Recent Developments

Financial Services Reform Enacted

On November 12, President Clinton signed the Gramm-Leach-Bliley Act as Public Law 106-102. The new law repealed the Glass-Steagall Act, ending the separation of banking, insurance, and securities operations. The bill’s enactment was the result of both unprecedented cooperation and heated battles among the interest groups involved.

Modernization supporters in Congress decided early to get the ball rolling on the legislation to avoid the fate that befell efforts in the 105th Congress. The House modernization bill was introduced within the first few weeks of 1999. The Senate bill appeared in late April but traveled through the Senate at an extremely rapid pace. From the moment of the bill’s introduction it was apparent that the sticking points of modernization would be operating subsidiary powers, unitary thrift holding companies, and Community Reinvestment Act (CRA) provisions. Later, concern over consumer privacy also became an issue.

The first barrier to modernization was resolved on October 13 when the Federal Reserve and the Treasury Department came to an agreement regarding the activities of bank operating subsidiaries. National banks would be allowed to engage in securities activities through operating subsidiaries. Banks could not directly engage in or have subsidiaries engaged in merchant banking, insurance underwriting, or real estate development. Rather, these activities would be housed in nonbank subsidiaries of the banks' holding companies. This compromise shifted the focus to issues that, while not fundamental to the modernization process, still had enough presence to scuttle the legislation. Just over a week later, government officials announced a compromise between Congress and the White House over CRA. The compromise, reached on October 22, barred banks or thrifts with an Unsatisfactory rating on their most recent CRA examination from acquiring additional banks, securities firms, or insurance companies, although they would not be required to sell off existing nonbanking assets. The CRA changes also allowed small banks longer time between examinations and required...
disclosure of agreements related to the CRA between community groups and financial institutions.

With these issues settled and an agreement reached to prohibit both the formation of new unitary thrifts and the purchase of existing thrifts by nonfinancial firms, the issue of privacy remained the final stumbling block. The law allows banks to share customer information with their affiliates. The act also requires banks to disclose their privacy policy to customers each year and to permit customers to refuse to allow private information to be shared.

The passage of this act culminates some 20 years of effort to end the separation of banks, insurance companies, and securities firms. The major provisions of the Gramm-Leach-Bliley Act are outlined below under Summary of Federal Legislation.

ATM Surcharge War Escalates
An ongoing dispute between banks and local California governments over ATM surcharging has intensified. On November 2, 1999, voters in San Francisco passed Proposition F, which prohibits the owner of an ATM from charging a noncustomer a fee for using the ATM. San Francisco became the second city in the state to prohibit the practice. The prohibition on ATM surcharging in Santa Monica took effect on November 10. Banks directly affected by these local ordinances have reacted. On November 3, the California Bankers Association filed a lawsuit in federal court seeking to block enforcement of the prohibition. At issue is whether the municipalities, which claim jurisdiction under the consumer protection clauses of the Electronic Funds Transfer Act, have the authority to enjoin national banks from charging fees specifically authorized by the Office of the Comptroller of the Currency (OCC).

The OCC, the regulator of national banks, has used the California flare-up to stake a more definitive position on the surcharge issue than in the past. In a brief filed with the U.S. District Court for the Northern District of California on November 5, the OCC opined that the setting of fees by national banks was part of the “business of banking,” and thus, a statutory right granted by the National Bank Act. Local governments, consumer groups, and financial institutions across the country are watching the developments in Santa Monica and San Francisco with interest. A victory by anti-surcharge proponents will more than likely foster similar efforts in other parts of the country.

Consumer groups and banks have been at odds over the issue of surcharging since the practice became widespread following VISA’s decision to permit surcharges in 1996. Federal legislative efforts aimed at limiting surcharging have gone nowhere since former chairman of the Senate Banking Committee Alfonse D’Amato lost his reelection bid. A bill prohibiting surcharges was introduced on November 4 (see New Legislation for a summary of H.R. 3229), but no action has been taken on it. As a result of this void, consumer groups and local governments have increasingly become more vocal and aggressive in attempting to halt the practice.

SUMMARY OF FEDERAL LEGISLATION

For more information on legislation, go to Thomas-US Congress on the Internet.

Enacted Legislation


The Gramm-Leach-Bliley Act (the act) repeals the provisions of the Bank Holding Company Act of 1956 and the Banking Act of 1933 (Glass-Steagall) that restricted the ability of banks to engage in underwriting, real estate, and insurance activities either directly or through affiliates in a bank holding company (BHC).

Financial Holding Companies (FHCs). The act allows qualifying BHCs to become FHCs and thereby engage in any activity that the Federal Reserve Board (Board) — with the agreement of the Department of the Treasury (Treasury) — deems financial in nature or complementary to a financial activity. This would include securities underwriting and dealing, merchant banking, and insurance. Merchant banking involves taking temporary equity positions in nonfinancial firms with an eye toward reselling the stake at a profit. To qualify as an FHC, each of the institution’s bank subsidiaries must be well capitalized and well managed and have at least a Satisfactory Community Reinvestment Act (CRA) rating. If an FHC’s bank subsidiary becomes less than well capitalized, the Board can order the FHC to divest its nonbanking activities or bank subsidiary.

The act also allows nonbanking
financial firms to acquire BHCs, as long as nonfinancial holdings do not exceed 15 percent of consolidated revenues and provided any commercial holdings are divested within 15 years.

Financial Subsidiaries. A national bank is permitted to operate subsidiaries that engage in financial activities that are not permissible for the bank. However, financial subsidiaries are precluded from engaging in insurance underwriting, merchant banking, and real estate development and investment activities. Within five years, the Board and the Treasury would have the option of jointly prescribing regulations permitting national banks to engage in merchant banking activities through a financial subsidiary. To have a financial subsidiary, the bank and its depository affiliates must be well capitalized and well managed; they must have Satisfactory CRA ratings; and the combined assets of all operating subsidiaries cannot exceed the lesser of 45 percent of the parent bank’s assets or $50 billion. If a bank is one of the 50 largest insured banks in the nation, it must have at least one issue of unsecured long-term debt that is rated in one of the three highest categories by a nationally recognized rating agency such as Moody’s or Standard and Poor’s. The next 50 largest banks may satisfy some alternative criterion yet to be determined by the Treasury and the Board.

The parent bank’s investment in its financial subsidiary and the subsidiary’s internal funds would be deducted from the bank’s capital when evaluating the bank’s capital adequacy.

New Products. The Board and the Treasury would jointly determine whether new financial activities may be carried out within financial subsidiaries or must be carried out in separate nonbank affiliates. The act provides for expedited judicial review of conflicts between state insurance regulators and federal banking regulators over the treatment of insurance products, with banking regulators accorded no undue preference. Finally, the act requires the Securities and Exchange Commission (SEC) to seek Board concurrence before imposing registration requirements on any new hybrid securities.

Functional Regulation. The act seeks to lessen the regulatory burden and promote functional regulation of FHCs by requiring the Board to use existing reports or financial statements when possible. To examine a nondepository subsidiary of an FHC, the Board would also need to show reasonable justification, specifically that the subsidiary poses a material risk to an affiliated bank or is out of compliance with the act. The Board would be prohibited from imposing capital requirements on any nondepository subsidiary that is deemed in compliance by its primary regulator. Similar restrictions would apply to nonbank regulators via a vis depository affiliates of the FHC.

State insurance authorities or the SEC would be able to block a Board order to an FHC to transfer assets to a depository institution if this would weaken the insurance or investment banking affiliate. In this situation, the Board may order divestiture of the depository institution. The act would exempt banks providing third-party brokerage arrangements, sweep accounts, employee benefit plans, and certain other security activities from being defined as a broker and thus subject to registration with the SEC. The term dealer would not apply to banks trading for their own account, to banks buying or selling commercial paper and other exempted securities — such as general obligation municipal or government bonds — or to those acting in a fiduciary capacity.

The SEC, in consultation with the banking agencies, is required to prescribe rules governing the loaning of money or property by an affiliate to an SEC registered company. Banks that choose to engage in investment advisory activities must conduct these activities in a manner clearly separate from the bank’s core activities of lending and deposit taking. The new law also addresses the rift between the banking agencies and the SEC over loan loss provisions by instructing the SEC to consult and coordinate with the appropriate banking agency before taking action on the reserve level of a depository institution. (See Banking Legislation and Policy, January–March 1999, for information on the loan loss reserve dispute.)

Insurance. The act reaffirms the general ban on national banks’ acting as insurance underwriters. Products that were legally provided before January 1, 1999, would be exempt. By November 2000 the banking agencies would be required to prescribe measures that would prohibit tying the extension of credit to the purchase of an insurance product, would require banks to clearly inform customers that insurance products are not federally insured, and would require banks to sell insurance through state licensed agents, among other measures.

While reaffirming the rights of states to regulate insurance activities, the act prohibits states from imposing insurance regulations that treat affiliated insurance providers differently from unaffiliated providers.

If a majority of states do not adopt uniform and reciprocal laws and regulations addressing the licensing of insurance agents by 2003, the act then mandates the creation of a new organization, the National Association of Registered Agents and Brokers. Its purpose would be to craft nationwide standards for licensing insurance agents while remanding to the individual states the job of supervising and regulating insurers.

Unitary Thrift Holding Companies. The Home Owner’s Loan Act is amended to bar any new affiliations between commercial firms and savings associations. Specifically, no new unitary thrifts could be formed and commercial firms could not purchase existing unitary thrifts. Commercial firms that, as of May 4, 1999, either owned a savings association or had an application pending.
with the Office of Thrift Supervision would be grandfathered.

Privacy. All financial institutions are required to take reasonable precautions to protect the security and confidentiality of personal customer information. Subject to some exceptions, financial institutions are prohibited from sharing customer information with unaffiliated third parties, unless the consumer has been previously notified of the sharing policy and has been given an opportunity to opt-out—that is, to refuse to allow information to be shared. Such notification must be given at the outset of the customer relationship and annually thereafter. In addition, the law gives states the authority to impose more stringent privacy provisions.

The new law would also criminalize the act of obtaining confidential customer information from a financial institution by making false statements. Knowingly receiving information obtained in this manner is also prohibited.

Federal Home Loan Bank System Modernization. The new law gives any small insured depository institution the option of becoming a member of the Federal Home Loan Bank (FHLB) system without requiring it to satisfy the Qualified Thrift Lender test. Home Loan Banks can now provide funds to member banks to help them make small-business and farm loans in addition to residential housing loans. In addition, the act clarifies the election procedure for FHLB senior officers and compensation levels for FHLB board members, authorizes powers for the Federal Housing Finance Board, and makes other changes affecting the structure and organization of the FHLB system.

Community Reinvestment Act. The act would require public disclosure of agreements between community groups and financial institutions made to satisfy the institution’s CRA obligations. In addition, actual funds transferred to community groups by financial institutions must be disclosed.

Small banks, those with assets below $250 million, are granted relaxed examination schedules if they passed their previous examination. Small banks whose most recent examination rating was Outstanding or Satisfactory would be placed on a 60- or 48-month examination schedule, respectively.


This act explicitly permits a prior user of a business practice to invoke the “First Inventor Defense” in a suit for patent infringement. Under this defense, an individual is protected if he or she used the business practice at least one year prior to the filing of a patent by another.

This clause is of importance to the financial services industry in the wake of the federal circuit court’s opinion in State Street Bank & Trust Co. v. Signature Financial Group. In that July 1998 ruling, the court found that “business methods” — which would include financial products — could and should be protected by patents. The Supreme Court chose not to review the case. (See Banking Legislation and Policy, July-September 1998, for a summary of the State Street ruling.)

New Legislation

1. Credit Card Interest Rate Change Disclosure Act (H.R. 3117). Introduced by Representative Maloney (D-NY) on October 20, 1999.

Status: Referred to Committee on Banking and Financial Services.

This bill would amend the Truth-in-Lending Act by requiring credit card issuers to give 90 days' notice before changing the annual percentage rate of interest on transactions made with the card. For a card with a rate linked to an index, the issuer would need to give 90 days' notice before making a change to the index. Issuers would not be allowed to raise rates on consumers electing to cancel their cards. The repayment terms for outstanding balances would remain the same as those in effect before the cancellation.

2. College Student Credit Card Protection Act (H.R. 3142). Introduced by Representative Slaughter (D-NY) on October 25, 1999.

Status: Referred to the Committee on Banking and Financial Services.

This bill would amend the Truth-in-Lending Act by capping the lending limit on credit cards issued to traditional full-time college students, unless the student’s parent or guardian assumes joint liability for all incurred debts. The balance would be capped at the greater of $2000 or 20 percent of the student’s annual income in the immediately preceding calendar year. Creditors would not be allowed to issue cards to traditional full-time students who have no annual income and already possess a credit card.

In addition, the credit limit on cards guaranteed by the student’s parent or guardian could not be raised without the parent’s or guardian’s permission.


Status: Referred to the Committee on Banking and Financial Services.

This bill would amend the Electronic Fund Transfer Act to prohibit the owner of an electronic terminal from imposing a usage
fee on a consumer whose account is at another financial institution. This restriction would apply only to transactions on regional and national networks.


Status: Referred to the Committee on Banking, Housing, and Urban Affairs.

This bill would amend the Federal Credit Union Act by exempting loans made to nonprofit religious organizations from the definition of “member business loans.” This provision would allow credit unions to exempt loans made to nonprofit religious groups from the regulatory ceiling on business loans made by credit unions.


Status: Referred to the Committee on Banking and Financial Services.

This bill would amend the Federal Deposit Insurance Act and the Federal Home Loan Bank Act by requiring the Federal Deposit Insurance Corporation to transfer any funds in excess of 1.35 percent of estimated year-end insured deposits to the Federal Housing Finance Board’s Financing Corporation (FICO).

The funds transferred to the Financing Corporation would be used to help make interest payments on FICO bonds used to finance the savings and loan cleanup of the 1980s. The bill would make it necessary to exhaust these funds before further assessments to pay off the bonds could be imposed on insured depository institutions.


Status: Referred to the Committees on Banking and Financial Services; Commerce, Transportation and Infrastructure; and Agriculture.

This bill would require an operator of a web site or online service to specify, on the site, the type of personal information collected along with how the information is used. Visitors to the site or subscribers to the service must be provided with an opt-out opportunity as well as the right to view any personal information collected.

At the request of an individual, operators would be required to disclose the identity of any third parties that have received the individual’s personal information. The web site operator may terminate the contracts of individuals who do not consent to allow personal information to be collected. Web site operators could seek a ruling from the Federal Trade Commission to receive a safe harbor for its privacy policies.

The bill would permit exceptions to protect the integrity of the site, to protect the site operator from liability, and to provide information to law enforcement agencies. The bill also protects site operators from liability under more stringent state or local laws, but retains the right of states and individuals to take legal actions against operators.

In addition to the FTC, enforcement authority under this act would be granted, when appropriate, to the Office of the Comptroller of the Currency, Board of Governors, FDIC, OTS, NCUA, Secretary of Transportation, Secretary of Agriculture, and the Farm Credit Administration.


Status: Referred to the Committee on Banking, Housing, and Urban Affairs.

This bill would amend the Gramm-Leach-Bliley Act by adding several requirements on the handling and use of personal customer information by financial institutions. The bill imposes restrictions on the sharing of personal information by affiliates in a holding company. This would add a new dimension to the Gramm-Leach-Bliley Act, which does not restrict information sharing between affiliates.

Financial institutions would be barred from sharing personal information with affiliated or unaffiliated third parties unless the customer gives permission for the sharing of his or her information and the institution discloses: 1) the types of data collected; 2) its policies addressing the use of customer information, including the types of third parties with whom such information may be shared; and 3) the procedures available to the customer to review and dispute collected information.

Institutions would not be allowed to discontinue services to customers as a result of their decision to withhold permission to share information. These disclosures must be made at the time an account is opened and then at least annually afterwards.

Financial institutions would also be prohibited from providing account numbers to third parties for use in marketing. Third parties receiving customer information would be prohibited from the further dissemination of that information. Enforcement authority would be exercised, where appropriate, by the banking agencies, SEC, NCUA, Federal Housing Finance Board, and the insurance authorities of individual states.

Finally, the bill would maintain the current prohibition on providing false information to a financial institution to gain confidential customer information or knowingly receiving information gained in this manner.

Pending Legislation


Status: Referred to the Committee on Banking and Financial Services.
This bill would require hedge funds, which are presently unregulated, to send to the Board of Governors quarterly information disclosing their funds’ total assets, derivative positions, and their ratio of assets to liabilities. Funds would also be required to provide information measuring market risk, such as stress test results, and any other information that the Board may require. The disclosures would also be made available to the general public with the exception of proprietary information such as investment strategies.

The act defines a hedge fund as a pooled investment vehicle that has over $3 billion in capital, is privately organized and not widely available to the public, and is not registered as an investment company under the Investment Company Act of 1940.
Office of the Comptroller of the Currency

Bank Activities and Operations (11/4/99)
Issued a final rule that would update and codify a number of previous interpretive rulings. First, the rule clarifies that a bank-owned messenger service would be designated a branch of the bank unless the service can demonstrate a level of autonomy in its business decisions. In the case of an affiliated messenger service, it must prove that it actually serves the general public, including other unaffiliated depository institutions, to avoid being designated as a branch of the affiliated depository institution.

The rule would make it easier for small banks to attract directors by allowing stock buyback and repurchase agreements between shareholders and directors. Examples of legitimate purposes for banks to buy back their own stock are provided. These include holding shares in connection with an employee stock plan, holding shares for sale to potential directors, purchasing a director’s shares owing to resignation or death, purchasing shares to qualify as an S corporation, and reducing the number of shareholders to reduce communication and meeting costs.

The rule also clarifies that any national bank is permitted to engage in reverse stock splits as long as dissenting shareholders’ rights are protected and the reverse split serves a legitimate corporate purpose. The rule also provides examples of reasons for an OCC official to visit a bank, including examinations, inspecting books and records, regulating and supervising bank activities, and enforcing compliance with federal and state laws.

Last, the rule codifies the OCC’s position that ATMs, deposit production offices, loan production offices, other remote service units, or combinations of the four are not branches and therefore are not subject to state-imposed geographic restrictions. This rule became effective December 6, 1999. For further information, see 64 Federal Register, pp. 60092-100.

Public Welfare Investments (12/20/99)
Issued a final rule simplifying certification procedures governing national bank investments designed to promote the public welfare. The rule eliminates the requirement that national banks demonstrate the extent to which the public welfare investment benefits the community. The rule also eases the requirements for demonstrating that the investment has nonbank community support by allowing the receipt of federal low-income housing tax credits related to the project to be evidence of community support.

The final rule also expands self-certification authority to all eligible national banks regardless of the bank’s asset size. Currently, self-certification guidelines do not apply to investments in projects if more than 25 percent of the investment is used to fund projects located outside states or metropolitan areas where the bank has a presence. The new rule abolishes this local community investment requirement.

Finally, the new rule allows banks to self-certify investments in community development financial institutions. This rule became final on January 19, 2000. For further information, see 64 Federal Register, pp. 70986-91.

SUMMARY OF JUDICIAL DEVELOPMENTS

For more information on federal court cases, go to the Federal Judiciary Homepage.

On December 20, the Supreme Court of the State of Connecticut ruled that a state statute did not prohibit a bank from surcharging noncustomers who frequent the bank’s automated teller machine (ATM). The ruling, John P. Burke, Commissioner of Banking, et al. v. Fleet National Bank et al. (SC-16157), brings to a standstill attempts by the Connecticut Department of Banking to stop banks that do business in the state, including national banks, from imposing the surcharge.

The court’s ruling, while clearly a victory for the banks, still leaves unresolved the vexing question of whether the state possesses the authority to prohibit ATM surcharging by federally chartered institutions. The matter of law that the majority opinion addressed was whether Connecticut General Statute § 36a-156 prohibited banks from surcharging noncustomers. The court’s finding that the statute did not prohibit surcharging does not enjoin the legislature from passing legislation explicitly prohibiting the practice. In the court’s opinion, “If there is to be state regulation of ATM customer fees, that is a policy matter for determination by the legislature based on current economic and other relevant data.”

FleetBoston Financial Corp. and First Union Corp., the banks that challenged the ban, have both reinstated surcharging at their terminals in Connecticut. It remains unclear whether new state legislation specifically banning surcharging will be passed. Similar legislative efforts are being met with fierce opposition from affected banks in California. (See Recent Developments). FleetBoston and First Union would most likely mount a challenge to such a law.
New Jersey
On October 15, 1999, Governor Whitman signed into law A2393. The new law, Chapter 252, redefines automated teller machines as communication terminals, as opposed to their earlier designation as branches. The law permits a director’s required shareholdings to be valued at market and also permits directors to delegate to the bank president the authority to appoint officers, so long as the appointed position is neither chairman nor president. In addition, the law removes time limits formerly placed on a customer’s right to dispute a fraudulent withdrawal or to challenge a mistaken bank statement. Finally, the law allows state banks to insure land titles.

Pennsylvania
On December 16, Governor Ridge signed into law the Electronic Transactions Act (SB 555). The new law gives legal recognition to electronic signatures and the electronic delivery of information. All parties involved must agree to conduct the transaction electronically, and the receiver of any information transmitted electronically must be able to store or print the information. The law provides guidelines for parties’ responsibilities when data are changed during transmission. For example, if the parties to a contract agreed to use a security procedure to maintain the integrity of a transmission and one of the parties does not adhere to the procedure, the party in compliance would be able to avoid the resulting effect or harm arising from an undetected alteration in the data.

The law also addresses the treatment of electronic signatures by government agencies, security procedures related to the transmission of electronic signatures, and admissibility of the signature or record into evidence in a legal proceeding.