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Office of Research and Policy Analysis

Background Issues Related to Financial Institution Regulation

To: **Economic Affairs Committee and State Administration and Veterans Affairs Committee**
From: **Pat Murdo, Legislative Services**
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The following background information is intended to provide some conceptual and historical context for the Jan. 23 meeting on financial services regulation, specifically keyed to three issues:
-- State/federal control
-- Regulation, its costs and benefits
-- The dual banking system and changes associated with the Gramm, Leach, Bliley Act and changes in international banking rules

An appendix provides:
-- A table on the types of financial institutions that are regulated in Montana;
-- Basic summaries of relevant federal banking, insurance and securities laws; and
-- Short biographies of panelists.

New Federalism and States' Rights or... Not
Federalism, referring to a strong central government, has as a counterpart, New Federalism, which typically refers to devolution of power from the federal government to the states. The concepts have been controversial throughout this country's history. New Federalism incorporates but is not strictly a matter of states' rights, which refers to the U.S. Constitution's 10th Amendment: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

In the 1990s, welfare reform characterized a New Federalism approach. States gained more responsibility from the federal government for managing welfare assistance and developing innovative programs to move people into jobs and off the welfare rolls. Today, a variety of issues, ranging from local input on national forests to educational standards, involves the question of who has regulatory authority. The question of who regulates whom is broader than, but depends on, who has legislative authority. Against this backdrop, it is helpful to remember that federal law preempts a contrary state law under the Supremacy Clause of the Constitution (Article VI).

Among points of federal vs. state regulatory contention are:
- regulatory consistency vs. site-specific needs;
- a bureaucracy not beholden to local interests vs. proximity to constituents and lawmakers; and
- enforcement that is either more or less available, more or less accountable, more or less stringent.

In the financial field, in general, the dual banking/credit union system provides for federal control of federally chartered banks and credit unions and state control of state-chartered banks and credit unions. States generally have regulated insurance. And for securities there is a mix of federal and state

regulation.

Regulatory Changes in Financial Services
-- Recent events. Laws passed by Congress at the end of 2003, a regulation proposed last year by the Office of the Comptroller of the Currency, and New York Attorney General Eliot Spitzer's litigation of mutual fund abuses have highlighted discussions about federal/state financial regulation.

--Fair Credit Reporting Act changes.
A revised Fair Credit Reporting Act, for example, passed by Congress in November 2003, included amendments preempting state laws by setting national standards in nine areas associated with identity theft. These include, according to t he National Conference of State Legislature:
1) truncation of credit or debit card numbers
2) fraud alerts and active duty alerts
3) blocks on information resulting from identity theft
4) Social Security number truncation
5) free credit reports
6) red flag guidelines and debt collector communications
7) coordination of consumer complaint investigations
8) obligations to prevent the repollution of credit reports
9) disposal of records.

According to the National Conference of State Legislatures, the conference report on the bill included a provision allowing consumers to opt out of solicitations from affiliates of companies with which they do business and another provision that requires "risk-based pricing" notices to be sent out by creditors to customers who receive less favorable terms due to low credit scores.

--OCC preemption proposal.
In the August 5, 2003, Federal Register, the Office of the Comptroller of the Currency laid out its case for preemption of state laws as they apply to federally chartered banks. The OCC cited case law, starting with an 1819 ruling in McCulloch v. Maryland in which the U.S. Supreme Court said the Supremacy Clause of the U.S. Constitution means states "have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control, the operations of an entity created under Federal law." (McCullough v. Maryland, 17 U.S. (4 Wheat.) 316, 436 (1819). See below for references to the dual banking system created when the National Bank Acts of 1863 and 1864 established a system of national banks; a separate system of state banks already existed

The OCC specifies various preemptions of state laws as applied to federally chartered banks, including preemptions of:
1) Filing requirements ("visitorial" powers)
2) Terms of real estate loans, as they apply to loan-to-value ratios, schedules for repayment of principal and interest, the term to maturity of real estate laws, adjustable rate mortgages.
3) Advertising.
4) Permissible rates of interest based on where the bank is located, not where the borrower is located.
5) Permissible fees and noninterest charges.

6) Management of credit accounts, including communications with credit card holders or terms of offers for credit.
7) Due-on-sale clauses.
8) Leaseholds as they relate to acceptable security (preempting, for example, state laws that specify covenants and restrictions that must be contained in a lease to qualify as acceptable security).
9) Mandated statements and disclosures.

The OCC seeks to clarify what state restrictions or requirements may apply to national banks, particularly in real estate lending.

Also as part of the OCC statement in the Federal Register, the agency listed principles for national banks to apply in attempting to minimize predatory lending without reducing credit available to subprime borrowers.

The OCC also noted that state laws that are not preempted include those that "generally pertain to contracts, debt collection, acquisition and transfer of property, taxation, zoning, crimes, torts, and homestead rights."

The National Conference of State Legislatures (NCSL), the National Association of Attorneys General (NAAG), the National Association of Insurance Commissioners (NAIC), the North American Securities Administrators Association (NASAA), and the Conference of State Bank Supervisors (CSBS) have all voiced concern over the OCC's preemption proposal.

Among various concerns raised by both NCSL and CSBS is that the preemption proposal refers to state laws "that obstruct, in whole or in part, or condition, national banks' exercise of real estate lending powers granted under Federal law." (Page 46128 of the *Federal Register,* Vol. 68, No. 150.) NCSL said this language is broader than past language by including the words "or condition".

In an October 6, 2003, letter commenting on the proposed rule, the NAAG called the OCC's preemption analysis "one-sided and self-serving" and noted that "well-established history and precedent" have "allowed the States and the OCC to coexist in a dual regulatory role for over 130 years." Among the precedents, NAAG said, are that "... national banks are subject to state laws unless the state laws significantly impair the national bank's powers created under federal law." In the area of consumer protection, particularly, the NAAG said, "As a general rule, state consumer protection laws prohibit businesses from engaging in unfair or deceptive practices. These laws are consistent with Section 5 of the Federal Trade Commission Act, and the States traditionally have enforced them in a wide range of financial activities involving consumers. ...It would be unprecedented and unfair to grant national banks (including in the OCC's view, affiliated <u>nonbank</u> institutions) total immunity from all state consumer protection regulation and enforcement." (emphasis in the original -- NAAG letter commenting on proposed OCC rule, Oct. 6, 2003.)

The NASAA comments on the OCC proposed preemption rule included the following: "We believe the proposal raises the legal and public

policy questions of whether one federal regulatory agency can and should be preempting laws that were lawfully enacted by state legislatures to protect their citizens without explicit Congressional authority." (NASAA letter to OCC, October 6, 2003.)

-- Activities by New York Attorney General Eliot Spitzer to address problems in the mutual fund industry.

Many mutual fund companies are domiciled in New York, which gives the State of New York as well as the SEC (the Securities and Exchange Commission) and self-regulating agencies like NASD (the National Association of Securities Dealers) both investigative and regulatory authority. Accusations of improper trading by mutual fund managers resulted in Attorney General Spitzer investigating and charging various mutual fund officers with illegal trades in 2003. The court cases have highlighted the dual role of federal and state oversight in the securities industry.

Accessibility

Another aspect of state versus federal lawmaking relates to accessibility to lawmakers and the comparative "ease" of passing laws at one level or the other. Some commentators suggest that state legislatures are more accessible and closer to citizen concerns, which they equate with legislation possibly passing more easily for such issues as consumer protection (although this depends on the electorate). The corollary also holds -- that legislation passed at the national level may take longer to pass and be subject to a broader range of voices. From another perspective, fewer legislators ultimately decide on regulations at the federal level than if 50 state legislatures act on similar legislation.

Another perspective on accessibility relates to the Community Reinvestment Act (CRA), which requires banks (both federal and state-chartered) to invest a portion of their deposits in moderate- to low-income projects or other economic development projects in their sphere of operation. Those banks affiliated with out-of-state operations may or may not have local CRA officers.

Innovation, Consistency and Surprises

Among the pluses of New Federalism is that states are considered to be a breeding ground for innovative approaches to dealing with various problems. A minus from business perspectives is that states may enact variations on laws that differ across borders, which for regional or national companies translates to more compliance costs.

One way that Montana has addressed concerns about federally regulated financial organizations gaining a competitive advantage over state-regulated financial institutions is to provide so-called wild card authority. Wild-card authority lets the Department of Administration, upon a request by banks or credit unions, authorize "activities that are not expressly prohibited or limited by the laws of this state" if the powers have been granted to their federally regulated counterparts. (See 32-1-362, MCA, "National bank powers extended to state banks" and 32-3-206, MCA, "Authorized activities of credit

unions.")

The surprises often contained in federal legislation, which allows numerous topics under one title, are not allowed in state legislation under Montana's Constitution. Montana's Constitution requires legislation to have only one subject, clearly noted in the title.

Regulation -- State or Federal?
Differences exist in severity or laxness of scrutiny and responsiveness to complaints.

Regulation costs. So does lack of regulation -- whether in lawsuits by consumers, by employees, by investors, or by competitors. Depending on the field being regulated, a regulation may impact physically or financially the health of either the general public or certain groups. For businesses, the paperwork and costs of compliance are often far more assured than the potential of a lawsuit. The tradeoff is that a lawsuit can be devastating. If fraud or malice is involved, the devastation may be well-earned, but even if neither is involved, the harm to the public may be greater than any cost of regulation. The balance lies in weighing public concerns and the public cost of enforcing regulations with the risks to the public and the costs to business. Balancing these concerns is no easy task.

Costs - The following observations about the costs of regulation are from a December 2003 study prepared for the Manufacturing Institute of the National Association of Manufacturers. The report notes that U.S. federal budget outlays for economic regulatory activities increased by 13.9 percent for the finance and banking sector between 1990 and 2003 to a cost in 2003 of $1.79 billion. That's only the federal oversight part of the cost. The estimated cost of compliance by manufacturers in 1997 for economic compliance was reported as $48 billion and for tax compliance was $15 billion. The largest cost hitting manufacturers was for environmental compliance, estimated at $69 billion. Compliance with workplace safety and employment regulations ran about $16 billion in 1997, according to a 2001 report by W. Mark Crain and Thomas D. Hopkins quoted in the Manufacturing Institute study. The Manufacturing Institute study also cited a working paper by the Mercatus Center at George Mason University, which estimated that the cost of compliance with 25 statutes and executive orders related to workplace regulation (not specified as to federal or state statutes) was about $32 billion in 2000 for 100 manufacturing companies. (Jeremy A. Leonard, "How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness," prepared for the Manufacturing Institute of the National Association of Manufacturers, 2003. See also the citations within the study.)

Differential Applications - Here are some other views regarding regulation, based on anecdotal examples about differences in the application of regulations:

Insurance -- The General Accounting Office reported in September 2003 that regulation of insurance companies by states resulted in some insurance companies bearing the cost of market conduct investigations while others escaped

with no costs. Some companies faced as many as five investigations over a 3-year period, with two property-casualty and one life insurance company listing 15 examinations or more during a 3-year time frame. (Not clarified was whether these companies were involved in suspicious activities that generated the investigations.) Clearly, however, some insurance companies experienced no investigations. Although the GAO study did not list any Montana market conduct investigations, the State Auditor's Office will conduct these investigations on insurance companies headquartered in Montana and on any insurance company that is the subject of questionable market conduct.. (*GAO: Insurance Regulation: Common Standards and Improved Coordination Needed to Strengthen Market Regulation*.)

Parallel Regulations -- Odd as it may seem to use anecdotal information from the meatpacking industry, the industry -- like banking -- has the option of either federal or state compliance monitoring. In the following example, a Miles City meatpacking firm had trouble with the U.S. Department of Agriculture after a federal meat inspector cited the firm for distributing meat that contained *e coli* bacteria. The Montana firm had received the meat from a large Con Agra plant in Colorado, where Con Agra was allowed by federal law to self-regulate. The Montana firm's inability to get the federal recognition that the problem started higher up the chain of distribution and not within the Miles City plant resulted in a number of problems for the small-business owner. Along with putting his plant up for sale, he also applied for oversight by a state meat inspector. In the businessman's view, state regulation is one way of getting phone calls returned and is more personal, even though regulations are the same under either state or federal meat inspectors. (E-mail from John Munsell to the Economic Affairs Committee and related conversation)

Dual Banking, Firewalls, Competitiveness

Changes in the playing fields -- they now are much broader than in the past -- are becoming more obvious as federal regulatory agencies and states begin to implement the Gramm-Leach-Bliley Act and other federal legislation that has lowered the so-called firewalls erected in the Glass-Steagall Act to address the financial scandals of the 1920s and 1930s. Perhaps less obvious among the influences on financial regulation are changes stemming from international treatment of financial services, such as the Basel Accords. Capitalization requirements from the Basel Accords have led to an emphasis on large, well-capitalized banks that operate internationally.

Dual Banking - *Banking and Financial Institutions Law in a Nutshell,* by William A. Lovett, (1988) describes the mixed history of national and state banks.

State Domination - Prior to the 1830s, the federal government tried at two different times to be involved in banking, holding 20 percent of the capital in two U.S. banks at separate times. Neither bank lasted, folding to a mixture of distrust and a plentiful number of state banks. The states ended up as the only chartering authority for banks between 1836 and 1863.

Increased Federal Clout - After Southern states seceded from the Union in the Civil War, the National Currency Act of 1863 and then the National Bank Act of 1864 passed, allowing federal chartering of banks and creating the Office of the Comptroller of the Currency. The National Bank Act of 1864 prohibited branch banking of federally chartered banks. Congress also increased federal taxes on state bank notes, which then started to disappear from circulation. Although the Panic of 1873 and ensuing depression resulted in more state banks failing than federally chartered banks, state banks started to make a comeback. By 1900 state banks had surpassed the number of federally chartered or national banks.

More Federal Oversight - Congress created the Federal Reserve System in 1913, which stabilized the country's currency, provided lending and discount rate authority, and created a governance structure that required every national bank to be a member but also allowed state banks to be members. New Deal Reforms after the Great Depression resulted in the Glass-Steagall Act (Banking Act of 1933), which included creation of the Federal Deposit Insurance Corp. and the separation of investment from commercial banking by putting "firewalls" in place between the two. Legislation requiring publicly owned corporations to disclose financial information was accompanied by creation of the Securities and Exchange Commission to enforce these requirements. Between the 1930s and mid-1970s, concerns about bank mergers led to a series of laws regulating mergers.

More Openness - Increasing competition from savings and loan associations and the creation of money market funds that provided an equivalent of demand deposits started to result in a breakdown of some of the lines dividing different financial institutions. The Depository Institutions Deregulation and Monetary Control Act of 1980 was the first of several acts that began to blur differences between banks and savings and loan associations. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 allowed interstate banking. In 1999 Congress passed the Gramm-Leach-Bliley Act, which removed the firewalls that had prevented commercial banking and investment companies from having joint ownership.

Firewalls - The Gramm-Leach-Bliley Act of 1999 also removed the firewalls for bank holding companies' ownership of securities companies. Some controls remain regarding a national bank's subsidiary engaging in certain insurance, real estate development, or investment activities. Under the Gramm-Leach-Bliley Act, states continue to have functional regulation of insurance sales activities, even if the insurance activity is performed by a national bank. One reason for confusion in the general public as to who regulates whom stems, in part, from implementation of the major changes to financial institutions allowed by the Gramm-Leach-Bliley Act.

Competition - International trade in financial services has meant that foreign banks operate on U.S. soil, just as American banks operate overseas. The Basel Accords are international agreements for capitalization of these large banks, a way of ensuring safety of deposits.

What that means on Main Street is that certain banks, typically the large federally chartered banks, have stringent capital-to-asset ratios that they are required to meet. Whether that helps or hurts in competition with state-chartered banks is a question.