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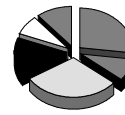
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# FOMC ALERT

AUGUST 24, 1999

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## BLUNDERBUSS OR RIFLE SHOT?

BY HENRY S. REUSS

On June 30, the Federal Reserve raised short-term interest rates for the first time in two years. In announcing its move, the central bank sounded cautionary notes about tight labor markets and “the emergence, or potential emergence, of inflationary forces.” It delicately refrained from mentioning one predictable effect of dampening growth: many of the young hard-core unemployed who have just found jobs in the Goldilocks economy will lose those jobs and go back to the streets.

Wall Street led the cheering for the statesmanship displayed by Chairman Greenspan:

*And still they gaz'd, and still  
the wonder grew  
That one small head could  
carry all he knew.*

As for the Clinton Administration, it contented itself with its usual, “we never comment on action by the Federal Reserve.” Most members of Congress remained silent, too. With fiscal policy – nominally the province of our elected leaders – effectively

hamstrung by congressional-administration gridlock, the central bank and its monetary policy remain pretty much the only game in town.

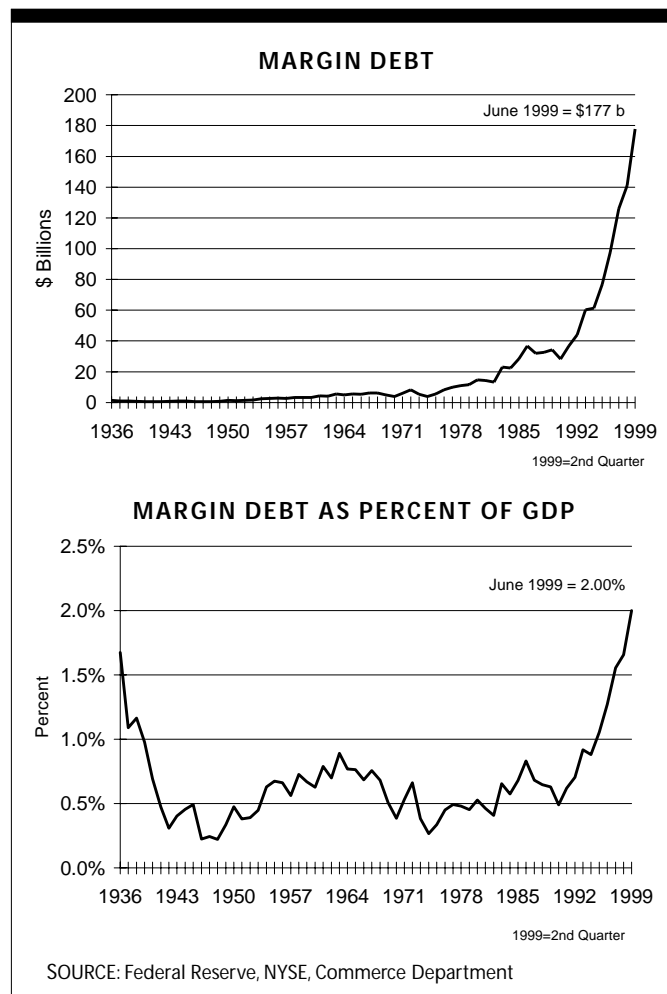
Still, there are a couple of questions that ought to be put to

Fed officials as they prepare for the August 24 Open Market Committee meeting. First, exactly where is the inflation in the domestic economy? Second, is there available a rifle shot for dealing with it that would make unnecessary the blunderbuss of higher interest rates across the board?

As to the first question, it should be plain that the type of inflation we are now experiencing is not commodity inflation, not services inflation, not wage inflation, but stock market inflation. Chairman Greenspan himself made this point back in December 1996. With the Dow hovering around 6000, he correctly called the market irrationally exuberant.

Since then, the Dow has nearly doubled, and stock prices have soared even further above their historic relationship to earnings. According

*(cont. on next page)*



## FOMC ALERT

*FOMC Alert* is published by the Financial Markets Center, an independent, nonprofit institute that provides research and education resources to grassroots groups, unions, policymakers and journalists interested in the Federal Reserve System and financial markets.

Through its work, the Center seeks to promote democratic values, accountable public institutions and improved living standards for ordinary citizens.

In addition to publishing the *Alert*, the Center produces periodic reports on issues in monetary policy and financial regulation. It also conducts educational workshops and conferences.

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## Blunderbuss or Rifle Shot *(cont.)*

to the Fed's own market valuation model, which examines corporate earnings in relation to ten-year bond yields, stocks were overvalued by a record 48 percent in July.

This financial asset inflation bodes ill for the economy and inevitably conjures up memories of 1929. One of the causes of that year's boom and bust was unregulated brokers' loans for stock speculation. Determined to prevent a replay, Congress enacted the Securities Exchange Act of 1934, empowering the Fed to control margin lending. The Fed promptly issued Regulation T to do just that.

As an Office of Price Administration lawyer assigned to monitor the Fed in 1941 (how time flies!), I saw Regulation T successfully administered. Again, in the 1950s and 1960s, Fed Chairman William McChesney Martin Jr. effectively raised the margin requirement to curb stock market speculation.

So the answer to the second question is: yes, there is a rifle-shot method to counter stock market inflation. It is known as Regulation T.

But since January 1974, Regulation T's margin requirement has been stuck at 50 percent. That's because the practices of William McChesney Martin and the lessons of 1929 have been displaced by a laissez-faire policy consensus that regards even the most modest, prudent regulatory action as unspeakably incorrect. (Martin, who developed his understanding of securities markets by presiding over the New York Stock Exchange before chairing the Fed, was responsible for fully 10 of the 22 margin rule adjustments in Federal Reserve history.)

Recently, brokers' loans have exploded, in large part due to the increase in day trading and hedge-fund activity. Specifically, margin debt has ballooned from \$97.4 billion

in December 1996, when Chairman Greenspan detected irrational exuberance, to \$177 billion in June 1999. The boom in stocks and the boom in margin lending have gone hand in hand.

Just how rapidly has margin borrowing expanded? According to the Financial Markets Center, margin debt has risen more than three times faster than household borrowing and overall credit market debt since 1993. During the same period, margin borrowing tripled in relation to gross domestic product; today it stands at the highest level relative to GDP in at least 63 years. Even though margin debt leveled off in June, it mushroomed by 13 percent in the second quarter of 1999 as a whole.

What the Fed should have done two years ago, and should do today, is modestly raise the margin requirement from the present 50 percent to, say, 60 percent, thus sending a signal that the Fed will no longer be pouring gasoline on the market's exuberance. Let us cool the speculation by firing a rifle shot at the real culprit, stock market speculation, rather than a blunderbuss volley at growth in general. If the Fed refuses to act, let the Administration end its "no comment" cop-out and let Congress provide the aggressive oversight our central bank deserves. ■

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*Henry Reuss represented the 5<sup>th</sup> District of Wisconsin in the House of Representatives from 1955 to 1983. During his chairmanship of the House Banking Committee (1975 to 1981), Congress enacted the most recent major reform of the Federal Reserve System, the Federal Reserve Reform Act of 1977. The University of Wisconsin Press recently published his memoir, When Government Was Good: Memories of a Life in Politics.*

# Margin Borrowing 101



Feeling lucky today? Here are a few basic facts to consider before plunging into a margin loan.

- Investors can open a *margin account* at their broker and borrow from the account to purchase stock. To open the account, investors must secure it with at least \$2,000 in cash or eligible securities from their investment portfolio.
- Under the Fed's *Regulation T*, investors may borrow up to 50 percent of the purchase price of stock when buying on margin. For example, an investor who wants to buy ten shares of a \$100 stock could put up of \$500 of his own money and borrow the remaining \$500 through his margin account. Buying stock on margin gives investors *leverage* and permits them to reap bigger gains than they would using only their own money if the stock price rises.
- Only *eligible stocks* may be purchased on margin. Both the Fed and the broker offering margin credit

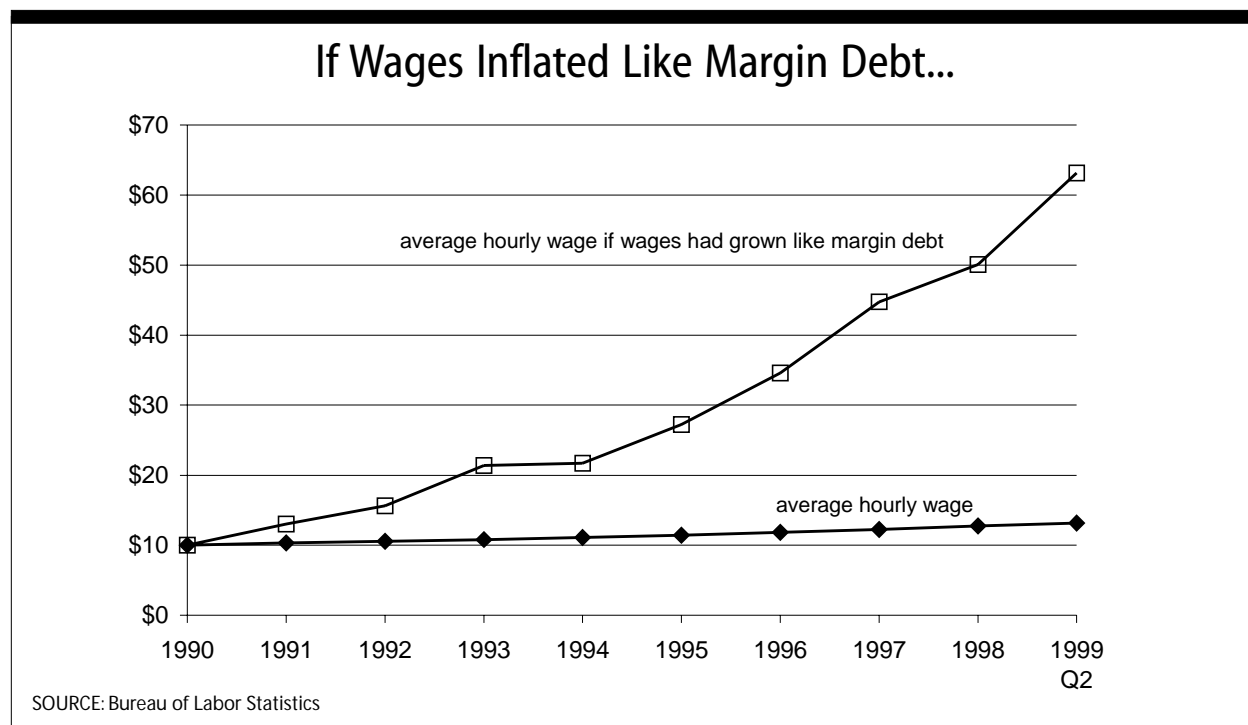
set the eligibility rules. In general, highly speculative or risky stocks cannot be margined.

- Borrowers must pay interest on a margin loan but don't have to repay it until they sell the margined stock. *Margin rates* generally range 1-2 percentage points above long-term fixed mortgage rates. Brokerages profit on the spread between the rate they charge customers and the rate they pay to borrow lendable funds in the credit markets.
- What's the risk? Just as leverage creates opportunities for bigger profits it also creates the possibility of bigger losses if prices drop for margined stocks. If the value of a margined portfolio falls appreciably, the borrower will face a *margin call*. The broker will tell the investor to deposit additional funds or stock in his account to make up the decline in the margin stocks' value.
- New York Stock Exchange firms issue margin calls whenever the value of a borrower's investment falls below

75 percent of its original value. If the investor can't meet the call, the brokerage firm can sell his stock to recoup its loan and unpaid interest. The investor eats the loss. Margin borrowing and margin rules are also features of some derivatives markets.

- When a lot of people pile up margin debt, the result can be *pyramiding and depyramiding*. Pyramiding occurs when stock used as collateral appreciates, allowing more borrowing and more stock purchases, which pumps up stock prices further. When prices start to fall, as they always do eventually, the value of the stock-collateral falls, lenders issue margin calls, and forced sales of stock contribute to plummeting prices.

For more information on margin borrowing and margin rules, visit the Center's web site at [www.fmcenter.org](http://www.fmcenter.org).



# The Case Against the Case Against Margin Requirements

As memories of the Great Crash of 1929 began to fade in the mid-1960s, conservative economists insisted with increasing certainty that margin requirements were ineffective, unnecessary, or even harmful. During the past two decades, the Board of Governors generally has embraced this view.

The argument against margin rules contains four major strands. First, say the neoclassicals, economic events and an improved understanding of economic behavior have mooted the concerns — notably worries about the displacement of credit from productive to speculative purposes —

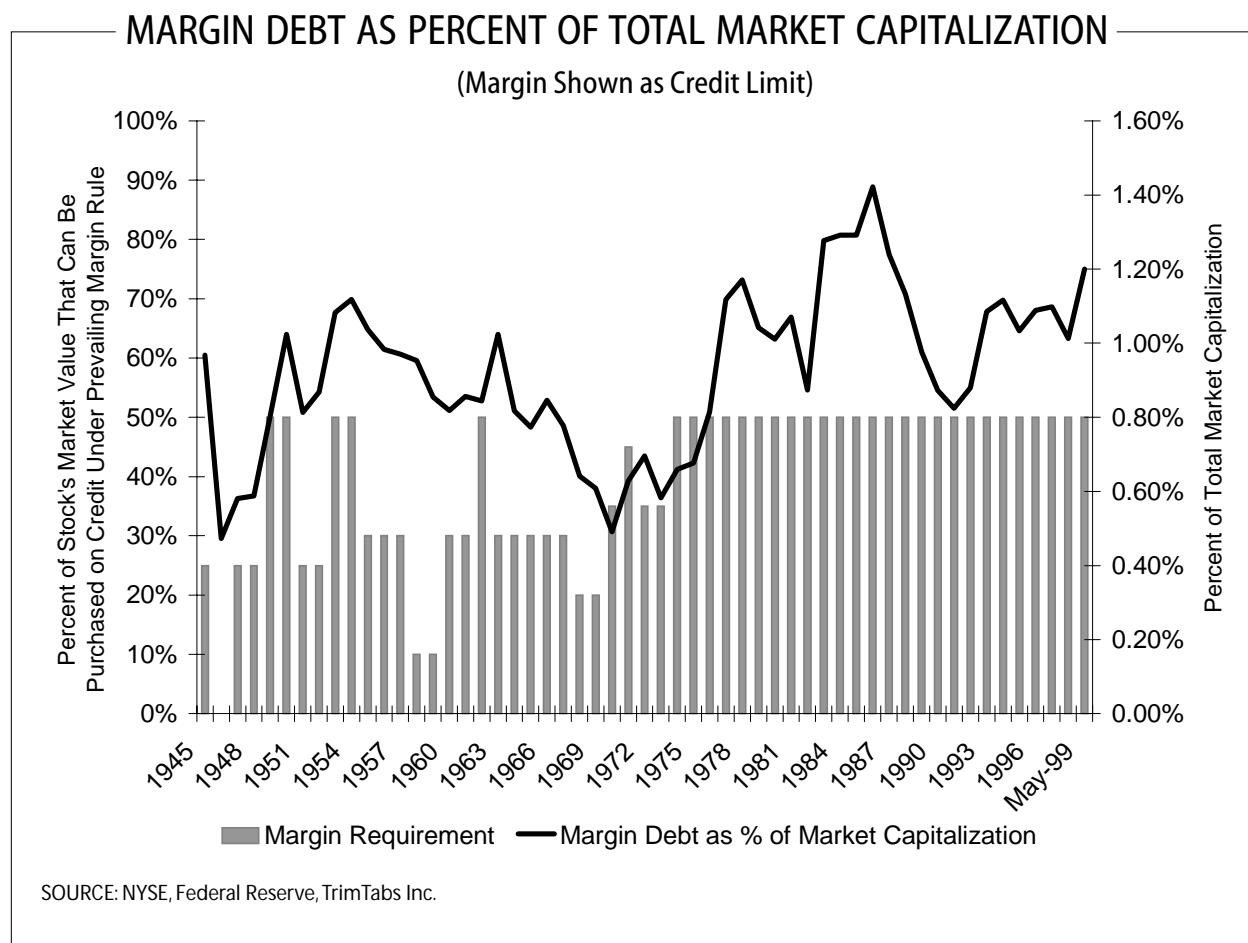
that led Congress to create the Fed's margin-setting authority.

Second, investors can readily evade margin rules by borrowing from other sources: even if Fed-mandated margin adjustments had an immediate impact on securities lending, the effect would be transitory. In any event, no statistical proof exists that margin requirements accomplish their goals, especially the goal of dampening market volatility. Third, the economics profession agrees that margin rules don't get the job done. Fourth, margin requirements represent a bygone paternalism that sought to protect investors from themselves but actually prevented markets from functioning efficiently.

To put it charitably, this argument is as solid as a South Sea bubble, beginning with its bait-and-switch premise.

Congress included margin-setting provisions in the Securities Exchange Act of 1934 primarily to prevent the kind of speculative build-up that might produce another crash. The Act instructs the Fed only to regulate "the use of excessive credit to finance transactions in securities." Credit diversion and investor protection were and always have been secondary, if related, considerations.

Ditto for ordinary market volatility. Some economists say margin rules come up short as



stabilizers when judged by volatility measures like the standard deviation of the S&P 500. But such measures are essentially beside the point. Again, the primary purpose of margin requirements is to prevent crashes, not to avoid routine stock price fluctuations, a point emphasized by a New York Stock Exchange (NYSE) panel that investigated concerns about volatility and investor confidence in 1990.

Since episodes of big-time volatility rarely occur, they can never yield the statistical justification demanded by critics of margin-setting's efficacy. But if the bar is set somewhere in the vicinity of common sense, margin adjustments appear eminently justified. Historically, when margin requirements went up, the volume of outstanding securities credit slowed or reversed. When they went down, margin debt rose. A simple graph using yearly data shows that margin adjustments have had sustained impacts on stock market capitalization.

Nonetheless, says a 1997 staff paper by Fed economist Paul Kupiec, "the majority in the finance profession appear to have abandoned the beliefs that underlie the original margin authority mandate." In fact, experts such as Gikas Hardouvelis, a commercial bank economist previously affiliated with the New York Fed, have generated a body of research that validates those beliefs. And Kupiec himself notes that both the SEC and the NYSE have endorsed margin rules as "a means to prevent and control market fluctuations and help stabilize the economy in general," to quote an official NYSE autopsy of the 1987 crash.

By contrast, the Fed has produced lengthy staff reports attacking margin rules and waged a turf war in reverse by proposing that capital-market officials take over the central bank's margin authority for broker-dealers. So why doesn't the Fed simply set margin requirements at zero and repeal Reg T through the kind of administrative initiative it has

## MARGIN RULE ADJUSTMENTS: 1934-1999

[Margin Requirement=Percent of Market Value for Stocks]

Date	Margin Requirement	Fed Chairman
October 1, 1934	25-45	
February 1, 1936	25-55	Marriner S. Eccles
April 1, 1936	55	Marriner S. Eccles
November 1, 1936	40	Marriner S. Eccles
February 5, 1945	50	Marriner S. Eccles
July 5, 1945	75	Marriner S. Eccles
January 21, 1946	100	Marriner S. Eccles
February 21, 1947	75	Marriner S. Eccles
March 3, 1949	50	Thomas McCabe
January 17, 1951	75	Thomas McCabe
February 20, 1953	50	William M. Martin
January 4, 1955	60	William M. Martin
April 23, 1955	70	William M. Martin
January 16, 1958	50	William M. Martin
August 5, 1958	70	William M. Martin
October 16, 1958	90	William M. Martin
July 28, 1960	70	William M. Martin
July 10, 1962	50	William M. Martin
November 6, 1963	70	William M. Martin
June 8, 1968	80	William M. Martin
May 6, 1970	65	Arthur F. Burns
December 6, 1971	55	Arthur F. Burns
November 24, 1972	65	Arthur F. Burns
January 3, 1974	50	Arthur F. Burns

## MARGIN RULE CHANGES BY DECADE: 1934-1999

Decade	Number of Margin Rule Adjustments	Average Adjustment [% Points]
1930-1939	3*	12.5
1940-1949	5	22.0
1950-1959	7	18.6
1960-1969	4	17.5
1970-1979	4	12.5
1980-1989	0	0
1990-1999	0	0

\* April 1, 1936 adjustment changed margin requirement from a range [25-55 percent] to a ceiling [55 percent] and is not included in the calculation of the decade's average adjustment

SOURCE: Federal Reserve System

used to shred Glass-Steagall Act restrictions on banks? The answer may lie in the Fed's studied ambivalence about markets and interventions.

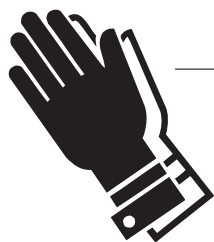
Despite his views on broker-dealer regulation, Alan Greenspan has insisted that the Fed retain its margin-setting authority for banks' securities

lending in order to preserve safety and soundness. And even the chairman at his most obfuscatory might have a hard time explaining why free-market principles prohibit margin adjustments to control asset inflation but justify interest rate adjustments to contain rising wages. ■

## GROWTH IN MARGIN DEBT, HOUSEHOLD DEBT AND DOMESTIC CREDIT MARKET DEBT: The Clinton-Greenspan Bubble

Year	Margin Debt [\$ Billion]	Annual Percentage Growth			Percentage Growth Since 1993		
		Margin Debt	Household Debt	U.S. Credit Market Debt	Margin Debt	Household Debt	U.S. Credit Market Debt
June 1999	176.9	19.8	n.a.	n.a.	193.4	n.a.	n.a.
March 1999	156.4	11.5	9.1	9.8	159.4	45.7	46.9
1998	141.0	11.8	8.6	9.6	133.8	43.5	43.4
1997	126.1	29.5	6.1	7.0	109.1	32.1	30.9
1996	97.4	27.0	6.8	7.2	61.5	24.5	22.3
1995	76.7	25.3	7.9	7.1	27.2	16.6	14.1
1994	61.2	1.5	8.1	6.5	1.5	8.1	6.5
1993	60.3	37.1	5.4	6.4			

SOURCE: NYSE, Federal Reserve



### THE MARGINAL CHORUS



**“ONCE UPON A TIME, WHEN FEDERAL Reserve chairmen were made of sterner stuff, they used margin requirements to curb irrational exuberance in Wall Street without inflicting undue damage on the real**

economy. Between the end of World War II and January 1974, margin was boosted 10 times (and lowered nine). However, since the great bear market of 1974, no Fed chairman has ever screwed up enough courage to raise margins, a craven tradition stalwartly upheld by Mr. Greenspan.

But then, Fed chairmen in the old days did not number among their solemn obligations, as does the present occupant of that powerful post, the need to be Wall Street's, the economy's and, indeed, the world's, best friend.”

— ALAN ABELSON, “UP & DOWN WALL STREET: NO MARGIN FOR ERROR,” *BARRON'S*, MAY 31, 1999

**“IN THE ACCEPTED HISTORY OF THESE TIMES, THE FEDERAL Reserve authorities are held to be not so much unaware or unwilling as impotent. They would have liked to stop the boom, but they lacked the means. In fact, the Federal**

Reserve was helpless only because it wanted to be. Had it been determined to do something, it could for example have asked Congress for authority to halt trading on margin by granting the Board the power to set margin requirements. Margins were not low in 1929; a residue of caution had caused most brokers to require customers to put up 45 to 50 percent of the value of the stock they were buying in cash. However, this was all the cash numerous of the customers had. An increase in margins to, say, 75 percent in January 1929, or even a serious proposal to do so, would have caused many small speculators and quite a few big ones to sell.

“Between the end of 1928 and the end of July 1929, a period when the popular folklore has Americans rushing like lemmings to participate in the market, the number of margin accounts on all of the exchanges of the country increased by only slightly more than fifty thousand. The striking thing about the stock market speculation of 1929 was not the massiveness of the participation. Rather it was the way it became central to the culture.”

— JOHN KENNETH GALBRAITH, *THE GREAT CRASH: 1929*

# The Dilemma

If Alan Greenspan declines to raise interest rates on August 24 in the face of tight labor markets and knee-jerk inflation fears, he'll be celebrated in many quarters as a fearlessly flexible seer headed for the central bank hall of fame.

If a new Federal Reserve governor with a master's degree in social work and a career in community development lending made the same decision, she'd likely be judged a bleeding heart pandering to Democratic interest groups.

Crudely put, that's the core dilemma facing Carol Parry, the 58-year old banker President Clinton nominated to the Board of Governors on August 5. For the past 20 years, Parry has worked at Chase Manhattan Bank and its predecessor institutions. Since Chase's 1996 merger with Chemical Bank, she has headed up its Community Development Group, which coordinates the bank's lending activities in poor and working-class communities. Parry is the first non-economist to be appointed to the Board since President Reagan nominated Governor Edward Kelley in 1987. She's the first appointee ever to be identified with the Community Reinvestment Act (CRA), a 1977 law that promotes bank lending in have-not communities.

The same qualities that attracted the CRA-friendly White House to Parry will paint a target on her at Senate confirmation hearing and at the Board if she is confirmed. Texas Senator Phil Gramm has made criticism of CRA a centerpiece of his Banking Committee chairmanship, inserting provisions in financial modernization legislation that would weaken the Act and conducting a far-ranging investigation of CRA activities by banks and grassroots groups. So far, Gramm hasn't commented publicly about Parry's nomination.

If Parry gets through the confirmation wringer, she may look back on the experience fondly from her office at the Fed. As former Vice Chairman Alan Blinder can attest, influential factions at the Board remain deeply inhospitable to woolly-minded concepts like maximum employment or fair lending. Female governors come in for a double dose of suspicion, regardless of their credentials.

"She was sounding the alarm about unemployment in a way that irritates people," a senior Board officer recalled of Governor Nancy Teeters in *Secrets of the Temple*. "Of course [the other FOMC members] were humane and they were concerned about unemployment, but they didn't need anyone lecturing them on that. It was her tone, her mode of argument."

Parry's views on monetary policy are unknown and deserve to be examined closely by the Senate. In all likelihood she will feel powerful pressure to compensate for the supposed "softness" of her community reinvestment experience by out-hawking the Board's inflation-phobes on

monetary policy issues. If she succumbs to these pressures, she wouldn't be the first – and her governorship would form an ironic mirror image of Martha Seger's, a

Republican economist and bank regulator who was the only woman Ronald Reagan appointed to the Board.

Seger's charmless manner and diffidence about CRA consistently riled reinvestment advocates – and, naturally, led to her selection as the Board's point person on consumer and community affairs. But unknown or unappreciated by many community activists, Seger was also the Board's most outspoken proponent of people-friendly monetary policy.

FOMC transcripts reveal that, like Nancy Teeters, Seger was both wonderfully unafraid to challenge the hawkish views of her colleagues and woefully ineffective in winning allies. Nevertheless, Seger effectively earned the space to be "soft" on interest rate policy by being "hard" on community reinvestment.

If Parry feels tempted to make the same trade-off in reverse, the Clinton Administration must shoulder part of the blame. In seven years it has never criticized the Fed or even advanced a compelling public case for linking the goals of financial regulation to boat-lifting macropolicy. Instead of opening up space for greater Fed accountability to the public, it has meekly acquiesced to the idea that central banks and financial markets ought to make society's governing choices. (In the venial sin department, Clinton continues to copy his immediate predecessors by ignoring the legal requirement that each governor must represent a different section of the country. Despite having spent most of her adult life in New York, Parry will be chosen to "represent" another region since the Fed's Second District is Greenspan territory.)

Parry also represents a moment of reckoning for the hundreds of grassroots groups that make up the community reinvestment movement. Those that have dealt with Parry at Chase give her mixed reviews. Naturally, reinvestment advocates and practitioners will be watching intently to see if she champions CRA effectively at the Board. But they ought to monitor her views on interest rates just as closely.

The expansion of the 1990s confirms that growth-oriented monetary policy alone can't substitute for targeted investments of public and financial capital in America's poorest communities. However, the expansion also shows

(cont. on page 11)



# Modernization and Its Discontents

BY MARY JO PARRINO AND PAUL REED

For the first time ever, the House and Senate have both passed versions of Glass-Steagall repeal legislation in the same Congressional session. And they've done it early enough to give repeal's proponents a real chance of victory after 20 years of trying.

Even though they're known as financial modernization measures, neither bill passed by Congress gives sufficiently careful consideration to the powerful impacts of financial regulation on our economy. Instead, the bills simply allow the law to momentarily catch up with the marketplace while providing financial firms general and parochial opportunities to expand their business — all within the same basic regulatory framework that has existed since the 1930s.

Still, as in all previous financial modernization efforts, substantial differences persist between legislators, regulators, industry factions and citizen groups. When Congress returns from its August recess, conference committee members attempting to reconcile the House and Senate bills will be paying consider-

able attention to six key issues: functional regulation, operating subsidiaries, umbrella regulation, unitary thrifts, community reinvestment and privacy concerns.

## Functional Regulation and Investor Protection

The repeal of Glass-Steagall provisions separating commercial banking from investment banking forms the heart of financial modernization. However, the House and Senate both crafted repeal to produce the fewest possible changes in the current activities of financial companies and the way they are regulated. By failing to restructure the regulatory framework in a comprehensive or forward-looking manner, this approach almost surely dooms financial regulators to a continued game of catch-up with the industry.

The House bill (H.R. 10) and the Senate bill (S. 900) contain similar provisions allowing commercial banks, securities firms and insurance companies to enter one another's product markets more fully. Regulation of these activities is supposed to

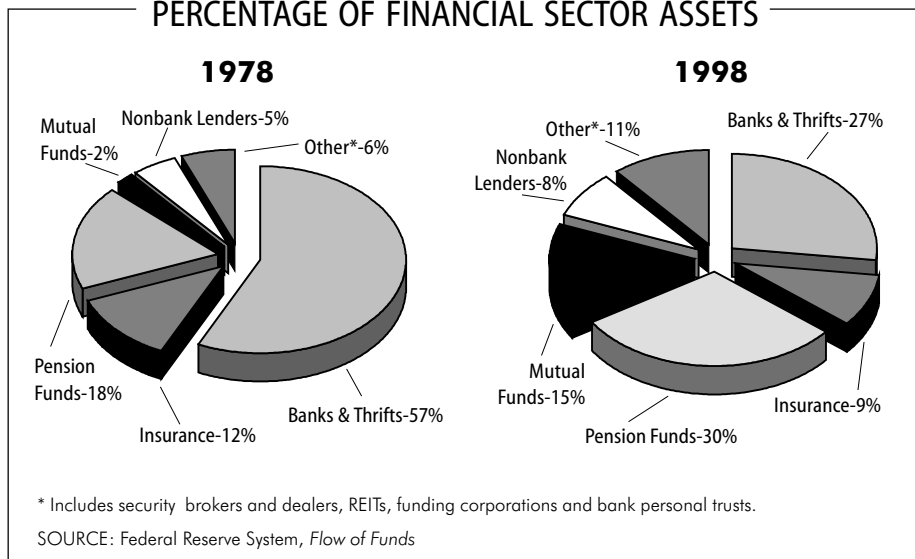
take place on a "functional" basis, meaning that bank, securities and insurance supervisors would continue to oversee their industries' traditional products regardless of the type of firm offering them.

In the name of functional regulation, the bills eliminate banks' existing exemptions from the securities laws. But they do in a highly selective fashion that may increase consumer risk — and that clearly illustrates the problem of superimposing old functional categories of regulation onto new hybrid financial firms. Under the new legislation, a bank intending to do straightforward brokerage or underwriting would have to register with the Securities and Exchange Commission (SEC) as a broker or dealer. But other banks could take advantage of eleven different exceptions that allow them to conduct various types of securities activities and remain exempt from the securities laws. Investors who buy a product from any bank relying on these exemptions would not receive the laws' protection. And many of the eleven exceptions contain layers of additional exemptions.

Some of these exceptions are available to banks that sell complex investment products to a "qualified investor." Among more than a dozen types of investors listed in this category, the bills include state-sponsored employee benefit plans, ERISA (Employee Retirement Income Security Act) pension plans and governments and political subdivisions that invest at least \$50 million.

Thus, under H.R. 10, a bank could sell, outside the scope of the securities laws, loan participations, private placements or asset-backed securities to a bevy of small pension plans, county governments and other customers that lack the resources to afford sophisticated investment

## PERCENTAGE OF FINANCIAL SECTOR ASSETS



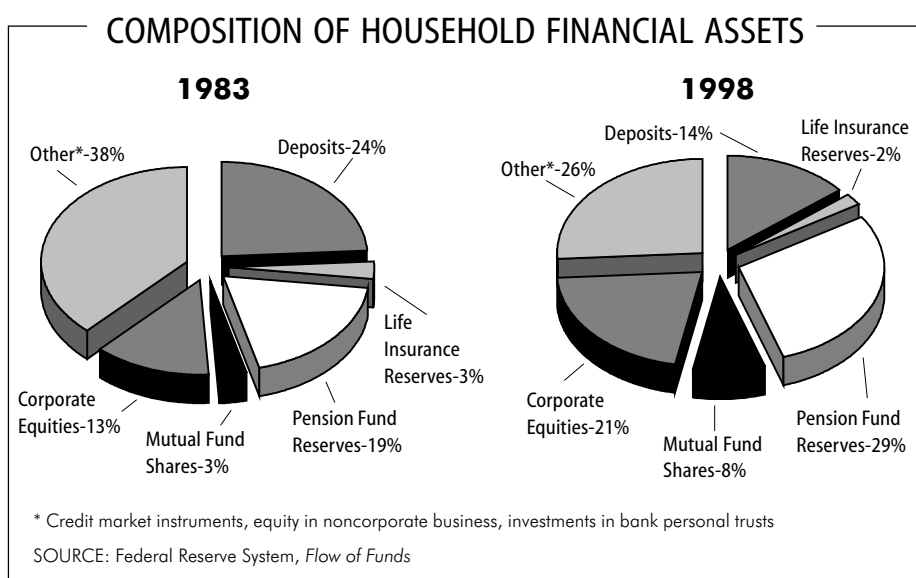
advice. S. 900 contains similar provisions but is silent on the subject of qualified investors for the private placement exemption – which means that banks could sell private placements to anyone, without safeguards, under the Senate bill.

To its credit, the House bill does subject banks to coverage by the Investment Company Act and the Investment Advisers Act. For example, H.R. 10 requires any bank advising a mutual fund to register with the SEC as an adviser. The bill also enhances mutual fund disclosures to consumers as well as strengthening the independence of mutual fund directors. In addition, H.R. 10 requires advisers to transfer their voting power when they hold voting control of an investment fund they advise.

These improvements to the Investment Company Act and the Investment Advisers Act are widely viewed as uncontroversial and were included in previous Glass-Steagall repeal measures voted out of the House Banking and Commerce Committees. Under the chairmanship of former Senator Alfonse D’Amato, the Senate Banking Committee included similar provisions in a financial modernization bill it approved last year. But S. 900 contains none of these measures.

### Operating Subsidiaries vs. Holding Companies

The issue of operating subsidiaries (called “financial subsidiaries” in both bills) is the biggest bone of contention between the Treasury Department, which represents the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board. The OCC regulates federally chartered banks while the Fed regulates bank holding companies and most banks without a national charter. Each agency wants the power to define and regulate banks’ nontraditional business lines, which have burgeoned in recent years as the OCC began allowing op subs to underwrite municipal bonds and conduct other



activities forbidden to banks and their affiliates.

In the Senate bill, the Fed wins the tug of war. In the House bill, it ends in a draw. S. 900 would stop the OCC from allowing banks to establish new nonbanking lines of business in an op sub, but would grandfather the existing activities. Instead of employing op subs, larger banks would have to conduct their securities, insurance or other nonbanking activities through holding company affiliates. S. 900 also authorizes small national banks to offer nonbank financial products through an op sub if they don’t operate within a holding company structure. In either case, the Fed would control the types of permissible activity; real estate development or investment would be flatly prohibited.

H.R. 10 contains a compromise that would allow op subs of national banks to conduct all types of financial activities, except real estate development, real estate investment or insurance underwriting. However, large (more than \$10 billion in assets) banks taking advantage of this opening would have to fit their op sub activities into a bank holding company structure, thus ensuring Fed oversight at the parent holding company level. In addition, the Fed would have sole authority over merchant banking activities conducted by an op sub.

Under H.R. 10, Treasury and the Fed would share the power to determine whether new activities fall under the rubric of “financial” and therefore are permissible. Treasury would take the lead in making this determination for op subs. If the Fed objected in writing, Treasury could not approve the new undertaking. On the other hand, if the Fed recommended approval of new activities for an op sub, Treasury would have to use the public rulemaking process to approve the request or provide the Fed with a written explanation of its denial. In essence, the two bank regulators would have an unwieldy veto over each other’s ability to approve new financial activities for banking firms.

### Umbrella Regulator

As a complement to functional regulation, both bills reinforce the Fed’s responsibility for supervising the overall activity taking place within multifunctional financial firms. In keeping with their remodel-don’t-rebuild theme, H.R. 10 and S. 900 ground the Fed’s power of umbrella supervision in the existing Bank Holding Company Act (BHCA).

Under the two bills, a bank holding company that bought a securities firm would do so within the structure and rules of the BHCA, but

# Modernization and Its Discontents *(cont.)*

with a new name — “financial holding company.” A securities firm that bought a bank also would become a financial holding company, also subject to the structure and rules of the BHCA. The “wholesale financial holding company” — a new type of special-purpose institution established by H.R. 10 — also would operate under the BHCA.

Both pieces of legislation would give the Fed additional authority to perform the tasks of umbrella regulation. The Fed could take any action against a financial holding company or a regulated subsidiary to prevent unsound practices or breaches of fiduciary duty if they posed a material risk to the bank affiliate or the payments system. Also, the Fed could order divestiture of a bank if functional regulators prohibited the institution’s holding company or a nonbank affiliate from infusing funds into the bank upon the Fed’s request. Finally, the central bank would have broad discretion to require reports and examinations for financial holding company subsidiaries.

## Unitary Thrifts

Just as administrative initiatives by the Fed and OCC have helped breach Glass-Steagall restrictions on banking activity, creative corporate strategists have used various means to circumvent the older wall separating banking and commerce. In recent years, the unitary thrift holding company (UTHC) charter has become the vehicle of choice. Both H.R. 10 and S. 900 would end the ride.

The UTHC charter enables commercial companies to enter the banking business by acquiring or establishing a single thrift institution that satisfies a required asset composition test. Since 1997, more than 75 nonbank companies have applied for UTHC charters and nearly two dozen commercial firms have received them. But ironically, the spread of UTHC strategies seems to have eroded political support for formally allowing banking to mix with commerce.

Unlike prior years, the current financial modernization bills do not include any major provisions that would further weaken the banking-

commerce separation. To eliminate the primary method of avoiding this separation, H.R. 10 and S. 900 would permit thrift acquisitions only by entities engaged in banking, securities, insurance or other financial activities. Both bills would preserve the existing thrift charter along with the current regulatory framework for thrifts and their holding companies.

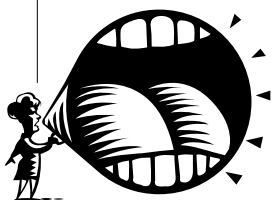
Existing commercial UTHCs would be grandfathered by both bills, but with different restrictions. Under H.R. 10, the cut-off for grandfather status would be March 4, 1999. Under S. 900, May 4, 1999 is the deadline. Both versions would pull the plug on Wal-Mart’s June application to buy an Oklahoma thrift. H.R. 10 also would allow grandfathered UTHCs to engage in new commercial activities and would permit the sale of such thrifts to other commercial entities, with regulatory approval. S. 900 would prohibit the transfer of grandfathered UTHCs to commercial entities.

## Community Reinvestment Act

The Senate bill would make two significant changes to the Community Reinvestment Act (CRA). First, it would provide a safe harbor to any bank that had received a CRA rating of “satisfactory” or better for three years prior to requesting regulatory approval for a merger, product expansion or other activity. Second, S. 900 would exempt from CRA small (less than \$100 million in assets) banks that operate outside metropolitan areas. In addition, S. 900 would require banks and community development groups to file reports with regulators on loans, investments and grants made in connection with CRA compliance programs.

The safe harbor provision would create substantial barriers to challeng-

## Call for Papers: The Henry B. Gonzalez Award



The Financial Markets Center sponsors an annual contest for papers on the subject of “Reengineering the Federal Reserve System.” The winning entry receives the Henry B. Gonzalez Award - \$2,500 and publication by the Center.

The Award seeks to promote institutional reforms that make the central bank more open, accountable and effective. Entries may be sweeping in scope or focused on a specific aspect of the Fed’s structure, governance, operations, staffing, culture or statutory authority. The award honors the service of Representative Henry B. Gonzalez, a tireless champion of democratic change at the Federal Reserve.

The contest is open to students in graduate and post-graduate programs in law, public policy, public administration, government, finance, economics and other relevant areas. Deadline for entries: April 28, 2000. For details on the contest, check out the Center’s web site ([www.fmcenter.org](http://www.fmcenter.org)) or contact the Center at (540) 338-5286 or [info@fmcenter.org](mailto:info@fmcenter.org).

ing a bank's performance. Less than two percent of all depository institutions receive less than "satisfactory" CRA evaluations. Yet once a bank is safely harbored, community organizations or other protestants seeking to challenge its status would have to file "substantial verifiable" information with the institution's regulator showing noncompliance since its last examination.

According to reinvestment advocates, S. 900's small-bank exemption would remove more than 3800 institutions from CRA coverage — approximately 70 percent of all rural banks in the U.S. Many of these institutions focus entirely on community lending by virtue of their size and location. But all the banks exempted by the S. 900 provision already benefit from a streamlined, less costly CRA examination instituted for small banks in the mid-1990s.

By contrast, the House bill contains a handful of provisions that would modestly enhance CRA. H.R. 10 applies CRA to wholesale financial institutions and requires banks to maintain at least a "satisfactory" CRA rating before their parent companies can affiliate with insurers or securities firms. The House version also encourages bank regulators to conduct public hearings on large bank mergers that likely will have substantial impact on their service areas.

## Privacy

Consumer privacy, a non-issue in previous financial modernization debates, has become a tipping point for the current legislation. Both bills would prohibit persons from fraudulently obtaining or disclosing consumer data held by a financial institution. S. 900 would do little else to protect consumers' privacy but H.R. 10 goes further.

The House bill provides some safeguards against financial institutions sharing nonpublic personal information about their customers

with third parties. H.R. 10 also requires companies that underwrite annuities or insurance contracts to protect the confidentiality of consumers' health, medical and genetic data. However, important exceptions would apply to both measures. For example, a financial firm would be permitted to share a consumer's information with third parties that provide services for the institution if the third parties keep the information confidential.

## Legislative Outlook

The chances for Glass-Steagall repeal being enacted into law may be slowly melting as summer slides by. In setting up their conference committee, the two Banking Committee chairmen, Senator Phil Gramm (R-TX) and Representative Jim Leach (R-IA) clashed over who would chair the committee, who would sit on the committee, what bill number would be used and what base text would be the starting point. They haven't begun negotiating about substantive differences and the possibility of a White House veto over CRA or regulatory turf issues remains real. Still Glass-Steagall repeal has advanced further and faster than in any previous Congress. Citizens concerned about the safety and responsiveness of their financial system should be watching carefully and weighing in freely. ■

## The Dilemma (cont.)

that the Fed has become America's single most important social policy institution for wage earners and business owners between the bottom 10 percent and top 30 percent of the income distribution. Mildly accommodative interest rates have helped produce tight labor markets that substantially benefit people on the bottom rungs of the job ladder in inner cities and rural areas — something even the largest community

### FOR MORE INFORMATION ON GLASS-STEAGALL REPEAL, CHECK OUT THESE WEB RESOURCES

[www.csbs.org](http://www.csbs.org)  
Conference of State Bank Supervisors

[www.nasaa.org](http://www.nasaa.org)  
North American Securities Administrators Association

[www.consumersunion.org](http://www.consumersunion.org)  
Consumers Union

[www.ibaa.org](http://www.ibaa.org)  
Independent Community Bankers of America

[www.ncrc.org](http://www.ncrc.org)  
National Community Reinvestment Coalition

[www.sia.com](http://www.sia.com)  
Securities Industry Association

[www.innercitypress.org](http://www.innercitypress.org)  
Inner City Press/Community on the Move

[www.commchange.org](http://www.commchange.org)  
Center for Community Change

[www.fmcenter.org](http://www.fmcenter.org)  
Financial Markets Center

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investment initiatives cannot accomplish on their own.

During the course of several decades, community activists gradually let macropolicy slide off their agenda as they pragmatically focused on finance, development and organizing strategies in their backyard. Parry's nomination gives those activists one more reason to start reconnecting the dots. ■

# Tool Kit: Reserve Bank Boards

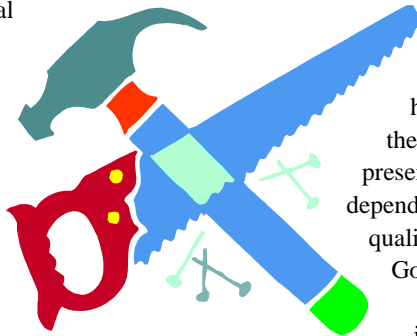
What do NBA general manager Wayne Embry, financier Peter Peterson and Sears CEO Arthur Martinez have in common? They all sit on the boards of directors of regional Federal Reserve Banks (Cleveland, New York and Chicago, respectively). What do the leaders of grassroots organizations have in common? Hardly any of them sit on the Reserve Banks' boards, despite a legal requirement providing for labor and consumer representation.

As fall approaches, the Fed will begin selecting a new crop of Reserve Bank directors for 2000. Every year, two seats open up at each regional bank board for directors representing the general public. The Fed's Board of Governors appoints one of those directors. Member banks in the district elect the other. Under the law, public directors are supposed to be chosen "with due, but not exclusive consideration to the interests of agriculture, commerce, industry, services, labor and consumers." Among their duties, directors approve Reserve Bank budgets, vote biweekly on the Fed's

discount rate and appoint Reserve Bank presidents, subject to Board of Governors approval.

For many years, the Fed simply excluded labor and consumer representatives from the Reserve Bank boards. More recently, the Fed has appointed a few representatives of these interests but they remain a minority presence at best. Building a larger presence depends in large measure on citizens proposing qualified director candidates to the Board of Governors and regional Reserve Banks.

Individuals and groups interested in suggesting candidates can obtain a tool kit from the Center that explains the selection process, the duties of directors and the composition of Reserve Bank boards. Portions of the kit are available at the *Tools* section of the Center's web site ([www.fmcenter.org](http://www.fmcenter.org)); the entire kit is available free of charge by contacting the Center at [info@fmcenter.org](mailto:info@fmcenter.org) or PO Box 334, Philomont, VA 20131. In response to a request from the Center, the IRS has ruled that 501[c]3 organizations may promote director candidates without violating their tax exempt status.



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