

product development, lower prices, or increased consumer choice;

5) "failure" analysis — where a firm is unlikely to be able to meet its financial obligations in the near future, has no hope of successful reorganization, no less anticompetitive purchaser is available, or key tangible and intangible assets of the failing firm will exit the relevant market.

The Securities Exchange Commission

The Securities and Exchange Commission provides a much more limited supervision over markets than banking and thrift regulatory agencies provide to banks. It is assumed that investors should take their own risks, that they understand that they are taking a calculated risk in hopes of a greater return, and that government should have minimal involvement.The major thrust of securities regulation is registration and disclosure, enforced by the SEC and private lawsuits.

The current system of regulation provides for[115]:

statutory registration and disclosure disciplines to enforce more complete, accurate information for market participants,

SEC supervision and regulation of the disclosure process, the stock exchanges, over-the-counter market, and National Association of Securities Dealers (NASD),

enforcement of disclosure and anti-deceptive practice disciplines by the SEC and private litigation.

Securities are defined under the Securities Act of 1933 as shares of stock, bonds, debentures, evidence of indebtedness, certificates of interest or participation in profit-sharing agreements, investment contracts, variable annuity contracts, mutual fund shares, fractional undivided interests in oil, gas, or other mineral rights, or rights and warrants to obtain or purchase any of the foregoing.

The Fed does have some regulatory power through the Margin Requirements Act. The crash of 1929 was aggravated by heavy speculation through margin account trading on

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[115]William A. Lovett, *Banking and Financial Institutions Law In A Nutshell*, West Publishing Co., St. Paul, 1988, p.301.

securities. In response, the Fed was given the power to set margin credit limits. Thus, a surge in stock trading through margin credit can be choked off by an increase in margin credit requirements. The Fed can also act to stimulate a recovery by relaxing margin requirements.

The SEC supervises the securities exchanges in the U.S. which are dominated by the New York Stock Exchange and the American Stock Exchange. There are also regional exchanges such as the Boston stock exchange, the Philadelphia Stock Exchange, and the Midwest and Pacific Exchanges.

The Over The Counter Market (OTC) has been taking on increased importance. The OTC is made up of hundreds of dealers throughout the country who are linked together by the NASDAQ (National Association of Securities Dealers Automatic Quotation system).

The National Association of Securities Dealers (NASD) is a self-regulatory organization supervised by the SEC (the SEC reviews and approves its rules and practices) made up of nationwide underwriter-dealer-brokerage firms such as Merrill-Lynch, major underwriters without distribution networks, exchange specialists, floor traders and brokers, regional broker-dealers, and many small brokers with varied emphasis or specialization. There are also many investment advisers that are members of the NASD.

The NASD Rules of Fair Practice mandate that broker-dealers should not recommend a security unless they have reason to believe it is suitable to the customer's financial situation and needs. The SEC does act to enforce this rule.

Investment companies such as mutual funds are designed to enable smaller investors to pool their resources and select and diversify investments in securities. Mutual fund and other investment company shares are considered securities under the Securities Act of 1933 and the Securities Exchange Act of 1934 and are therefore subject to SEC supervision. They are also subject to the Investment Company Act of 1940 and the Investment Advisers Act of 1940 which mandate separate registration with the SEC. The only real enforceable requirement is that investment companies conform with the investment strategy they advertised in order to attract investors.

The Commodity Futures Trading Commission (CFTC)

Congress created the Commodity Futures Trading Commission (CFTC) in 1974[116]. The CFTC was intended as an analog to the Securities and Exchange Commission, with exclusive jurisdiction over all futures trading and injunctive authority.

The CFTC replaced the Commodity Exchange Authority (CEA), a minor agency within the Department of Agriculture in existence for 40 years, which Congress determined had insufficient resources to do the job in light of market changes.

The CFTC has the power to declare a market emergency, which allows it to "direct a contract market to take such action as the CFTC believes is necessary to maintain or restore orderly trading in, or liquidation, of any futures contract. Such emergencies include threatened or actual market manipulation and corners, any act of the United States or foreign government that would affect a commodity, or any major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity."[117] The CFTC also has the power to impose civil penalties up to $100,000 for each violation of the Commodities Exchange Act.

Insurance Regulators

Regulation of the insurance industry comes from three major sources: the regulatory agencies created by statute in each state, the state legislatures, and state courts.

Insurance law has very much to do with the common law of tort and contract, and therefore the court systems of individual states play a large role.

Insurance regulation by the states is implemented through:

- licensing,
- rate regulation,
- statutory prescription of language to be contained in an insurer's policies,

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[116]The Commodities Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389.

[117]Jerry W. Markham, "Manipulation of Commodity Futures Prices -- The Unprosecutable Crime," *Yale Journal On Regulation*, Summer 1991, p. 333.

- annual statements of financial condition to state regulatory agencies,
- penalty statutes for tardy payment of proceeds on policies,
- regulation of unfair competition,
- investment restrictions.

Due to the collapse of Mutual Benefit Life Insurance in 1991, and the well-publicized precarious financial position of some others, in 1993 state regulators proposed tighter controls on how insurance companies invest their money.[118]

An insurance regulator task force is seeking to have the National Association of Insurance Commissioners adopt a plan to extend investment restrictions to each state and provide uniformity. The proposal is opposed by insurers as "micromanagement" of their businesses, and supported by regulators who point out that significant failures hurt all insurance companies who must rescue failed institutions through industry-supported guaranty funds.

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[118]"Regulators Seek Tighter Rules on Insurers' Investments," *The Wall Street Journal*, October 25, 1993.

Appendix B

Regulatory Background on Specific Issues

Interstate Banking

Full service branching across state lines is not widespread because of the power of states to prohibit it on a state-by-state basis. Banks may not branch across state lines unless a particular state allows it, because the McFadden Act of 1927 requires national banks to comply with the same branching powers accorded to state banks by their own state laws. The Bank Holding Company Act of 1956 states that the interstate acquisition of banks is controlled by state law.

States also tend to prohibit "*De novo*" (new) entry across state lines as well. Banks generally must purchase a "going concern" to do business in another state. The result has been that larger banks doing business in a number of states normally need to operate a separate company for each state they enter, with all of the attendant administrative and legal overhead.

Nevertheless, interstate expansion has continued and has been largely a matter of acquisition. In 1980, only the state of Maine permitted out-of-state holding companies to acquire its banks. By 1990, forty-five states allowed the acquisitions, with some safeguards and limitations, to take place.[119]

Large banks have sought to convert their multibank holding companies into more efficient, less costly nationwide branching networks. Some have sought to make legislative compromises, such as striking a deal with insurance agents to rollback some insurance powers currently exercised by banks — and to specifically prohibit national banks from underwriting, selling or soliciting universal life insurance, variable life insurance, surety bonds and liability insurance.[120]

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[119]Peter S. Rose, Interstate Banking: Performance, Market Share, and Market Concentration Issues, *The Antitrust Bulletin*, Fall 1992.

[120]Interstate Banking: Negotiations Continue Over Legislative Compromise On Interstate Branching, *Banking Policy Report*, Vol. 11, No. 12, p.6, June 15, 1992.

In exchange, these banks[121] have sought legislation that calls for:

- Bank acquisitions by bank holding companies anywhere in the nation within one year of enactment, regardless of state law.

- Interstate branching through consolidation of multistate banks into one interstate bank within 18 months of enactment — with state law in the host state governing the extent of geographic expansion and the financial powers exercised by out-of-state banking organizations. In addition, states would have the option of enacting "opt-out" legislation prohibiting interstate branching across their borders.

Due to the positive outcome for banks of lawsuits regarding their right to market insurance products, such a legislative compromise is not likely to happen, but banks and bank regulators are continuing to push for interstate banking.

Federal Reserve Board Governor John P. LaWare testified in favor of interstate branch banking in hearings before the House Banking Subcommittee on Financial Institutions on June 22, 1993. Mr. LaWare stated that the Fed strongly supports legislative initiatives that would authorize interstate banking acquisitions nationwide as well as interstate branching, noting that "All of the relevant evidence indicates that small banks generally survive entry by large out-of-market banks and are frequently more profitable than the entrant".[122]

Small banks, which fear the marketing might of money center banks, and insurance agents, will no doubt continue to lobby against interstate banking.

Insurance and annuity sales by commercial banks

The banking and insurance industries have a long history of skirmishes concerning the issue of bank insurance and annuity sales.[123] The battle terrain has been the competing regulatory and legislative initiatives of state and federal government and the judicial interpretations of their respective judicial systems.

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[121] North Carolina based NationsBank, California based BankAmerica Corp., California based First Interstate Bancorp, Rhode Island based Fleet Financial Group, Minnesota based Norwest Corp., and Pennsylvania-based PNC Corporation.

[122] Congress Opens hearings On Interstate Branching With Fed Endorsement, *Banking Policy Report*, Vol. 12. No.13, July 5, 1993.

[123] See Keith R. Fisher, Reweaving the Safety Net: Bank Diversification Into Securities and Insurance Activities, 27 *Wake Forest Law Review* 1, 1992.

Much of the conflict has to do with the "dual banking system" of the United States. As explained in a Federal Reserve Board staff opinion,

> A bank's authority to sell insurance is derived from the bank's charter. A bank's charter, and consequently a bank's power to conduct business, is granted and regulated by the bank's chartering authority, either the Comptroller of the Currency in the case of a national bank or the state banking authority in the case of a state bank. Thus, the [Federal Reserve] Board generally does not have authority to regulate or grant approval for the sale of insurance by a bank, even though the bank may be a subsidiary of a bank holding company.[124]

A good example of how convoluted the conflicts can become is provided by what became known as the "South Dakota Loophole". Section 4(c)8 of The Bank Holding Company Act[125] enables the Federal Reserve Board to approve a Bank Holding Company's acquisition and control of a nonbanking company only where the Board has determined that the activities of the acquired company are "so closely related to banking or managing or controlling banks as to be a proper incident thereto."

In 1982, federal legislation spelled out some specific statutory prohibitions and exceptions on bank insurance sales. All insurance activities by banks except the following were prohibited[126]:

1. providing life, disability, and involuntary unemployment insurance where the insurance is limited to assure repayment of outstanding balances on specific extensions of credit by a bank holding company or its subsidiary;

2. acting as agent in the sale of property insurance on loan collateral, where the insurance is limited to assuring the repayment of the outstanding balance of the loan;
3. engaging in general insurance activities in towns with a population of 5,000 or less;

4. engaging in "grandfathered" insurance activities (predating May 1, 1982);

5. acting as a managing general agent over retail agents who sell insurance coverage to the holding company;

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[124]Staff Op. of Jan 12, 1982, *reprinted in* Fed. Res. Reg. Serv. Section 4-591.

[125]Bank Holding Company Act of 1956, 70 Stat. 133.

[126]The Garn-St. Germain Depository Institutions Act of 1982, Pub.L. No. 97-320.

6. engaging in any insurance activity if the bank holding company has less than $50 million in assets . . .

7. continuing to engage in activities grandfathered under the Bank Holding Company Amendments of 1970 . . .

The South Dakota loophole came about as a result of the fact that the prohibition and exceptions applied only to Section 4 of the Bank Holding Company Act (activities of *nonbank* subsidiaries of a bank holding company) and not Section 3 (which controls bank holding company acquisitions of *banks*).

In looking for ways to get around the new specific limitations on their insurance activities, bank attorneys came up with the idea of taking advantage of the dual banking system, and using *state chartered banks* to sell insurance.

In March of 1983 South Dakota passed legislation which permitted South Dakota state chartered banks to "engage in all facets of the insurance business".[127] Shortly thereafter Citicorp applied to the Federal Reserve Board for approval to acquire all of the shares of the American State Bank of Rapid City, South Dakota. First Interstate Bancorp sought to acquire Big Stone State Bank of Big Stone City, South Dakota, and BankAmerica went after Bank of America — South Dakota, in Rapid City.

After more than a year's delay, the Board rejected the Citicorp application, finding that the only reason Citicorp sought the acquisition was to get around Section 4 of the Bank Holding Company Act.

Following that determination by the Board, there have been an number of Supreme Court and Appellate Court Decisions that have had to do with the Fed's rule-making powers. and Section 3 and 4 of the Bank Holding Company Act.

Citicorp tried again in 1990, this time in Delaware, with the Family Guardian Life Insurance Company, an operating subsidiary of the state chartered bank of Citibank-Delaware. Citibank had obtained Board approval to use Family Guardian to sell insurance specifically allowed under Section 4 of the Bank Holding Company Act. However, the nationally chartered Citibank transferred all of its shares in Family Guardian to the state chartered

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[127] S.D. Codified Laws Ann. Section 51-18-30 (Supp 1983).

Citibank-Delaware, the day after Delaware passed a new law authorizing state chartered banks to act as insurers and to transact the business of insurance through a "department" or "division" of the bank or through a subsidiary. Citibank-Delaware began to market insurance to its customers in thirty-five states.

This time Citicorp won, when the Second Circuit Federal Court of Appeals held that the Bank Holding Company Act does not allow the Federal Reserve Board to regulate the activities of a subsidiary of a bank subsidiary of a bank holding company.[128] The court stated:

> We have been given no reason to believe that Congress wanted the jurisdiction of bank chartering authorities to end at the corporate structure of the bank itself, rather than extend throughout the chain of companies owned by the bank. Surely, a bank chartering agency charged with the responsibility to maintain the soundness of a bank, is vitally interested in the assets owned by a bank, including shares of wholly owned subsidiaries. . . . Moreover, the Board has provided no basis for believing that Congress wished to create two classes of state-chartered banks—those owned and those not owned by bank holding companies.[129]

In regard to national banks, which are chartered by the Office of the Comptroller of the Currency, there has been significant erosion of restrictions on insurance sales. This has been accomplished by efforts to semantically describe insurance products as banking products so that they are part of the "business of banking."

A very significant OCC ruling in 1986 said that banks that had a <u>branch</u> engaging in general insurance activities in towns with a population of 5,000 or less could sell insurance nationwide.[130] In July of 1993, in a case that began in 1984 in Oregon, The U.S. Court of Appeals for the District of Columbia decided that no law bars the OCC from allowing national banks in towns with fewer than 5,000 people to market insurance nationwide.[131] The case has been appealed to the Supreme Court but may or may not be heard, at the

[128]*Citicorp v. Board of Governors*, 936 F.2d 66, 72-73 (2d Cir. 1991).

[129]Id. at 73.

[130]OCC Interpretive Letter No. 366 [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) (August 18, 1986).

[131]"Banks Win Big Victory In Fight To Sell Insurance," *American Banker*, Monday, July 19, 1993 p.1.

Court's discretion. In the meantime, banks that have been hesitant to get into the insurance business are now moving forward. As one industry expert said: "I don't think many banks will wait too long; there is no reason to. I would not hold back on any business plan."[132]

Insurance companies are now turning to Congress. Paul Equale, senior vice president of government affairs at the Independent Insurance Agents Association, said that insurance agents will lobby Congress to pass restrictions on banks allowing them to sell insurance only in the small towns from which they operate, rather than from the small towns to other locations.[133]

The current Comptroller, Eugene Ludwig, has come out strongly in favor of allowing nationally chartered banks to sell insurance, stating that "Lending is inherently risky and bank-lending is getting riskier as higher-quality credits increasingly move out of the banking system . . . If we leave banks without other safe lines of business, we are sowing the seeds of disaster—guaranteeing that the industry will become steadily less safe and less sound, and that we will pay the price tomorrow."[134]

Mutual funds/securities sales by commercial banks (Glass-Steagall Restrictions)

Bank-managed mutual funds grew from 213 funds and $35.4 billion in assets in 1988 to 1,156 funds and $194.7 billion in assets in 1993.[135] Banks, through freedoms granted to nonbank subsidiaries of holding companies by the Fed and the OCC, have been vigorous in the mutual fund market. In the same way, banks are offering services to customers that come very close to underwriting and other investment banking activities. It would appear that the Fed and the OCC are proactively eroding the Glass-Steagall Act.

The Glass Steagall Act restricts the securities activities of commercial banks in three major provisions:

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[132]Id. p.11.

[133]Id.

[134]"U.S. Comptroller Favors Letting Banks Sell Insurance, Other Financial Services," *The Wall Street Journal*, September 14, 1993.

[135]"Most Holders of Money-Market Funds Have Wrong Ideas on Bank Insurance," *The Wall Street Journal*, November 11, 1993.

1. Section 16 prohibits national banks from underwriting securities, but allows them to purchase or sell securities without recourse, solely upon the order, and for the account of, customers. Other legislation extended the prohibitions of section 16 to state-chartered member banks.

2. Section 20 prohibits member banks from being affiliated with any firms that are engaged principally in the issue, flotation, underwriting, public sale, or distribution of securities.

3. Section 21 prohibits any firms engaged in the deposit-taking business, including banks, from engaging in the business of issuing, underwriting, selling, or distributing securities with some exceptions.

Likewise, the Bank Holding Company Act of 1956 prohibits a bank holding company and its nonbank subsidiaries from engaging in any nonbanking activity, except where the Fed under Section 4(c)8 determines that the activity is closely related to banking.

However, the Office of the Comptroller of the Currency and the Fed have substantially loosened the restrictions through rulings and interpretations so that banks have quite a bit more freedom to sell securities than the legislation might indicate on its face.

The most significant break for banks occurred in 1987 when the Federal Reserve Board approved a number of applications permitting bank holding companies to establish nonbank subsidiaries to underwrite and trade in different types of municipal revenue bonds, mortgage related securities, commercial paper, and consumer-related receivables.[136] The most significant restriction on these so-called section 20 subsidiaries, is that they must not be "engaged principally" in underwriting or dealing activity. The Fed determined that this requirement would be met if gross revenues from such activities were limited to ten percent of their total gross revenue. That test has evolved since then, but remains in effect.[137]

On April 22, 1992, the Fed revised a rule to allow bank holding companies to sell, solely as agents or brokers, shares of so-called "proprietary mutual funds" (an investment company for which the bank holding company or one of its subsidiaries acts as investment adviser). The bank holding company may also provide investment advice to customers. The rule[138]

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[136]See Robert M. Kurucza, "Securities and Investment Activities of Banks," 43 *Bus. Law.* 1107 (1988).

[137]Kurucza, Ballen, Diana, "Securities and Investment Activities of Banks," 48 *Bus. Law.* 1105 (May, 1993).

[138]Id. at 1112.

requires the bank holding company to:

1. disclose its dual role to customers,

2. caution customers to read the prospectus of the fund before investing,

3. advise customers in writing that the fund's shares are not deposits, are not obligations of any bank, and are not endorsed or guaranteed in any way by any bank.

A recent SEC survey, however, demonstrates that the public is purchasing mutual funds from banks under the mistaken impression that they are insured by federal deposit insurance. The following appeared in a November 11, 1993 article in the Wall Street Journal[139]:

> The survey involved 1,000 households, of whom 47% owned shares of mutual funds. Of the respondents who purchased mutual fund shares at a bank, 66% said money-market mutual funds sold by banks are federally insured. Of the same group of respondents, 49% said mutual funds purchased from a stockbroker are federally insured.

The OCC has also proactively and substantially loosened the Glass-Steagall restrictions. For example, banks have been allowed by the OCC to make available to *corporate* deposit customers, brokerage services provided by an unaffiliated securities broker-dealer.[140]The OCC upheld the services by finding that the bank would be acting merely as an agent for its corporate customers.

It is interesting to note the extent to which banks are actually in the securities business. In this instance, the bank receives a percentage of the fees charged by the broker-dealer to the bank's customers.The bank provides transaction information to customers and assists them in resolving questions regarding their brokerage service accounts. However, the bank may not advise customers on the selection of funds, or discuss the substance of a fund prospectus, or endorse or recommend any of the funds.

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[139]"Most Holders of Money-Market Funds Have Wrong Ideas on Bank Insurance," *The Wall Street Journal*, November 11, 1993.

[140]OCC Interpretive Letter No. 591 (June 18, 1992) reprinted in Fed. Banking L. Rep. (CCH) Section 83,416 (1992).

Community Reinvestment Act (Should nonbank financial institutions be subjected to CRA type investment objectives?)

The Community Reinvestment Act of 1977[141] came about as a congressional response to allegations of "redlining"—the failure of banks to provide loans and other services to specific low-income and minority city neighborhoods.

The CRA obligates commercial banks and thrifts to "meet the credit needs of the local community in which they are chartered consistent with the safe and sound operation of such institutions."

The premise behind CRA is that public policy concerns are a proper focus for regulation of the banking industry by virtue of the fact that banks receive special advantages and subsidies from the federal government—that is, subsidization through the operation of federal deposit insurance and access to the Fed as a "lender of last resort."[142]

The CRA provides a number of enforcement and oversight mechanisms. First, it provides standing for community associations and neighborhood groups to comment on and participate in bank expansion application proceedings, including most merger and acquisition request by depository institutions. It has been estimated that since 1978 fifteen expansion requests have been denied on CRA grounds, and that there have been fifty to sixty cases of conditional grants which imposed CRA requirements.[143]

Community activist groups often utilize the mechanism to extract voluntary concessions from banks, independent of government enforcement. For example, in late 1991, when BankAmerica Corp. sought to acquire Security Pacific Corp. to create one of the four largest banking organizations in the country, BankAmerica committed to $12 billion dollars in CRA lending over a period of ten years.[144]

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[141]Pub. L. No. 95-128 Sections 801-806, 91 Stat. 1147 (codified as amended at 12 U.S.C Sections 2901-2907 (1988 & Supp. III 1991).

[142]Allan J. Fishbein, "The Community Reinvestment Act After Fifteen Years: It Works But Strengthened Federal Enforcement Is Needed," 20 *Fordham Urban Law Journal* 293, Winter, 1993.

[143]Id. at 297.

[144]Broderick and Teitelbaum, "Recent Developments Under The Community Reinvestment Act: 1991-1992," 48 *Bus. Law.* 1063 (May, 1993).

The CRA also provides for periodic ratings of depository institutions compliance with the Act. The government agency charged with regulating and overseeing a particular type of depository institution must rate compliance as outstanding, satisfactory, or poor. In practice, depository institutions were required to prove the absence of discriminatory patterns of lending by maintaining appropriate documentation. For example, the Federal Financial Institutions Examination Council issued a Policy Statement in 1991 specifically requiring each depository institution to prepare analyses of the geographic distribution of credit applications, denials, and extensions of credit in all of its major product lines, overlaid with demographic patterns such as income levels and minority-population densities.[145]

Critics of the CRA argue that banks have been steadily losing market share in credit and financial services to nonbank bank competitors, and that CRA shackles depository institutions with administrative costs and bad loans costs that worsen an already difficult situation.[146] With a logic that is difficult to refute, the point is made that the United States has a long history, e.g. in telecommunications and transportation, of "trying to avoid open and direct subsidies by trying instead to force regulated firms to provide the same transfers through internal cross-subsidy, policies that are more open and transparent are surely a superior form of government."[147] And that increasing competition "among banks and between banks and non-bank providers of financial services is eroding the above-normal profits that banks may have previously earned in their protected market-niches and must doom any scheme that relies on internal cross-subsidy."[148]

"Tying" of commercial banking services with security services

The Bank Holding Company Act Amendments of 1970[149] prohibit the "tying" of credit to other products and services. Likewise, the Glass-Steagall Act prohibited banks, under the "subtle hazards" doctrine, from providing both commercial and investment banking services.

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[145]Id. at 1064.

[146]Lawrence J. White, "The Community Reinvestment Act: Good Intentions Headed In The Wrong Direction," 20 *Fordham Urban Law Journal* 281 (Winter, 1993).

[147]Id. at 291.

[148]Id. at 287.

[149]Pub. L. No. 91-607 Section 106, 84 Stat. 1768, 12 U.S.C. Sections 1971-1978 (1988).

Tying is considered an anti-competitive practice and a violation of antitrust law.

The potential for abuse exists with both small and large customers. In regard to small customers, according to a representative of the national Association of Professional Insurance Agents[150] the tying takes place as follows:

> My concern—and the concern of the 180,000 members who belong to the PIA—is that bankers would exploit their unique powers as lenders to undermine competition. Specifically, I am referring to the power of credit to coerce customers—implicitly or explicitly—and the leverage of federal deposit insurance.
>
> A few months ago, one of the PIA's officers, Frank Wald, testified before the Senate Banking Committee on customer coercion. He relayed his experience as a former small town bank insurance agent to the committee. He explained how the bank's loan officer would tell customers that they needed insurance for the products the bank was financing. The loan officer would then tell the customer, 'Frank will take care of that.' The loan officer would then escort the customer to the desk at his right—Frank's.
>
> Frank told the committee: 'I had a captive client who usually would buy the bank's insurance.' To Frank, tying credit to insurance was 'an understanding, a foregone conclusion.' Many of you say that regulation can prevent this type of coercion. But it can't. To investigate matters in states that allow bank insurance sales, look at what consumers must do: File complaints with a state agency against the very bank that controls their credit. Realistically, who is going to file that complaint?

Potential of abuse related to large customers has mainly to do with illegal overlap between commercial banking and investment banking.[151]

> The Corporate Director of Financing at a top ten Fortune service company reported that he was told by a commercial bank that the company's continued access to credit under a revolving credit agreement was dependent upon the inclusion of the bank's affiliate as co-manager on some of the company's debt issues. The company's ability to access its revolving credit line was vitally important, because the company, with approximately $10 billion in commercial paper, believed it would be unable to roll over all of its commercial paper if its rating dipped by even a single rank. Access to

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[150]Keith R. Fisher, "Reweaving The Safety Net: Bank Diversification Into Securities And Insurance Activities," 27 *Wake Forest Law Review* 1 (1992) p.220 *quoting* Dan Blum, President-Elect, National Association of Professional Insurance Agents, Arlington, Oct. 7, 1991.

[151]Keith R. Fisher, "Reweaving The Safety Net: Bank Diversification Into Securities And Insurance Activities," 27 *Wake Forest Law Review* 1 (1992) p.222 *quoting* Hearing before the Economic and Commercial Law Subcomm of the House Comm. on the Judiciary. 102d Cong., Sess, 2-3, 5 (1991), Testimony of John S. Tamagni, Partner, Lazard Freres & Co. and Chairman, Investment Banking Comm., Securities Industry Association).

the line of credit was believed by the company to be critical to avoiding that possibility, and so the bank's affiliate was included as co-manager on future issues.

Appendix C

Germane Topics Addressed in Program Publications*

Ganley	Rewards & Risks
Tygier	Global currency markets
Ginsburg	Legal aspects of national banking
Crawford	Communications networks for finance in Eastern Europe and the Soviet Union
Prives	State Laws on Electronic Fund Transfer
Knauf	Accidental and deliberately planned communications & information failures
Branscomb	Computer viruses
Coakley	C^3I: Issues of Command and Control
Coakley	Command and Control for War and Peace
Jelen	Information security: an elusive goal
LeGates & McLaughlin	Glitches—where do you get your information (intelligence) and to whom do you listen
Lingl	Transactions/liability of Swift and CHIPS
Ganley & Ganley	To Inform or To Control?
McManus	Rights and restrictions on transaction generated information and privacy issues
Crawford	The Common Market and communications & information industries
Crawford	Singapore as a financial service center in Asia
Seipp	Privacy

*Complete citations on next page

Branscomb, Anne W.
Rogue Computer Programs—Viruses, Worms, Trojan Horses, and Time Bombs: Prank, Prowess, Protection, or Prosecution? (I-89-3)

Coakley, Thomas P.
C³I: Issues of Command and Control, National Defense University, 1991

Coakley, Thomas P.
Command and Control for War and Peace, National Defense University, 1991

Crawford, Morris H.
The Common Market for Telecommunications and Information Services (P-90-6)
Communications Networks for Finance and Trade in the USSR and Eastern Europe (I-91-1)

Data Communications and Industrial Policy in Southeast Asia: A Summary of Interviews with Nine Government and Industry Leaders in Malaysia, Singapore and Indonesia (I-84-3)

Ganley, Oswald H.
Reward & Risks: Communications & Information in the Global Financial Services Industries, PIRP Perspectives, November 1992

Ganley, Oswald H., and Gladys D. Ganley
To Inform or To Control? The New Communications Networks, 2nd ed. Norwood, N.J: Ablex Publishing Corp., 1989

Ginsburg, Douglas
Interstate Banking (P-82-4)

Jelen, George F.
Information Security: An Elusive Goal (P-85-8)

Knauf, Daniel J.
The Family Jewels: Corporate Policy on the Protection of Information Resources (P-91-5)

LeGates, John C., and McLaughlin, John F.
Forces, Trends, and Glitches in the World of Compunications (P-89-2)

Lingl, Herbert F.
Risk Allocation in International Interbank Electronic Funds Transfers: CHIPS & SWIFT (I-82-1)

McManus, Thomas, E.
Telephone Transaction-Generated Information: Rights and Restrictions (P-90-5)

Prives, Daniel
The Explosion of State Laws on Electronic Fund Transfer Systems: Its Significance for Financial Institutions, Non-Financial Institutions, and Consumers (P-76-1)

Seipp, David John
The Right to Privacy in American History (P-78-3)

Tygier, Claude
The Foreign Exchange Market: A Descriptive Study (P-86-8)

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