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Statement of the Shadow Financial Regulatory Committee

on

An Open Letter to the New President and Congress
On an Agenda for Financial Reform

December 4, 2000

During the past several years, policy toward the financial sector has played an important role in our economy and in the economies of other countries around the world. Here at home, the Congress enacted the Gramm-Leach-Bliley Act of 1999 (GLBA), which, after almost two decades of debate, helped bring our financial laws closer to the realities of the modern financial marketplace. While it may be tempting to believe that little of substance remains on the financial policy agenda, this is not correct. In fact, a number of important financial and regulatory issues deserve to be addressed -- through announcements of Administration policy, legislation, and regulatory action. As you take office to lead our country, the Shadow Financial Regulatory Committee urges that you give attention to the following issues.

1. Further Modernize the Laws Governing the Separation of Finance and Commerce

After considerable debate, the GLBA limited financial holding companies to "financial" activities, while vesting in both the Federal Reserve and the Treasury the authority to define the scope of this term. This approach was widely seen as maintaining the separation of banking and commerce. The Committee believes the distinction between finance and commerce is artificial and certain to be outflanked by future market developments. Indeed, financial institutions in

Europe are already affiliating with telecommunications companies to deliver financial services jointly through wireless telephones. There is no reason, in principle, why the same corporate structures for separating insured banks from other parts of financial enterprises – separate affiliates or subsidiaries, separate capital requirements, and limitations on inter-company transfer – cannot also be applied to financial organizations engaged in non-financial activities or owned by non-financial or commercial enterprises. The Committee urges the next Administration and Congress to recognize sooner rather than later that the finance-commerce distinction is untenable and ought to be removed from the current law.

2. Reconsider Administration of the GLBA by the Federal Reserve

The fact that nonbanking organizations have made limited use of the expanded activity authority in the GLBA has raised questions about whether the Act was well designed to achieve its ostensible deregulatory purposes. In addition, the Fed's merchant banking regulations have raised questions—particularly in the banking industry—about whether the Fed is fully carrying out the spirit of the Act. Together, these developments suggest the need for Congress to take another look at the legislation passed in the last session, and to reconsider in this context whether some further adjustments in the law are warranted.

3. Set a uniform national policy on the privacy of financial information

As part of the GLBA, Congress enacted new protections for personal data collected by financial institutions. These required financial organizations to notify consumers of how information collected about them will be used, and to offer consumers, subject to some exceptions, the ability to "opt out" of having such information transferred to third parties outside the financial organization. At the same time, Congress authorized states to enact more stringent privacy rules for financial institutions. By deferring to the states, however, Congress has created a significant risk that there will be multiple – up to 51 – different financial privacy rules applicable to financial organizations. This will lead not only to consumer confusion but also to excessive compliance costs by national financial organizations—costs which ultimately will be borne by consumers themselves. As part of the attention that Congress is expected to give to financial and medical privacy in its next session, the Committee strongly urges that any new legislation provide for uniform national rules regarding financial records that would preempt multiple state-based requirements.

4. Limit and Better Target Federal Subsidies of Government-Sponsored Enterprises

Toward the end of its current session, Congress has undertaken a serious examination of the implications for taxpayers of the rapid growth in the three major housing-related government-sponsored enterprises (GSEs): Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. As Federal Reserve Chairman Greenspan has pointed out, the GSEs benefit from the implicit backing of the federal government and, in the process, distort the allocation of credit. The Committee also believes there is a possibility that if any of the GSEs were threatened with insolvency, there would be strong political pressures to bail out the holders of its debt and any securities it may have guaranteed. The risks to taxpayers are likely to grow even greater because the amount of debt issued and guaranteed by the GSEs is rising at double-digit rates. Accordingly, if full privatization of these institutions is not feasible at this time, the Committee urges the next Administration and the Congress to consider and implement measures that will limit taxpayer risk, while also more carefully targeting the benefits conferred by the GSEs on those who are truly need the assistance to purchase homes.

There is also the possibility—raised by the Treasury Department in testimony last year—that unlimited bank investment in the sureties of the GSEs might be creating systemic risk. It is difficult to evaluate whether this is a legitimate concern without better information about bank holdings of GSE securities. Accordingly, two possible initiatives deserving immediate attention are changes to bank call reports that would require banks to disclose their investments in GSE securities and other securities guaranteed by the GSEs, and investment limits on securities of both types (analogous to current "loan-to-one borrower" limits for conventional loans) that would keep banks from excessive exposure to such securities and allay any systemic risk such investment might entail.

5. Reconsider Statutory Concentration Limits on Banks

As part of the 1994 legislation authorizing banks to establish branches across state lines, Congress prohibited banks from merging if their combined deposits exceeded 10% of the nationwide market, or if in any state the combined deposits exceeded 30% of the statewide total. The concentration limits, however well motivated, are looking increasingly anachronistic in light of the continued rapid growth of non-bank financial institutions (other lenders, mutual funds and pension funds in particular). A far more sensible way to ensure viable competition in all banking – and indeed all financial – markets is to apply to banks the same antitrust laws that are applicable to all other firms in the economy, and thus remove the redundant and unjustifiably restrictive concentration limits that are part of current law. Indeed, there is a strong case for eliminating the overlapping jurisdiction over bank mergers now shared by the bank regulatory agencies and the Justice Department. A more streamlined system would vest sole authority for the competitive aspects of bank mergers in the Justice Department.

6. Consider an Optional Federal Charter for Insurance Companies

With the gradual convergence of products, growing globalization of financial services, and the development of diversified financial services firms, the U.S. insurance industry is facing increasing competition from other industries and from abroad. Yet the existing insurance regulatory system in the United States, in which insurance companies are chartered and regulated at the state level, has not kept pace with the need for prompt new product approval and the development of competitive rate structures. As a result, many in the insurance industry have begun to call for an optional federal chartering and regulation system, similar to the national bank chartering and regulation system, which would give insurance companies that operate on a multi-state basis an opportunity to achieve more uniform and less cumbersome regulation. Unless the state insurance regulatory structure can be substantially reformed more effectively, enabling U.S. insurance companies to meet their competition, Congress should consider an optional federal chartering system in its next session.

7. Review and Clarify Regulation of Financial Derivatives

The Congress has been debating, but so far has failed to enact, legislation that would clarify the regulatory structure governing over-the-counter (OTC) derivatives markets, especially the swap market. The Committee urges the next Administration and the Congress to complete the job by making explicit that the swap market is exempt from oversight and regulation by the Commodities Futures Trading Commission (CFTC). Major swap participants and dealers, such as banks and securities firms, already are regulated by either bank regulatory agencies or the Securities and Exchange Commission (SEC). The regulations governing exchange-traded futures also should be reviewed and made compatible with recent innovations and developments in derivatives markets and in financial markets more generally.

8. Set A Policy For Dealing With The Next International Financial Crisis

In 1997-98 East Asia, and later Russia and Brazil, were rocked by financial crises marked by, among other things, weak and poorly supervised financial systems. In the view of many observers, the availability of relatively cheap financing by the International Monetary Fund during and after these crises tended to support the lending excesses that contributed to these crises in the first instance. These financial crises have spawned a major debate in policy and academic circles both about what policies ought to be pursued to prevent another international financial crisis and, should another crisis occur, how better to manage it. In particular, the Congress appointed the Meltzer Commission to offer recommendations on these issues. Although the debate on appropriate reform of the "international financial architecture" continues, it is now widely agreed that in the event of another crisis private creditors should bear a significant portion of any losses – both on grounds of fairness and to discourage excessive risk-taking by borrowers and lenders that can precipitate and aggravate financial crises. The Committee urges the next Administration to quickly announce what policies and principles it believes should govern the resolution of any future financial crisis, so that all relevant actors – governments, lenders and borrowers – can be put on notice soon and adjust their activities accordingly.