TESTIMONY OF

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Interim Studies For

FINANCIAL MODERNIZATION

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THE GRAMM-LEACH FINANCIAL MODERNIZATION ACT OF 1999

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Coordination of Regulatory Efforts

- ??DOB, TDI, and SSB currently have information sharing agreements

- ??DOB, TDI, and SSB currently share regulatory authority over state banks that sell securities or insurance, and prepaid funeral licensees who use insurance to fund prepaid funeral contracts

- ??Increased coordination of examinations and information sharing will occur under financial modernization

- ??Existing interagency agreements will need to be expanded

- ??Part of Senate Interim Study may focus on defining future interagency coordination/information sharing

FUNCTIONAL REGULATION

??Financial entities will have ?diversification of regulators?

??More complex activity must be understood by the chartering authority

??Chartering authority will rely on licensing agency to review and supervise non-banking activity

??Agencies must avoid duplication of regulatory burden

??Recognize difference between regulatory programs:
Safety and soundness
Annual exams
Exception-driven investigations
Annual licensing

PREEMPTION OF STATE LAWS

- ??Existing framework of usury law application is not effected

- ??Some state insurance laws may be preempted

- ??State licensing laws must be reviewed to ensure consistency of treatment

- ??Avoid discrimination between state and national bank charters

- ??OTS maintains broad preemptive capacity over state laws (i.e. overturning state limits on ATM surcharges, defining fiduciary practices)

PRIVACY

- ??Customer can opt-out of sharing their personal information with 3rd parties

- ??Some exceptions to opt-out, such as sharing of information with 3rd party performing bank processing (under confidentiality agreement and with consumer disclosure)

- ??States may establish higher privacy standards

COMMUNITY REINVESTMENT ACT (CRA)

??Existing CRA examination schedule 18 - 36 months

??Extended to 4 years for banks < $250MM with satisfactory CRA ratings

??Extended to 5 years for banks < $250MM with outstanding CRA ratings

??CRA Ratings: Outstanding, Satisfactory, Needs Improvement, Substantial Noncompliance

??As of 6-30-99, Texas had 721 state and national banks under $250MM in total assets

??Banks required to disclose CRA grants > $10M and CRA loans > $50M, and report on use of funds

AFFILIATE TRANSACTIONS

??Bank affiliation with securities and insurance underwriting, and merchant banking allowed through a ?financial holding company? regulated by the Federal Reserve

??FDIC assistance prohibited to affiliates and subsidiaries of insured banks

??Possible additional restrictions on transfers of capital between affiliates

II. BACKGROUND

Passage of financial modernization legislation by Congress now appears imminent. S. 900, the Gramm-Leach Financial Modernization Act (the "Gramm-Leach Act"), would repeal parts of the 1933 Glass-Steagall Act and the Bank Holding Company Act of 1956, laws that have separated banks, securities firms and insurance companies. The intention is to level the playing field for banks, insurance companies and brokerages, and allow U.S. firms to compete better in the evolving global financial marketplace. Financial modernization would make it easier for U.S. financial institutions to merge and sell all manner of financial products (from checking accounts to stocks, bonds and insurance) under one roof and one brand name.

<u>The Glass-Steagall Act</u>

Since its passage in 1933, the Glass-Steagall Act has maintained a division between commercial banking and investment banking. In effect, the law keeps banks from doing business on Wall Street, and vice versa. (In actuality, there are two Glass-Steagall measures. The first was the Glass-Steagall Act of 1932, a bookkeeping provision that allowed the Treasury to balance its account. And what is commonly known today as the Glass-Steagall Act is actually part of the Bank Act of 1933, containing the provision erecting a wall between the banking and securities businesses as well as creating federal deposit insurance.)

In 1933, the U.S. was in one of the worst depressions of its history. A quarter of the working population was unemployed. The nation's banking system was chaotic. Over 11,000 banks had failed or had to merge, reducing the number by 40 percent, from 25,000 to 14,000. The governors of several states had closed their states' banks and in March, President Roosevelt closed all the banks in the country.
The Banking Act of 1933 was the newly-elected Roosevelt administration's response to the shambles of the nation's financial and economic system. The Act established new approaches to financial regulation, particularly the institution of federal deposit insurance and the legal separation of most aspects of commercial and investment banking.

Through time, the Glass-Steagall Act has eroded to only those sections of the Banking

Act of 1933 that refer to banks' securities operations - sections 16, 20, 21, and 32. These four sections of the Act, as amended and interpreted by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the courts, govern commercial banks' domestic securities operations in various ways. While these provisions by their terms apply only to member banks, the Federal Deposit Insurance Act incorporates these limits to apply to insured non-member banks.

Sections 16 and 21 refer to the direct operations of commercial banks. Section 16, as amended by the Banking Act of 1935, generally prohibits Federal Reserve member banks from purchasing securities for their own account. Other laws carve out limited exceptions to permit a bank to purchase and hold investment securities (defined generally as marketable debt instruments such as bonds, notes, or debentures) up to defined limits expressed as a percentage of the bank's capital and surplus. Sections 16 and 21 also forbid deposit-taking institutions from both accepting deposits and engaging in the business of "issuing, underwriting, selling, or distributing, at wholesale or retail, or through syndicate participation, stock, bonds, debentures, notes or other securities," with some important exceptions for U.S. Government obligations, obligations issued by government agencies, college and university dormitory bonds, and the general obligations of states and political subdivisions. Municipal revenue bonds (other than those used to finance higher education and teaching hospitals) are not included in the exceptions. Section 16 permits commercial banks to purchase and sell securities, but only directly, without recourse, and solely on the order of and for the account of customers.

Sections 20 and 32 refer to commercial bank affiliations. Section 20 forbids member banks from affiliating with a company "engaged principally" in the "issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes, or other securities." "Principally engaged" has been defined by the Federal Reserve Board as activities contributing more than from 5 to 10 percent of the affiliate's total revenue, thereby permitting banks to affiliate with companies underwriting commercial paper, municipal revenue bonds, and securities backed by mortgages and consumer debts, as long as the affiliate does not "principally engage" in those activities. Banks also may offer retail discount brokerage service (excluding investment advice) under an interpretation that these activities do not involve an underwriting of securities, and that "public sale" refers to an underwriting.

Section 32 prohibits a bank from having interlocking directorships or close officer or employee relationships with a firm "principally engaged" in securities underwriting and distribution. Section 32 applies even if there is no common ownership or corporate affiliation between the commercial bank and the investment company.

Commercial banks are not forbidden from underwriting and dealing in securities outside of the United States. Larger, money center banks, are particularly active in these markets. Furthermore, commercial banks' trust departments can trade securities through their bank's securities subsidiaries or affiliates for pension plans and other trust accounts.

Of the world's important financial nations, only the United States and Japan (which was forced to adopt laws similar to the U.S. banking statutes after World War II) legally require these separations. (Japanese banks can engage in many securities activities, however, including underwriting and dealing in commercial paper and ownership of up to 5 percent of non-bank enterprises.)

The Bank Holding Company Act of 1956

During the 1930s and 1940s, banks stuck to the basics of taking deposits and making loans. Congress did not intervene again until 1956, when it enacted the Bank Holding Company Act to keep financial-services conglomerates from amassing too much power. That law created a barrier between banking and insurance in response to aggressive acquisitions and expansion by TransAmerica Corp., an insurance company that owned Bank of America and an array of other businesses. Congress thought it improper for banks to risk possible losses from underwriting insurance. While many banks today sell insurance products provided by insurers, banks can not take on the risk of underwriting.

III. DISCUSSION OF MAJOR PROVISIONS OF THE GRAMM-LEACH FINANCIAL MODERNIZATION ACT

Summary: The Gramm-Leach Act (S. 900) will repeal parts of the 1933 Glass-Steagall Act and 1956 Bank Holding Company Act to level the playing field for banks, insurance companies and brokerages and allow U.S. firms to compete better in the evolving global financial marketplace. The Federal Reserve has already interpreted current law to allow U.S. banks to buy securities firms, subject to severe limits on acquisition size in relation to the acquirer. Last year, the Federal Reserve granted a limited-time exemption for the banking and insurance merger that created Citigroup. Brokerages and insurers will now, in turn, be able to target banks.

Major Provisions:

Bank Holding Company Provisions and Affiliations. The bill allows banks with satisfactory CRA ratings to affiliate with securities firms and insurance companies, and preempts state laws that would interfere with these combinations. Bank/securities and bank/insurance combinations will be financial holding companies (FHCs), under the umbrella supervision of the Federal Reserve. The Securities and Exchange Commission and state insurance commissioners will regulate the securities and insurance activities of these holding companies.

A Texas bank holding company will have the option of becoming a "financial holding company" under section 4 of the Bank Holding Company Act, permitting the company to engage in a statutorily provided list of financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities. Activities that are "complementary" to financial activities will also be authorized. The nonfinancial activities of firms predominantly engaged in financial activities (at least 85% financial) are grandfathered for at least ten years, with a possibility for a five year extension. Bank holding company supervision will be clarified by language defining the regulatory roles of the Federal Reserve on the one hand, as the umbrella holding company supervisor, and on the other, the state and other federal

financial regulators that will “functionally” regulate various affiliates. The Department of Banking under Finance Code, Chapter 202, currently regulates, to a limited extent, bank holding companies in Texas. Some statutory revisions will be necessary.

Besides banking, insurance and securities activities, FHCs can also conduct activities that are "financial in nature," "incidental to financial activities," or "complementary to financial activities," including insurance underwriting and merchant banking. The Federal Reserve, in consultation with the Treasury, may identify additional permissible activities that meet these criteria.

Newly formed financial holding companies that already own commercial firms may hold onto these firms for ten years, with a possible five-year extension, as long as they make up no more than 15% of the holding company's gross annual revenues. Insurance companies that are part of FHCs may acquire interests in commercial firms in the ordinary course of business, as authorized by state law, and provided that the holding company isn't involved in the commercial firm's daily management.

Mutual savings banks can form mutual holding companies, and the bill repeals Section 3(f) of the Bank Holding Company Act, so savings banks will be able to conduct the same activities as commercial banks through a holding company structure.

Because of the proposed repeal of Sections 20 and 32 of the Glass-Steagall Act, affiliations among securities firms, insurance companies, and Texas banks will be possible. State laws that interfere with permitted affiliations will be preempted. It would appear unlikely that significant changes will occur with respect to smaller banks, in that the primary benefits of the legislation accrues to the largest U.S. financial institutions. Texas law was almost enacted to fully authorize the licensing of banks as insurance agents this last session. To the extent that national banks may exercise authorities under the Financial Modernization Act that Texas state law prevents state-chartered banks from exercising, state statute is preempted by our State Constitution. Substantial revisions to state laws are in order to bring all into conformity.

Banks will generally be prohibited from engaging directly in underwriting and sale of title insurance except to the extent permitted by state law. Bank subsidiaries will be permitted to sell all types of insurance, including title insurance, and bank affiliates may underwrite

or sell all types of insurance, including title insurance. The title insurance authorization does not conflict with existing state law that has been interpreted to permit banks to become licensees as title insurance agents.

Provided Texas law does not discriminate against persons affiliated with a bank, state regulation of insurance and securities activities of banks is authorized.

Because national banks will be authorized to underwrite municipal revenue bonds, state banks will also have this authority under the Texas Constitution, Article XVI, Section 16(c), and Texas Finance Code, Section 32.009. However, it would be appropriate to amend Finance Code, Chapter 34, Subchapter B, to eliminate currently similar state statutory prohibitions.

National Bank Operating Subsidiaries. Under the deal struck by the Federal Reserve and the Treasury Department, well-managed, well-capitalized national banks can conduct any new financial activity through a subsidiary (rather than a holding company affiliate), except insurance underwriting, merchant banking, real estate development or real estate investment. National banks may also conduct agency activities through subsidiaries, as long as they are financial in nature (e.g., insurance sales). National bank investments in subsidiaries cannot exceed 45% of the parent bank's assets, or $50 billion, whichever is less. The nation's 100 largest banks must issue subordinated debt before creating an operating subsidiary to conduct expanded activities. Merchant banking activities will be possible, with the Fed's permission, five years after the bill's enactment.

State Bank Operating Subsidiaries. In a major tribute to the value of the dual banking system, the Gramm-Leach Act does not limit the ability of state-chartered banks to innovate through operating subsidiaries. State-chartered banks will still be able to conduct activities through operating subsidiaries to a greater extent than national banks under the provisions of Section 24 of the Federal Deposit Insurance Fund (that is, with the FDIC's approval). Thus, modernization can continue at the state level even after the federal law is enacted.

Insurance. Although the bill preempts state laws that interfere with bank insurance sales, it also affirms state authority to regulate insurance activities under the McCarran-Ferguson Act, and requires licensing for any person or business that sells insurance. The

bill eliminates the existing deference courts give the OCC in interpreting the applicability of state insurance laws to national banks.

In addition to the state laws that govern insurance sales, the bill requires the federal banking agencies to issue joint consumer protection regulations on the sale of insurance. Where state law protections are stronger than the federal rules, the state laws will apply. To preempt state consumer laws, federal regulators must find jointly that the federal protections are stronger than state law; they must then notify the state of this finding, and give the state three years to enact stronger laws of their own.

The bill continues the general prohibition on national bank insurance underwriting. It also bans title insurance sales and underwriting for national banks that were not engaged in the activity before the bill's enactment. The big exception to this is that national banks may sell title insurance in states that allow title insurance sales for state-chartered banks. The loophole...national banks may sell title insurance in any state (except Iowa which prohibits the sale of title insurance generally) through subsidiaries. In addition, affiliates of national banks may underwrite and sell title insurance in any state (except Iowa).

The bill creates the National Association of Registered Agents and Brokers (NARAB), to set uniform licensing and regulatory requirements for insurance sales, in 2002 - unless states enact uniform requirements before then on their own.

Securities. The Gramm-Leach Act eliminates banks' broad exemption from broker-dealer registration requirements, with an exception for traditional banking activities, including trust services and government securities. Banks will also be subject to the Investment Advisors Act of 1940 if they offer investment advice to a mutual fund. The SEC has the authority to identify new activities as "securities products" and require that banks move the activity from within a financial institution into a securities affiliate; the Federal Reserve has the authority to challenge these rulings.

State Law Preemption. Gramm-Leach generally preempts any state law that would "prevent or restrict" the bill's major provisions allowing bank affiliations with insurance and securities firms, and expanding national bank powers. This includes preempting state laws that "significantly interfere" with bank insurance sales, except for the 13 so-called "safe harbors" that specify state insurance laws that can not be preempted.

Foreign Bank Branching. Foreign banks may upgrade their U.S. agencies to branches, with the approval of the Federal Reserve and the appropriate state regulator (or OCC), if the agency has been open since September 29, 1994 or for the appropriate period of time specified by state interstate branching laws.

These new powers will also accrue to foreign banks engaged in the banking business in Texas. Presently, 27 foreign banks have operations in Texas subject to regulation by the Department of Banking under Finance Code, Chapter 204. Some statutory revisions to Chapter 204 will be necessary to fully coordinate state with federal law.

Thrifts and the Unitary Thrift Holding Company. The bill preserves the federal savings and loan charter, and allows thrift holding companies to conduct all financial activities (banking, securities and insurance). It prohibits unitary thrift holding companies that had not applied for a charter by May 4, 1999, from affiliating with commercial companies. Existing unitary thrift holding companies retain their powers, but cannot be acquired by commercial firms. Thrift holding companies will not be able to engage in new commercial activities.

Federal savings and loans that convert to state or national bank charters can keep the word "Federal" in their names.

Community Reinvestment Act (CRA). The Federal Reserve will not be permitted to authorize financial institutions, their affiliates, and FHCs to engage in any new activities or make any new acquisitions (or even form an FHC) unless all of the insured institutions in the holding company received at least a "Satisfactory" rating in their last CRA exam.

Banks that lend or give money to community groups as a way to ward off protests over CRA will be required to disclose the funds dispersed through grants of more than $10,000 and loans of more than $50,000.

Each bank and each non-bank party to a CRA agreement will be required to publicly report each year on how the money and other resources involved in the agreement were used.

The Act will grant regulatory relief regarding the frequency of CRA exams to small banks and thrifts (those with no more than $250 million in assets), a provision that will benefit many smaller banks. Small institutions having received an Outstanding rating at their most recent CRA exam will not receive a routine CRA exam more often than once each five years. Small institutions having received a Satisfactory rating at their most recent CRA exam will not receive a routine CRA exam more often than once each four years. Under current law, small institutions generally undergo a CRA review every 18 months to three years.

The Federal Reserve Board is directed to conduct a study of the default rates, delinquency rates, and profitability of CRA loans, and the Treasury, in consultation with the bank regulators, will study the extent to which adequate services are being provided as intended by the CRA.

Consumer Privacy. Financial institutions must disclose their policies on sharing information with affiliates and third parties to customers when they open an account, and at least once a year after that. Banks must give customers the chance to "opt out" of sharing confidential financial information with nonaffiliated third parties; the bill includes an exemption for joint marketing agreements between financial institutions and third-party service providers. It will be against the law to obtain customer information from a financial institution under false pretenses.

However, state law that provides greater privacy protection to consumers will be binding on financial institutions. States will possess and can exercise nonexclusive enforcement authority, although the bill could apparently preempt state remedies in lieu of those provided by the Act.

Relevant federal and state regulators are directed to establish comprehensive standards for ensuring the security and confidentiality of consumers' personal information maintained by financial institutions, and to protect against unauthorized access to or use of such information. The relevant federal and state agencies may act separately but are directed to consult and coordinate with one another for purposes of assuring to the maximum extent possible that the regulations that each prescribes are consistent and comparable with those prescribed by the other agencies. Functional regulators are granted flexibility to prescribe necessary exceptions and clarifications to the statutory

requirements applicable to sharing of information. A federal study of financial institutions' information-sharing practices will be conducted in the 18 months following enactment.

Federal Home Loan Bank Reforms. Any insured depository institution with less than $500 million in assets can join the Federal Home Loan Bank system. Member institutions will be able to get long-term advances for small business, small farm and small agri-business lending, as well as for housing finance. Federal Home Loan Bank membership will be optional for thrifts, rather than mandatory. This provision will provide additional funding sources to many banks.

Nonbank Banks. The Act eliminates some of the restrictions placed on nonbank banks, and grants them 180 days to correct violations before being subject to the Bank Holding Company Act or mandatory divestiture. Industrial loan companies will be allowed to incur daylight overdrafts from the Federal Reserve Banks.

ATM Disclosure. ATM operators who impose a fee for use of an ATM by a non-customer will be required to post a notice on the machine and on the screen that a fee will be charged and the amount of the fee. This notice must be posted before the consumer is irrevocably committed to completing the transaction. A paper notice issued from the machine may be used in lieu of a posting on the screen. No surcharge may be imposed unless the notices are made and the consumer elects to proceed with the transaction. The Act requires a notice when ATM cards are issued that other parties may impose surcharges when transactions are initiated from ATMs not operated by the card issuer. ATM operators will be exempt from liability if properly placed notices on the machines are subsequently removed, damaged, or altered by anyone other than the ATM operator. While somewhat broader than Texas law, Texas businesses are already subject to similar requirements under Finance Code, Section 59.202, which could be repealed in lieu of the new federal law.

Plain Language. Last but not least, Federal banking agencies must use plain language in all rules published after January 1, 2000.

Other Miscellaneous Provisions:

Provides for technical assistance to micro-enterprises (meaning businesses with fewer than 5 employees that lack access to conventional loans, equity, or other banking services). This program will be administered by the Small Business Administration.

Requires annual independent audits of the financial statements of each Federal Reserve Bank and the Board of Governors of the Federal Reserve System.

Authorizes information sharing among the Federal Reserve Board and federal or state authorities.

Requires a GAO study analyzing the conflict of interest faced by the Board of Governors of the Federal Reserve System between its role as a primary regulator of the banking industry and its role as a vendor of services to the banking and financial services industry.

Requires the federal banking agencies to conduct a study of banking regulations regarding the delivery of financial services, and make recommendations on adapting those rules to online (internet) banking and lending activities.

Protects FDIC resources by restricting claims for the return of assets transferred from a holding company to an insolvent subsidiary bank.

Provides relief to out-of-state banks generally by allowing them to charge interest rates in certain host states that are no higher than rates in their home states.

Allows foreign banks generally to establish and operate federal branches or agencies with the approval of the Federal Reserve Board and the appropriate banking regulator if the branch has been in operation since September 29, 1994, or the applicable period under appropriate state law.

Expresses the sense of the Congress that individuals offering financial advice and products should offer such services and products in a nondiscriminatory, nongender-specific manner.

Permits the Chairman of the Federal Reserve Board and the Chairman of the Securities and Exchange Commission to substitute designees to serve on the Emergency Oil and

Gas Loan Guarantee Board and the Emergency Steel Loan Guarantee Board.

Repeals section 11(m) of the Federal Reserve Act, removing the stock collateral restriction on the amount of a loan made by a state bank member of the Federal Reserve System.

Allows the FDIC to reverse an accounting entry designating about $1 billion of SAIF dollars to a SAIF special reserve, which would not otherwise be available to the FDIC unless the SAIF designated reserve ratio declines by about 50% and would be expected to remain at that level for more than one year.

Allows directors serving on the boards of public utility companies to also serve on the boards of banks.