INFORMATION NOTE

Financial System of the United Sates of America

1. Background

1.1 The Panel on Financial Affairs and Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000 of the Legislative Council (LegCo) scheduled to conduct an overseas duty visit to New York and London to study the regulatory regimes and market operations of these two leading international financial centres, as well as to establish direct links with regulatory bodies and market players in these places in early April 2001. To facilitate their visit, the Research and Library Services Division of the LegCo prepared two separate information notes providing basic information on the regulatory regimes and reform of the financial services industry of these two countries.

1.2 The financial system of the United States of America (US) constitutes the banking system[1], nonbank financial institutions[2] and financial markets[3]. This paper provides background information on the banking system and financial markets of the US. We have not covered nonbank financial institutions due to resource constraints.

2. Overview of the Population and Economic Situation of the US

2.1 In 1999, the US had a total population of 272.7 million[4] and Gross Domestic Product (GDP) was US$8,808.7 billion[5] (HK$68,708 billion)[6]. Per capita GDP was US$32,302 (HK$251,956). In 1996, finance industry accounted for 5.1% of GDP.[7]

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1 Banking system comprises the Federal Reserve System, commercial banks, foreign banks, offshore banks, saving institutions and credit unions.
2 Nonbank financial institutions comprises asset-based finance companies, insurance companies and commercial lending companies.
3 Financial markets comprises equities markets, debt and money markets and futures and options markets.
4 Population Reference Bureau, 2000 United States Population Data Sheet, Section 1; http://www.prb.org/pubs/usds2000/section1.html
5 http://www.bea.doc.gov/bea/dn/niptbl-d.htm
6 As at December 2000, US$1=HK$7.798. Information extracted from Hong Kong Monthly Digest of Statistics, January 2001, Census and Statistics Department, Table 7.12, p125
7 http://www.census.gov/prod/99pubs/99statab/sec16.pdf

3. Legislative Framework of the US Financial Services Industry

3.1 The US Congress introduces legislation relating to financial services, and regulators at federal and state levels issue rules and regulations governing the practices of the industry.

3.2 Committees at Congress handling financial affairs are the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.

Committee on Banking, Housing and Urban Affairs of the Senate

3.3 Committee on Banking, Housing and Urban Affairs handles all proposed legislation, messages, petitions, memorials and other matters relating to the following subjects:

(a) "banks, banking and financial institutions;
(b) control of prices of commodities, rents and services;
(c) deposit insurance;
(d) economic stabilization and defense production;
(e) export and foreign trade promotion;
(f) export controls;
(g) federal monetary policy, including the Federal Reserve System;
(h) financial aid to commerce and industry;
(i) issuance and redemption of notes;
(j) money and credit, including currency and coinage;
(k) nursing home construction;
(l) public and private housing (including veterans housing);
(m) renegotiation of Government contracts; and
(n) urban development and urban mass transit."[8]

3.4 This Committee also studies and reviews on a comprehensive basis, matters relating to international economic policy as it affects the US monetary affairs, credit, financial institutions, economic growth and urban affairs.

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[8] Information extracted from http://www.senate.gov/~banking/jurisd.htm

Committee on Financial Services of the House of Representatives

3.5 Committee on Financial Services of the House of Representatives handles bills, resolutions and other matters relating to the following financial services:

(a) "banks and banking, including deposit insurance and Federal monetary policy;

(b) economic stabilization, defense production, renegotiation, control of the price of commodities, rents and services;

(c) financial aid to commerce and industry (other than transportation);

(d) insurance generally;

(e) international finance;

(f) international financial and monetary organization;

(g) money and credit, including currency and the issuance of notes and redemption thereof; gold and silver, including the coinage thereof; valuation and revaluation of the dollar;

(h) public and private housing;

(i) securities and exchanges; and

(j) urban development."[9]

4. The Banking System

4.1 The US banking system comprises the Federal Reserve System, commercial banks, savings institutions and credit unions. The whole system is regulated at both federal and state levels. Table 1 shows the regulators and insurance agencies for the US banking system.

Table 1 - Regulators and Insurance Agencies for the US Banking System

Banking Institution	Federal Regulator	Banking Insurance Agency
Federal-chartered banks	Office of the Comptroller of the Currency	Federal Deposit Insurance Corporation
State-chartered banks	Federal Deposit Insurance Corporation	Federal Deposit Insurance Corporation
Savings institutions	Office of Thrift Supervision	Federal Deposit Insurance Corporation
Credit unions	National Credit Union Administration	(a) National Credit Union Administration (b) State or Private Agencies

[9] Information extracted from http://www.house.gov/banking/jurisdic.htm

The Federal Reserve System

4.2 The Federal Reserve System (Fed) is the central bank of the US. It constitutes a Board of Governors and 12 regional Reserve Banks. The Board of Governors is made up of seven members appointed by the US President and confirmed by the Senate. Only one member of the Board is selected from any one of the 12 regional Reserve Banks. The full term of a Board member is 14 years.

4.3 Listed below are the functions of the Federal Reserve Board:

(a) conducting the nation's monetary policy;
(b) supervising and regulating banking institutions and protecting the credit rights of consumers;
(c) maintaining the stability of the financial system; and
(d) providing certain financial services to the US government, the public, financial institutions and foreign official institutions.

4.4 The duties of the 12 regional Reserve Banks include:

(a) operating a nationwide payments system;
(b) distributing the nation's currency and coin;
(c) supervising and regulating member banks and bank holding companies;
(d) serving as banker for the US Treasury; and
(e) acting as depository for the banks in its own District.

Commercial Banks

4.5 In 1998, there were 8 774 commercial banks with total assets and deposits amounted to US$5,440.9 billion (HK$42,428 billion) and US$3,681.5 (HK$28,708) billion respectively.[10] These banks channel the majority of financial transactions and services in the US. They are either federally or state chartered. Federally-chartered banks (i.e. national banks) are regulated by the Office of the Comptroller of the Currency (OCC) and must be members of the Federal Reserve System and the Federal Deposit Insurance Corporation (FDIC). Bank holding companies, foreign banks and offshore banks are regulated by the Federal Reserve. State-chartered banks are regulated by the FDIC and banking authorities in the specific state in which they are incorporated.

[10] US Census Bureau, Statistical Abstract of the US:1999, Table No. 815, Insured Commercial Banks, by State and Other Area: 1998; http://www.census.gov/prod/99pubs/99statab/sec16.pdf

Office of the Comptroller of the Currency

4.6 The Office of the Comptroller of the Currency (OCC) is a bureau of the Treasury Department. The Comptroller of the Currency is appointed by the US President and confirmed by the Senate for a term of five years. The principal function of the OCC is to regulate the national banking system and agencies of foreign banks.

4.7 In regulating national banks, the OCC has the power to:

(a) examine banks;

(b) approve or deny applications for new charters, branches, capital, or other changes in corporate or banking structure;

(c) take supervisory actions against banks that do not comply with laws and regulations or that otherwise engage in unsound banking practices. The agency can remove officers and directors, negotiate agreements to change banking practices and issue cease and desist orders as well as civil money penalties; and

(d) issue rules and regulations governing bank investments, lending and other practices.

4.8 The OCC does not receive any appropriations from the Congress. Instead, its operations are funded by assessments on national banks. National banks pay OCC for their examinations and corporate applications. The OCC also receives revenue from its investment income.

Federal Deposit Insurance Corporation

4.9 The Federal Deposit Insurance Corporation (FDIC) is a federal government agency that provides insurance protection for depositors at most commercial banks and mutual savings banks. It is managed by a five-member board of directors appointed by the US President and confirmed by the Senate.

4.10 The responsibilities of the FDIC are as follows:

(a) insures deposits up to US$100,000 (HK$779,800) in all the US banks and savings institutions;

(b) arranges a resolution for each failing institution[11];

[11] A resolution is a solution to the bank which is the least-costly to the insurance fund and the least disruptive for customers in the event of insolvency.

(c) promotes the safety and soundness of insured depository institutions and the US financial system by identifying, monitoring and addressing risks to the deposit insurance funds; and

(d) regulates about 6 000 state-chartered "nonmember" banks[12].

4.11 The FDIC receives no congressional appropriations. Its funds come from deposit insurance premiums paid by banks and savings institutions and from earnings on investments in US Treasury securities.

4.12 The FDIC administers two federal deposit insurance funds, namely, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). Deposits in most commercial banks and many savings banks are insured by the BIF. Deposits in savings associations are insured by the SAIF. Both the BIF and SAIF deposit insurance programmes are backed by the full faith and credit of the US government.

4.13 To be insured by the FDIC, a bank must prove it is being run profitably and fairly and pays insurance premiums. The amount of money each bank pays depends on how much the bank has in its deposits and how much money is in BIF and SAIF.

4.14 The FDIC uses a risk-based premium system to determine the premium rates. As at 30 June 2000, the rates ranged from zero to 27 cents per US$100 in assessable deposits per year[13]. Only 7% of all banks and saving institutions paid premiums into the deposit insurance funds, the remaining 93% or 8 139 institutions did not need to pay premiums[14,15].

4.15 To ensure that the deposit insurance system continues to protect depositors and contributes to its full extent to the stability of the banking system, the FDIC announced in March 2000 that a comprehensive review would be conducted and is now in the process of public consultation. The FDIC had identified three areas for review, namely, processes for setting premiums against risks, funding for insurance losses and coverage limits.

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12 Nonmember banks refer to commercial and savings banks that are not members of the Federal Reserve System.

13 BIF Assessment Rates for the First Semiannual Assessment Period of 2001; http://www.fdic.gov/deposit/insurance/risk/Bif2001-01.html

14 The 8 139 institutions were classified as the highest rated BIF institutions and the assessment rate for paying deposit insurance premiums is zero.

15 BIF Assessment Rates for the First Semiannual Assessment Period of 2001; http://www.fdic.gov/deposit/insurance/risk/Bif2001-01.html

Savings Institutions

4.16 Savings institutions refer to savings banks and savings and loan associations (S&Ls) and are generally known as thrifts. Thrifts accept deposits from and extend credit primarily to individuals. Thrifts are regulated by the Office of Thrift Supervision (OTS) and deposits are insured with the FDIC. In 1998, there were 1 687 saving institutions with total assets amounted to US$1,088 billion (HK$8,484 billion); total liabilities amounted to US$993 billion (HK$7,743 billion) and deposits amounted to US$705 billion (HK$5,498 billion).[16]

Office of Thrift Supervision

4.17 The Office of Thrift Supervision (OTS) is a bureau of the Department of the Treasury and is the primary regulator of all federally-chartered and many state-chartered thrift institutions. OTS is headed by a Director who is appointed by the US President with the Senate's confirmation.

4.18 OTS is responsible for chartering, examining, supervising and regulating federal savings associations, federal savings banks and state-chartered saving associations belonging to the SAIF.

4.19 OTS is funded by assessments and fees levied on the institutions it regulates.

Credit Unions

4.20 Credit unions are non-profit, co-operative financial institutions owned and run by its members. They are being exempted from reserve requirements, FDIC membership and certain other rules that apply to other banking institutions.

4.21 In 1998, there were 6 814 federally-chartered credit unions with 24.5 million memberships, US$40 billion (HK$312 billion) asset, US$26.4 billion (HK$206 billion) outstanding loans and US$36.3 billion (HK$283 billion) deposits.[17] Federally-chartered credit unions are under the supervision of the National Credit Union Administration (NCUA). Deposit insurance (up to US$100,000 (HK$779,800) per account) is provided to members by the National Credit Union Share Insurance Fund (NCUSIF).

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[16] US Census Bureau, Statistical Abstract of the US:1999, Table No. 817, Insured Savings Institutions - Financial Summary: 1985 to 1998; http://www.census.gov/prod/99pubs/99statab/sec16.pdf

[17] US Census Bureau, Statistical Abstract of the US:1999, Table No. 816, Federal and State-Chartered Credit Unions - Summary: 1980 to 1998; http://www.census.gov/prod/99pubs/99statab/sec16.pdf

4.22 There were also 4 181 state-chartered credit unions with 12.3 million memberships, US$20.8 billion (HK$162 billion) asset, US$14.6 billion (HK$114 billion) outstanding loans and US$18.5 billion (HK$144 billion) deposits in 1998.[18] State-chartered credit unions are supervised by the respective state supervisory authorities. Deposit insurance for state-chartered credit unions is available in some states under private or state-administered insurance programmes. State credit unions may also be federally-insured by the NCUSIF.

National Credit Union Administration

4.23 The National Credit Union Administration (NCUA) is an independent federal agency that charters and supervises federally-chartered credit unions and to manage the NCUSIF. NCUA is managed by a board of three members who are appointed by the US President and confirmed by the Senate.

Office of the Ombudsman

4.24 If a national bank and its supervisory office, i.e. the OCC, cannot resolve a dispute through informal discussions, the bank may refer the matter to the Office of the Ombudsman. If a customer has any complaint about a bank, the customer may file the complaint with the Customer Assistance Group of the OCC.

4.25 The Office of the Ombudsman was established by the OCC to administer the National Bank Appeals Process that ensures national banks a fair and expeditious review of agency decisions and actions. Through the appeals process, the ombudsman reviews disputes from both banker and regulator perspective.

4.26 Apart from administering the National Bank Appeals Process, the OCC's ombudsman also assumed responsibility for the supervision and administration of the OCC's customer assistance function. The Customer Assistance Group of the OCC was created to answer questions, offer guidance and assist consumers in resolving complaints about national banks. If the complaint involves a bank or other institution not regulated by the OCC, the OCC may refer it to other relevant agencies.

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[18] US Census Bureau, Statistical Abstract of the US:1999, Table No. 816, Federal and State-Chartered Credit Unions - Summary: 1980 to 1998; http://www.census.gov/prod/99pubs/99statab/sec16.pdf

5. Financial Markets

5.1 The US financial markets are highly developed and influential on the world economy. Its equities markets, debt markets, money markets, foreign exchange markets and futures and options markets, all exercise enormous influence over financial markets in other countries. In 1996, there were 45 600 security and commodity brokers.[19] Table 2 lists the regulators and self-regulating organizations (SROs) for the US financial markets.

Table 2 - Regulators and Self-Regulating Organizations for the US Financial Markets

Types of instrument	Federal Government Regulator	Self-Regulating Organization
Corporate stocks/bonds	Securities & Exchange Commission	National Association of Stock Dealers
Asset-backed securities	None	None
Municipal securities	None	Municipal Securities Rulemaking Board
Money market instruments	None	None
Futures	Commodity Futures Trading Commission	National Futures Association
Options	Commodity Futures Trading Commission	Options Clearing Corporation
OTC Foreign exchange	None	None

Source: http://www.bus.duq.edu/faculty/burnham/RegFinmrks-OVH.html

<u>Equities Markets</u>

5.2 Equities are shares that represent part ownership of a business enterprise. There are different types of equities, namely, stocks, preferred stocks and warrants.

[19] http://www.census.gov/prod/99pubs/99statab/sec16.pdf

5.3 The US equities markets comprise several stock exchanges. The most important are located in New York City: the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX). Other smaller regional exchanges are located in Boston, Philadelphia, Cincinnati, Chicago, San Francisco and Los Angeles. Stocks not listed on a formal exchange are traded in the over-the-counter (OTC) market which includes the National Association of Securities Dealers Automated Quotation system (Nasdaq) and the National Market system (NMS). Securities markets are regulated by the Securities and Exchange Commission (SEC).

5.4 To operate in the securities business, firms must be licensed and subscribe to the Security Investor's Protection Corporation (SPIC) which insures client balances against brokerage failure.

The Securities and Exchange Commission

5.5 The Securities and Exchange Commission (SEC) protects investors and maintains the integrity of the securities markets. SEC is empowered with broad authority over all aspects of the securities industry. This includes the power to register, regulate and oversee brokerage firms, transfer agents, clearing agencies as well as the nation's securities SROs such as the NYSE and the National Association of Securities Dealers (NASD). The SEC has five Commissioners who are appointed by the US President with the advice and consent of the Senate. Their term of service is five years.

5.6 In implementing the various pieces of federal securities legislation, the SEC establishes rules that regulate procedures and standards for a variety of activities. These include rules for short selling, solicitations, rights distributions, confirmation procedures, margin credit arrangements, proxy solicitation, tender offers, net capital requirements for securities firms and broker-dealers, reserves, commissions, off-exchange trading, sales of unregistered securities and shelf and active registrations.

The Security Investor's Protection Corporation

5.7 The Securities Investor's Protection Corporation (SIPC) is a nonprofit, membership corporation, funded by its member securities broker-dealers. It protects customers of the SEC registered broker-dealers against losses caused by financial failure of the broker-dealers. The maximum claim amount is US$500,000 (HK$3,899,000) with a limitation of US$100,000 (HK$779,800) in cash. In the event the SIPC Fund is insufficient for all claims, the SIPC may borrow up to US$1 billion (HK$7.8 billion) from the US Treasury through the SEC. If the SEC determines that industry assessments cannot repay the loan, it may impose a transaction fee on purchasers of equity securities at a rate not exceeding 1/50 of 1% of the purchase price, i.e. US$0.2 per US$1,000. This fee does not apply to transactions of less than US$5,000 (HK$38,990).

5.8 SIPC is run by a Board of seven directors, five of whom are appointed by the US President. The others are designated by the Secretary of the Treasury and the Federal Reserve Board.

National Association of Securities Dealers

5.9 The National Association of Securities Dealers (NASD) is the largest securities-industry SRO in the US. NASD develops rules and regulations, conducts regulatory reviews of members' business activities and disciplines violators. It also designs, operates and regulates securities markets and services for the ultimate benefit and protection of investors.

Debt Markets

5.10 There are many debt securities that are of different nature which are outlined below.

Bonds

5.11 Bonds are debt securities with maturities of longer than one year and must be registered with the SEC. They may be issued by governments or by private sector companies.

Asset-backed Securities

5.12 Asset-backed securities are divided into two categories, namely, mortgage-backed securities and non-mortgage securities. Mortgage-backed securities give investors the right to interest payments from a large number of mortgage loans. Examples of mortgage-backed securities are Fannie Maes[20], Ginnie Maes[21], Freddie Macs[22] and Farmer Macs[23]. Non-mortgage securities are asset-backed securities which give owners the right to income from other assets. Examples of non-mortgage securities are credit card securities, home equity loans, automotive loans, manufactured-housing securities, student loans, stranded-cost securities and other novel types of asset-backed securities. There is no government regulator or SRO to regulate the asset-backed securities industry.

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20 Fannie Maes are securities issued by the Federal National Mortgage Association, a publicly owned, federally sponsored corporation that provides liquidity to the financial system by buying mortgages from the institutions that originate them, thus allowing them to relend the funds.

21 Ginnie Maes are securities issued by mortgage bankers, under the auspices of the Government National Mortgage Association, to facilitate government mortgage lending.

22 Freddie Macs are issued by the Federal Home Loan Mortgage Corporation (FHLMC). FHLMC packages the individual mortgages they buy into pools (groups of similar types of mortgages with similar rates and maturities) and sell them to investors as debt securities.

23 Farmer Macs are pass-throughs of mortgages on farms and rural homes. The Federal Agricultural Mortgage Credit Corporation, a shareholder-owned company established by the US government, securitizes both agricultural mortgages and loans guaranteed by the US Department of Agriculture, some of which are not mortgages.

Municipal Securities

5.13 Municipal securities are debt securities such as bonds and notes issued by states, cities and counties or their agencies to help financing public projects. Municipal securities are regulated by the Municipal Securities Rulemaking Board (MSRB).

- Municipal Securities Rulemaking Board

5.14 The Municipal Securities Rulemaking Board (MSRB) is a SRO subject to oversight by the SEC. It develops rules regulating securities firms and banks involved in underwriting, trading and selling municipal securities.

5.15 The Board has broad rulemaking authority over municipal securities dealers' activities. This includes:

(a) professional qualification standards;

(b) fair practice;

(c) recordkeeping;

(d) confirmation, clearance and settlement of transactions;

(e) the scope and frequency of compliance examinations; and

(f) the nature of securities quotations.

5.16 MSRB constitutes 15 members, five of whom come from banking sector, five from securities firms and five from public who are not associated with any bank or securities dealer. The term of service is three years.

Money Markets

5.17 Money markets provide liquidity for investors to obtain or lend funds on a short-term basis. Debt instruments with maturities of one year or less are traded in money markets. These instruments include commercial paper[24], bankers' acceptances[25], treasury bills[26], government agency notes[27], local government notes[28], interbank loans[29], time deposits[30] and international agency paper.

5.18 There is neither a government regulator nor a SRO for the money markets.

Futures Markets

5.19 A future contract is an agreement to buy or sell a standard amount of a specific commodity in the future at a certain price. There are two forms of future contracts, namely, commodity futures and financial futures. Commodity futures concern agricultural products, metals, energy and transport. Financial futures include interest-rate futures, currency futures, stock-index futures, share-price futures, etc.

5.20 In the US, the major futures exchanges are the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (Merc). Other futures exchanges include the New York Futures Exchange (NYFE), the New York Mercantile Exchange (MYM), the New York Coffee, Sugar, and Cocoa Exchange (CSCE), the New York Cotton Exchange (CTN), the New York Commodity Exchange (COMEX), the New York Financial Exchange (FINEX), the International Petroleum Exchange (IPE), the Kansas City Board of Trade (KC), the MidAmerica Commodity Exchange (MCE) and the Minneapolis Grain Exchange (MPLS). The US futures activities are regulated by the federal Commodity Futures Trading Commission (CFTC) which operates through the various exchanges and through the National Futures Association (NFA).

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24 Commercial paper is a short-term debt obligation of a private-sector firm or a government-sponsored corporation.

25 Bankers' acceptances are promissory notes issued by a non-financial firm to bank for a loan.

26 Treasury bills, often referred to as T-bills, are securities issued by national governments with a maturity of one year or less.

27 Government agency notes are short-term debt notes issued by national government agencies or government-sponsored corporations.

28 Local government notes are short-term debt notes issued by state, provincial or local governments or by agencies of these governments.

29 Interbank loans are loans extended from one bank to another with which it has no affiliation.

30 Time deposits are interest-bearing bank deposits that cannot be withdrawn without penalty before a specified date. They are also called certificates of deposit (CDS).

The Commodity Futures Trading Commission

5.21 The Commodity Futures Trading Commission (CFTC) is an independent agency with the mandate to regulate commodity futures and option markets in the US. CFTC protects market participants against manipulation, abusive trade practices and fraud.

5.22 The Commission constitutes five Commissioners, appointed by the US President with the advice and consent of the Senate to serve staggered five-year terms.

National Futures Association

5.23 National Futures Association (NFA) is the industrywide SRO for the US futures industry. Any firm or individual that conducts futures or options on futures business with the public must be registered with the CFTC and be a Member of NFA[31]. NFA performs the registration process on behalf of the CFTC.

5.24 NFA's mission is to provide innovative regulatory programmes and services that ensure futures industry integrity, protect market participants and help its Members meet their regulatory responsibilities. NFA's activities are overseen by the CFTC.

<u>Options Markets</u>

5.25 Options are contracts that give the holder the right, but not the obligation to either buy or sell a stipulated commodity at a specified price on or before the expiration date. The most widely traded types of options are equity options, index options, interest-rate options, commodity options and currency options. Options are traded on the AMEX, the NYSE, the Pacific Stock Exchange, the Philadelphia Stock Exchange and the Chicago Board of Options Exchange (COBE). All listed options are cleared through the Options Clearing Exchange.

Options Clearing Exchange

5.26 Options Clearing Exchange is the largest clearing organization for financial derivatives instruments[32]. Operating under the jurisdiction of the SEC, Options Clearing Exchange is the issuer and registered clearing facility for all the US exchange-listed securities options. Options Clearing Exchange receives most of its revenue from clearing fees charged to its members.

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31 NFA Member categories include Commodity Trading Advisors (CTA), Commodity Pool Operators (CPO), Futures Commission Merchants (FCM) and Introducing Brokers (IB).

32 Derivatives refer to a large number of financial instruments whose value is based on, or derived from, the prices of securities, commodities, money or other external variables.

<u>OTC Foreign Exchange Markets</u>

5.27 The Treasury Department monitors and conducts foreign exchange operations through the Federal Reserve System. As there is no exchange control in the US, no specific license is required to deal in foreign exchange. Foreign exchange is available in spot markets and forward markets.

6. Financial Reform in the US

6.1 In 1999, the US Senate and House of Representatives passed the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (Financial Services Modernization Act).

<u>Reasons for Reform</u>

6.2 Federal laws enacted during the Great Depression such as the Glass-Steagall Act[33] and Bank Holding Company Act[34] block banks, stockbrokers and insurance companies from entering each other's line of business. In order to create financial supermarkets that provide everything from checking accounts to auto insurance, the three industries had lobbied Congress for years to streamline regulatory hurdles that bar such operations. The passage of the Financial Services Modernization Act represents the most significant deregulation of the US financial services industry in over half of a century.

6.3 The Financial Services Modernization Act repeals the Glass-Steagall Act's restrictions on bank and securities firm affiliations and amends the Bank Holding Company Act to permit affiliations among financial services companies, including banks, registered investment companies, securities firms and insurance companies. The Financial Services Modernization Act includes several amendments to the Investment Company Act and the Investment Advisers Act that are intended to ensure that the SEC has full authority over investment companies that are affiliated with banks. It also imposes privacy requirements and disclosure obligations on all financial firms, even if they are not affiliated with a bank or thrift. Please refer to Appendix I for summary of provisions of the Financial Services Modernization Act.

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[33] Glass-Steagall Act is the Banking Act of 1933 (P.L. 73-66, 48 STAT. 162). This Act separated commercial banking from investment banking, establishing them as separate lines of commerce.

[34] Bank Holding Company Act of 1956 (P.L. 84-511, 70 STAT. 133) required Federal Reserve Board approval for the establishment of a bank holding company. Prohibited bank holding companies headquartered in one state from acquiring a bank in another state.

Appendix I

Summary of Provisions of Financial Services Modernization Act

TITLE I -- FACILITATING AFFILIATION AMONG BANKS, SECURITIES FIRMS, AND INSURANCE COMPANIES

- Repeals the restrictions on banks affiliating with securities firms contained in sections 20 and 32 of the Glass-Steagall Act.
- Creates a new "financial holding company" under section 4 of the Bank Holding Company Act. Such holding company can 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 also are authorized. The nonfinancial activities of firms predominantly engaged in financial activities (at least 85% financial) are grandfathered for at least 10 years, with a possibility for a five year extension.
- The Federal Reserve may not permit a company to form a financial holding company if any of its insured depository institution subsidiaries are not well capitalized and well managed, or did not receive at least a satisfactory rating in their most recent CRA exam.
- If any insured depository institution or insured depository institution affiliate of a financial holding company received less than a satisfactory rating in its most recent CRA exam, the appropriate Federal banking agency may not approve any additional new activities or acquisitions under the authorities granted under the Act.
- Provides for State regulation of insurance, subject to a standard that no State may discriminate against persons affiliated with a bank.
- Provides that bank holding companies organized as a mutual holding companies will be regulated on terms comparable to other bank holding companies.
- Lifts some restrictions governing nonbank banks.
- Provides for a study of the use of subordinated debt to protect the financial system and deposit funds from "too big to fail" institutions and a study on the effect of financial modernization on the accessibility of small business and farm loans.
- Streamlines bank holding company supervision by clarifying the regulatory roles of the Federal Reserve as the umbrella holding company supervisor, and the State and other Federal financial regulators which ‘functionally' regulate various affiliates.

- Provides for Federal bank regulators to prescribe prudential safeguards for bank organizations engaging in new financial activities.
- Prohibits FDIC assistance to affiliates and subsidiaries of banks and thrifts.
- Allows a national bank to engage in new financial activities in a financial subsidiary, except for insurance underwriting, merchant banking, insurance company portfolio investments, real estate development and real estate investment, so long as the aggregate assets of all financial subsidiaries do not exceed 45% of the parent bank's assets or $50 billion, whichever is less. To take advantage of the new activities through a financial subsidiary, the national bank must be well capitalized and well managed. In addition, the top 100 banks are required to have an issue of outstanding subordinated debt. Merchant banking activities may be approved as a permissible activity beginning 5 years after the date of enactment of the Act.
- Ensures that appropriate anti-trust review is conducted for new financial combinations allowed under the Act.
- Provides for national treatment for foreign banks wanting to engage in the new financial activities authorized under the Act.
- Allows national banks to underwrite municipal revenue bonds

TITLE II -- FUNCTIONAL REGULATION

- Amends the Federal securities laws to incorporate functional regulation of bank securities activities.
- The broad exemptions banks have from broker-dealer regulation would be replaced by more limited exemptions designed to permit banks to continue their current activities and to develop new products.
- Provides for limited exemptions from broker-dealer registration for transactions in the following areas: trust, safekeeping, custodian, shareholder and employee benefit plans, sweep accounts, private placements (under certain conditions), and third party networking arrangements to offer brokerage services to bank customers, among others.
- Allows banks to continue to be active participants in the derivatives business for all credit and equity swaps (other than equity swaps to retail customers).
- Provides for a "jump ball" rulemaking and resolution process between the SEC and the Federal Reserve regarding new hybrid products.
- Amends the Investment Company Act to address potential conflicts of interest in the mutual fund business and amendments to the Investment Advisers Act to require banks that advise mutual funds to register as investment advisers.

TITLE III -- INSURANCE

- Provides for the functional regulation of insurance activities.
- Establishes which insurance products banks and bank subsidiaries may provide as principal.
- Prohibits national banks not currently engaged in underwriting or sale of title insurance from commencing that activity. However, sales activities by banks are permitted in States that specifically authorize such sales for State banks, but only on the same conditions. National bank subsidiaries are permitted to sell all types of insurance including title insurance. Affiliates may underwrite or sell all types of insurance including title insurance.
- State insurance and Federal regulators may seek an expedited judicial review of disputes with equalized deference.
- The Federal banking agencies are directed to establish consumer protections governing bank insurance sales.
- Preempts state laws interfering with affiliations.
- Provides for interagency consultation and confidential sharing of information between the Federal Reserve Board and State insurance regulators.
- Allows mutual insurance companies to re-domesticate.
- Allows multi-state insurance agency licensing.

TITLE IV -- UNITARY SAVINGS AND LOAN HOLDING COMPANIES

- De novo unitary thrift holding company applications received by the Office of Thrift Supervision after May 4, 1999, shall not be approved.
- Existing unitary thrift holding companies may only be sold to financial companies.

TITLE V -- PRIVACY

- Requires clear disclosure by all financial institutions of their privacy policy regarding the sharing of non-public personal information with both affiliates and third parties.
- Requires a notice to consumers and an opportunity to "opt-out" of sharing of non-public personal information with nonaffiliated third parties subject to certain limited exceptions.

- Addresses a potential imbalance between the treatment of large financial services conglomerates and small banks by including an exception, subject to strict controls, for joint marketing arrangements between financial institutions.
- Clarifies that the disclosure of a financial institution's privacy policy is required to take place at the time of establishing a customer relationship with a consumer and not less than annually during the continuation of such relationship.
- Provides for a separate rather than joint rulemaking to carry out the purposes of the subtitle; the relevant agencies are directed, however, 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.
- Allows the functional regulators sufficient flexibility to prescribe necessary exceptions and clarifications to the prohibitions and requirements of section 502.
- Clarifies that the remedies described in section 505 are the exclusive remedies for violations of the subtitle.
- Clarifies that nothing in this title is intended to modify, limit, or supersede the operation of the Fair Credit Reporting Act.
- Extends the time period for completion of a study on financial institutions' information-sharing practices from 6 to 18 months from date of enactment.
- Requires that rules for the disclosure of institutions' privacy policies must be issued by regulators within 6 months of the date of enactment. The rules will become effective 6 months after they are required to be prescribed unless the regulators specify a later date.
- Assigns authority for enforcing the subtitle's provisions to the Federal Trade Commission and the Federal banking agencies, the National Credit Union Administration, the Securities and Exchange Commission, according to their respective jurisdictions, and provides for enforcement of the subtitle by the States.

TITLE VI -- FEDERAL HOME LOAN BANK SYSTEM MODERNIZATION

- Banks with less than $500 million in assets may use long-term advances for loans to small businesses, small farms and small agri-businesses.
- A new, permanent capital structure for the Federal Home Loan Banks is established. Two classes of stock are authorized, redeemable on 6-months and 5-years notice. Federal Home Loan Banks must meet a 5% leverage minimum tied to total capital and a risk-based requirement tied to permanent capital
- Equalizes the stock purchase requirements for banks and thrifts.

- Voluntary membership for Federal savings associations takes effect six months after enactment.
- The current annual $300 million funding formula for the REFCORP obligations of the Federal Home Loan Banks is changed to 20% of annual net earnings.
- Governance of the Federal Home Loan Banks is decentralized from the Federal Housing Finance Board to the individual Federal Home Loan Banks. Changes include the election of chairperson and vice chairperson of each Federal Home Loan Bank by its directors rather than the Finance Board, and a statutory limit on Federal Home Loan Bank directors' compensation.

TITLE VII -- OTHER PROVISIONS

- Requires ATM operators who impose a fee for use of an ATM by a non-customer to post a notice on the machine that a fee will be charged 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. Provision is made for those older machines that are unable to provide the notices required. Requires a notice when ATM cards are issued that surcharges may be imposed by other parties when transactions are initiated from ATMs not operated by the card issuer. Exempts ATM operators from liability if properly placed notices on the machines are subsequently removed, damaged, or altered by anyone other than the ATM operator.
- Clarifies that nothing in the act repeals any provision of the CRA.
- Requires full public disclosure of all CRA agreements.
- Requires each bank and each non-bank party to a CRA agreement to make a public report each year on how the money and other resources involved in the agreement were used.
- Grants regulatory relief regarding the frequency of CRA exams to small banks and savings and loans (those with no more than $250 million in assets). Small institutions having received an outstanding rating at their most recent CRA exam shall not receive a routine CRA exam more often than once each 5 years. Small institutions having received a satisfactory rating at their most recent CRA exam shall not receive a routine CRA exam more often than once each 4 years.
- Directs the Federal Reserve Board to conduct a study of the default rates, delinquency rates, and profitability of CRA loans.
- Directs the Treasury, in consultation with the bank regulators, to study the extent to which adequate services are being provided as intended by the CRA.

- Requires a GAO study of possible revisions to S corporation rules that may be helpful to small banks.
- Requires Federal banking regulators to use plain language in their rules published after January 1, 2000.
- Allows Federal savings associations converting to national or State bank charters to retain the term "Federal" in their names.
- Allows one or more thrifts to own a banker's bank.
- Provides for technical assistance to miccroenterprises (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 recommendations on adapting those rules to online 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 Guarantee 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.
- Allow directors serving on the boards of public utility companies to also serve on the boards of banks.

Source: http://www.senate.gov/~banking/conf/grmleach.htm

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